Commercial Bank Examination Manual

Division of Banking Supervision and Regulation

Commercial Bank Examination Manual

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Commercial Bank Examination Manual
Supplement 20—December 2003

This supplement corrects two pages in the new ''Insurance Sales Activities and Consumer Protection in Sales of Insurance'' sections that were added to the manual in supplement 19 (November 2003). In section 4043.1, the list of short-form insurance disclosures should appear in all capital letters. In section 4043.3, examination procedure number 7 under ''Consumer Protection in Sales of Insurance Regulation'' has been revised.

FILING INSTRUCTIONS

Remove	*Insert*
4043.1, pages 11 and 12	4043.1, pages 11 and 12
4043.3, pages 3 and 4	4043.3, pages 3 and 4

Commercial Bank Examination Manual
Supplement 19—November 2003

This supplement reflects changes since the publication of the May 2003 supplement.

LIST OF CHANGES

Section number	*Description of the change*
1010.1	This revised section on the internal control and audit function, oversight, and outsourcing incorporates the May 5, 2003, Statement on Application of Recent Corporate Governance Initiatives to Nonpublic Banking Organizations issued by the Federal Reserve, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision. The interagency statement responds to questions the agencies received regarding how small, nonpublic banking organizations are to comply with the corporate-governance, auditing, and other requirements of the Sarbanes-Oxley Act. Although the act does not require small, nonpublic banking organizations to strictly adhere to its provisions, the agencies expect these banking organizations to ensure that their policies and procedures are consistent with applicable law, regulations, and supervisory guidance and that they remain appropriate for the organizations' size, complexity, risks, and resources. The revision also briefly discusses guidance issued by the Securities and Exchange Commission (SEC) on the independence of external auditors for public institutions. (See SR-03-08.)
4020.1, 4020.3, 4020.4	These revised sections on asset/liability management incorporate the July 25, 2003, Interagency Advisory on the Use of the Federal Reserve's Primary Credit Program in Effective Liquidity Management. The interagency advisory presents information on the new Federal Reserve primary and secondary credit programs. The advisory provides guidance on the appropriate use of primary credit in effective liquidity management. The board of directors and senior management of a depository institution are advised to consider the Federal Reserve's primary credit program as part of their contingency funding plans and to provide for adequate diversified potential sources of funds to satisfy liquidity needs, which includes planning for certain significant liquidity events. (See SR-03-15.) The examination procedures and internal control questionnaire are also revised.
4043.1, 4043.2, 4043.3, 4043.4	These new sections provide examination guidance on insurance and annuity sales activities and consumer protection in sales of insurance. Guidance is provided to examiners for (1) conducting risk assessments of state member bank insurance and annuity sales activities in accordance with the Federal Reserve's risk-focused supervisory approach and (2) examining a state member bank's compliance with the new Consumer Protection in Sales of Insurance (CPSI) regulation, subpart H of the Board's Regulation H (12 CFR 208.81–86). The CPSI regulation (effective October 1, 2001) implements section 305 of the Gramm-Leach-Bliley Act (12 USC 1831x) (the GLB Act). The guidance provides a comprehensive review of insurance and annuity sales activities as they pertain to state member banks and discusses the Federal Reserve's responsibility for enforcing a depository institution's compliance with the CPSI regulation. Consistent with the GLB Act, the guidance incorporates applicable restrictions on examining a functionally regulated insurance subsidiary of a state member bank.

Section number	*Description of the change*
	The CPSI regulation requires certain disclosures in connection with the retail sale or solicitation of insurance products and annuities by a bank, by any other person at bank offices where retail deposits are accepted from the public, or by any person ‘‘acting on behalf of the bank.’’ Appendix A discusses the August 17, 2001, joint interpretations of the CPSI regulation (the issues raised and the banking agencies’ responses) that were issued by the federal banking agencies. The appendix also includes a summary of the February 28, 2003, joint statement in which the agencies responded to a request to clarify whether the disclosure requirements apply to renewals of pre-existing insurance policies sold before October 1, 2001. Appendix B is a glossary of terms associated with insurance and annuity sales activities. Examination objectives, examination procedures, and an internal control questionnaire are also provided.
4050.1, 4050.3	The section on bank-related organizations is revised to incorporate the examples found in Regulation W for the rule’s quantitative limits, collateral requirements, valuations, exemptions, and timing of covered transactions. Additional interim examination procedures for Regulation W are included; these new procedures are based on the expected examination procedures discussed in the rule’s preamble, procedures found in examination modules, and other examiner and staff guidance.
4200.1	The introduction to the fiduciary activities section has been revised to provide more examination guidance on the industry standards and examiner responsibilities. For a state member bank’s subsidiary that is engaged in fiduciary activities, the examiner should rely on the findings of the appropriate functional regulator that has the primary supervisory responsibility for evaluating risks, hedging, and risk management. (See SR-00-13.) The revision includes a discussion of the available reported supervisory information and analytical support tools that an examiner can use to evaluate a bank’s fiduciary activities.
5040.1	This revised section on formal and informal corrective actions discusses the existing restrictions on, and requirements for, severance payments made to institution-affiliated parties (so-called golden parachute payments). The restrictions originated from the Crime Control Act of 1990, which added section 18(k) to the Federal Deposit Insurance Act (12 USC 1828(k)) (the FDI Act). The FDIC’s regulations on golden parachute agreements, found in 12 CFR 359, are discussed. The 30-day prior-notice requirement for appointing any new directors or senior executive officers of state member banks and bank holding companies is also discussed. (See section 32 of the FDI Act (12 USC 1831i) and subpart H of Regulation Y (12 CFR 225.71.) This notice requirement also applies to any change in the responsibilities of any current senior executive officer who proposes to assume a different position. (See SR-03-06.)

Section number	*Description of the change*
2080.3, 2090.1, 2110.3, 2160.3, 3000.1, 5000.3, 7030.3, 7050.3	These sections update references to, and include certain provisions of, sections 23A (Relations with Affiliates) and 23B (Restrictions on Transactions with Affiliates) of the Federal Reserve Act, Regulation W (Transactions Between Member Banks and Their Affiliates), Regulation CC (Availability of Funds and Collection of Checks), Regulation L (Management Official Interlocks), Regulation O (Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks), and other statutes or regulations.

FILING INSTRUCTIONS

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Table of Contents, pages 1–2	Table of Contents, pages 1–2
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Commercial Bank Examination Manual
Supplement 18—May 2003

This supplement reflects changes since the publication of the November 2002 supplement.

LIST OF CHANGES

Section number	*Description of the change*
1010.1, 1010.2, 1010.3, 1010.4	The internal control section was revised to incorporate the Interagency Policy Statement on the Internal Audit Function and Its Outsourcing, issued by the federal banking and thrift regulatory agencies on March 17, 2003. The section is now titled ''Internal Control and Audit Function, Oversight, and Outsourcing'' to reflect its broadened scope. The 2003 policy statement supersedes a 1997 interagency policy statement on internal auditing. The new policy conveys recent developments in internal auditing and addresses supervisory concerns, policies, practices, and procedures about the internal audit function and its outsourcing. Supervisory guidance is also provided on the independence of accountants, especially those who provide both internal and external audit services to institutions. Provisions of the 2002 Sarbanes-Oxley Act and associated Securities and Exchange Commission (SEC) rules are also addressed in the 2003 policy statement. Banking institutions that are subject to section 36 of the Federal Deposit Insurance Act—essentially those with $500 million or more in assets—should comply with the Sarbanes-Oxley Act prohibition on internal audit outsourcing to an external auditor. When discussing the prohibitions on nonaudit services, the Sarbanes-Oxley Act describes three broad principles that define potential conflicts of interest for an external auditor. An external auditor should not (1) audit his or her own work, (2) perform management functions, or (3) act in an advocacy role for the client. Institutions should use these principles as a framework for analyzing existing or proposed nonaudit services in order to avoid potential conflicts of interest for the external auditor. The Sarbanes-Oxley Act also established a Public Company Accounting Oversight Board (PCOAB). The section discusses the PCOAB's authority to set and enforce auditing, attestation, quality-control, and ethics (including independence) standards for auditors of public companies. Accounting firms that conduct audits of public companies must register with the PCOAB and be subject to its supervision. The examination objectives, examination procedures, and internal control questionnaire were amended to consider any new provisions within this policy statement. (See SR-03-5 and SR-02-20.)
2020.1	This revised section on investment securities and end-user activities provides historical information on the nature and application of the ''Uniform Agreement on the Classification of Assets and Appraisal of Securities Held by Banks.'' Table 3 of the section was revised to acknowledge the use of ''fair values'' (market values), which is the current terminology used in the application of generally accepted accounting principles (GAAP) when classifying securities. (Table 3 of section 2020.1 is referenced within the preamble to the final Regulation W, which the Board approved on November 27, 2002.)

Section number	*Description of the change*
2040.1, 2040.2, 2040.3, 2040.4	This revised section on loan portfolio management incorporates a February 25, 2003, interagency advisory on mortgage banking. The advisory highlights various supervisory concerns regarding the valuation and hedging of mortgage-servicing assets and similar mortgage banking assets. Supervisory guidance also is provided on sound risk-management practices pertaining to valuation and modeling processes, management information systems, and internal audit involved with mortgage banking activities. (See SR-03-4.) The examination objectives, examination procedures, and internal control questionnaire were also revised.
2080.1	The commercial and industrial loans section was revised to include a reference to the use of statistical sampling for reviewing loan portfolios of community banks. (See SR-02-19.)
2082.1, 2082.2, 2082.3	This new section discusses the Federal Reserve System's loan-sampling program for certain community banks. The section discusses the use of a statistically based sampling approach to loan reviews as an alternative to the traditional target-coverage approach. The loan-sampling program is directed toward banks currently having a CAMELS composite and asset quality rating of 1 or 2 and also assets less than $1 billion. The section discusses the concept and structure of a sampling program to be used as an alternative to the ''top-down'' loan-coverage approach, the benefits for using it, and its specific implementation procedures. (See SR-02-19.) Examination objectives and examination procedures are provided.
2130.1, 2130.2, 2130.3, 2130.4	The revised consumer credit section includes the January 8, 2003, interagency guidance on supervisory account management and the allowance for loan and lease losses (ALLL) methodology for credit card lending issued by the Federal Financial Institutions Examination Council (FFIEC). In addition to setting forth supervisory expectations for credit card credit-line management, over-limit practices, minimum payments, negative amortization, and workout and forbearance practices, the guidance clarifies various reporting requirements related to income recognition and the ALLL. The credit card lending examination procedures were also revised and expanded. The examination procedures also include the credit card lending examination procedures that are currently found in examination modules. (See SR-03-1.) The examination objectives and internal control questionnaire were also revised.
3010.1	The revised section on borrowed funds includes a discussion of the Board's approval of an amendment to Regulation A on October 31, 2002 (effective January 9, 2003). The revised rule sets forth the Federal Reserve's primary and secondary credit programs, which replace the former adjustment and extended credit programs. The existing seasonal credit program is essentially unchanged. The revised Regulation A is intended to improve the functioning of the discount window.
3020.1	The revised section on the assessment of capital adequacy addresses the accounting treatment of accrued interest receivables (AIRs) related to credit card securitizations, as discussed in a December 4, 2002, interagency advisory. The AIR asset typically represents a subordinated retained interest in transferred assets. The Financial Accounting Standards Board's FAS 140, ''Accounting for Transfers and Servicing of Financial Assets and Extinguish-

Section number	*Description of the change*
	ments of Liabilities,'' sets forth the accounting standards for the securitization and sale of credit card receivables and also for computing the gain or loss on their sale. The banking institution (seller) should report the AIR asset on the date of transfer at its adjusted cost, based on its relative fair (market) value. (See SR-02-12 and SR-02-22.)
4050.1	The revised bank-related organizations section discusses the Board's November 27, 2002, approval of Regulation W (effective April 1, 2003) as it applies to transactions with affiliates under the statutory provisions of sections 23A and 23B of the Federal Reserve Act. Regulation W facilitates compliance with these statutes, provides new exemptions, and combines the statutory restrictions on transactions between a member and its affiliates that were found within the previously issued Board interpretations and exemptions. (See SR-03-2.)
4063.1, 4063.3, 4063.4	The revised electronic banking section incorporates the August 8, 2001, FFIEC interagency guidance on authentication in an electronic banking environment, as well as a discussion of the risks and needed risk-management measures and controls pertaining to existing and emerging authentication practices. The processes for verifying the identity of prospective customers and for the authentication of existing customers who use online systems, such as Internet banking services, are addressed. (See SR-01-20.) The examination procedures and internal control questionnaire were also revised.
4150.1	The section on the review of regulatory reports has been revised to discuss the provisions of the Securities Exchange Act of 1934, as it was amended by the Sarbanes-Oxley Act of 2002. The Board was given the authority to administer and enforce certain provisions of the 1934 act and the Sarbanes-Oxley Act with respect to state member banks that have a class of securities registered under section 12(b) or 12(g) of the 1934 act (registered state member banks). Examiners should consult with a registered state member bank's management to ensure that the required reports have been filed with the Federal Reserve Board pursuant to section 208.36(a) of Regulation H. The section was also revised to list and discuss some of the most common SEC forms that must be filed under the 1934 act and the Sarbanes-Oxley Act.
7010.1	The revised international glossary section includes an expanded definition, as well as the detailed components of, the allocated transfer-risk reserve (ATRR), as stated in the Board's January 6, 2003, revision to subpart D of Regulation K, sections 211.41–43 (effective February 10, 2003). The ATRR is established by a charge to current income, is accounted for separately from the ALLL, and is deducted from the ''gross loans and leases'' to arrive at a ''net loans and leases.'' The ATRR is established and accounted for on a consolidated basis, as required. In addition to the ATRR, the revised rule states that international loan fees are to be accounted for in accordance with GAAP.

FILING INSTRUCTIONS

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Commercial Bank Examination Manual
Supplement 17—November 2002

This supplement reflects changes since the publication of the May 2002 supplement.

LIST OF CHANGES

Section number	*Description of the change*
1000.1	The examination strategy and risk-focused examinations section was revised in the ''Branches'' subsection to discuss a prohibition against a bank's using interstate branches for deposit production. Section 109 of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 prohibits any bank from establishing or acquiring a branch or branches outside of its home state primarily for that purpose. The coverage of section 109 includes any branch of a bank controlled by an out-of-state bank holding company, including a bank consisting only of a main office. An amendment (approved by the Board and the Federal Financial Institutions Examination Council (FFIEC), effective October 1, 2002) conformed the uniform rule to section 109. (See Regulation H, section 208.7(b)(2).) Section 109 sets forth a process that is based on published loan-to-deposit ratios that can be used to test compliance with the statutory requirements. (See the published host-state loan-to-deposit ratios, announced on June 24, 2002.) A noncompliant bank is subject to sanctions.
2070.1	The general allowance for loan and lease losses (ALLL) section was revised to provide a reference to the ALLL guidance issued for subprime lending, which is found in the new section 2133.1. The former methodologies and documentation summary of the 2001 FFIEC policy statement (SR-01-17) has been moved to a new section, 2072.1.
2072.1, 2072.2, 2072.3	These new sections provide supervisory guidance on the design and implementation of ALLL methodologies and documentation practices (as discussed in the July 2, 2001, FFIEC policy statement) that are tailored to the size and complexity of an institution and its loan portfolio. The policy statement emphasizes that the institution's board of directors is responsible for ensuring that controls are in place to determine the appropriate level of the ALLL. The institution should maintain and support the ALLL with documentation that is consistent with its stated policies and procedures, generally accepted accounting principles (GAAP), and applicable supervisory guidance. The institution's ALLL methodology must be a thorough, disciplined, and consistently applied process that incorporates management's current judgment about the credit quality of the loan portfolio. The institution must maintain, at a minimum, written supporting documentation for the following decisions, strategies, and processes: (1) policies and procedures (over the systems and controls that maintain an appropriate ALLL and over the ALLL methodology), (2) a loan-grading system or process, (3) validation of the ALLL methodology, and (4) periodic adjustments to the ALLL process. The questions and answers found in appendix A of the policy statement have been incorporated into section 2072.1 as numbered examples. Examination objectives and procedures are also provided.
2133.1, 2133.2, 2133.3	These new sections discuss subprime lending, which is defined as extending credit to borrowers who exhibit characteristics indicating a significantly higher risk of default than traditional bank lending customers. The section

Section number	*Description of the change*
	emphasizes first that institutions engaged in subprime lending need to have strong risk-management practices and internal controls, as well as board-approved policies and procedures, that appropriately identify, measure, monitor, and control all risks in this activity. Institutions considering or engaging in subprime lending should recognize the additional risks inherent in this activity and determine if these risks are acceptable and controllable, given the institution's staff, financial condition, size, and level of capital support. (See the March 1, 1999, interagency guidance on subprime lending and SR-99-6.) In addition, supplemental interagency guidance from January 2001 is included. The supplemental guidance is directed primarily to those institutions that have subprime-lending programs that equal or exceed 25 percent of tier 1 regulatory capital. (See SR-01-04.) The agencies stated that responsible subprime lending can expand credit access for consumers and offer attractive returns. Institutions are expected, however, to recognize that the elevated levels of credit and other risks arising from these activities require more intensive risk management and, often, additional capital. This expanded guidance discusses (1) the characteristics of a subprime-lending program, (2) a set of specific borrower characteristics that may indicate that an institution is involved in the subprime-lending market, (3) analysis and documentation standards for the ALLL, (4) factors to be considered when determining the appropriate level of capital needed to support subprime lending, (5) examination procedures for assessing the quality of subprime-loan portfolios, and (6) a list of potentially predatory or abusive lending practices that safety-and-soundness examiners would criticize. An appendix consisting of questions and answers pertaining to the January 2001 supplemental guidance is provided. Subprime-lending examination objectives and procedures are also provided.
3020.1	The section on the assessment of capital adequacy has been revised for several rule changes and clarifying interpretations. The first revision is for a limited rule change (issued jointly by the federal banking agencies) that the Board approved on March 27, 2002 (effective July 1, 2002). It lowered, from 100 percent to 20 percent, the risk weight that is applied to certain securities claims on, or guaranteed by, a qualifying securities firm in the United States and in other countries that are members of the Organization for Economic Cooperation and Development (OECD). (See the Federal Reserve's joint press release of April 9, 2002, and its attachment.) This section was also revised to include interpretive guidance on the appropriate applications of the November 29, 2001, joint final rule issued by the Federal Reserve, Federal Deposit Insurance Corporation (FDIC), Office of the Comptroller of the Currency (OCC), and Office of Thrift Supervision (OTS) on the capital treatment of recourse obligations, direct-credit substitutes, and residual interests in asset securitizations. The guidance (SR-02-16 and the joint interagency interpretive guidance issued on September 5, 2002) is in the form of questions and answers. It addresses risk-based capital treatment pertaining to (1) split or partially rated instruments (instruments that are derived from a securitization and assigned separate ratings for principal and interest), (2) a ratings-based qualification for corporate bonds or other securities that are not related in any way to a securitization or

Section number	*Description of the change*
	structured-finance program (they do not qualify for the ratings-based approach), (3) spread accounts that function as credit-enhancing interest-only strips, (4) audits of internal credit-risk rating systems (if audits must be performed by a bank's internal-audit department rather than another independent internal entity), and (5) clean-up calls (related to the repurchase of assets pursuant to a clean-up call and whether certain clean-up calls are treated as a recourse obligation or a direct-credit substitute).
	The section addresses the risk-based capital treatment of accrued interest receivables (AIR) related to credit card securitizations, as discussed in a May 17, 2002, interagency advisory. The AIR asset represents a subordinated retained interest in the transferred assets. The AIR asset therefore meets the definition of a "residual interest" that requires dollar-for-dollar capital, even if the amount exceeds the fully equivalent risk-based capital charge on the transferred assets under the November 2001 rule amendment, which was effective December 31, 2001. (See SR-02-12.)
	The section also includes changes in the capital adequacy guidelines for state member banks, as the guidelines pertain to a bank's tier 1 leverage measure. The revisions to the rule were a result of the capital changes in Regulation H (12 CFR 208, appendix B), approved by the Board on November 8, 2001 (effective January 1, 2002), and issued in a joint agency press release dated November 29, 2001. The changes were for (1) agreements involving recourse, direct-credit substitutes, and residual interests and (2) the final rule pertaining to nonfinancial equity investments that was approved by the Board on January 7, 2002 (effective April 1, 2002). (See the January 8, 2002, joint interagency press release and SR-02-4.)
4030.1	The asset-securitization section was revised to address covenants in asset-securitization contracts that are linked to supervisory thresholds or adverse supervisory actions. The revisions are based on an interagency advisory issued May 23, 2002, which alerted bank management and boards of directors that including such covenants in securitization documents is considered to be an unsafe and unsound banking practice that undermines the objective of supervisory actions. (See SR-02-14.) Further, bank management and boards of directors are encouraged to amend, modify, or remove these types of covenants in existing transactions. An early amortization or transfer of servicing that is triggered by such events could create or exacerbate any liquidity and earnings problems for a bank, possibly leading to a further deterioration in its financial condition.
	The section was also revised to discuss the Interagency Guidance on Implicit Recourse Provided to Asset Securitizations, issued May 23, 2002. (See SR-02-15.) The question-and-answer format of the guidance has been reformatted for this section as illustrative examples. Implicit recourse occurs when a banking organization provides credit support beyond its contractual obligation to one or more of its securitizations. Implicit recourse is of supervisory concern because it demonstrates that the securitizing institution is reassuming risk associated with the securitized assets—risk that the institution initially transferred to the marketplace. The May 2002 guidance assists bankers and supervisors in assessing the types of actions that may, or may not, constitute implicit recourse. Several possible supervisory actions

Section number	*Description of the change*
	that the Federal Reserve may take upon a determination that the bank has provided implicit recourse in an asset securitization are discussed, including (1) increasing the bank's regulatory capital requirements for the selling institution, (2) requiring regulatory capital to be held against the entire amount of assets sold, and (3) requiring the possible deduction of the residual interests from regulatory capital.
4050.1	The bank-related organizations section was revised to include parallel-owned banking organizations and the risks and supervisory approach needed for those organizations. The revision is based on an April 23, 2002, joint agency statement. A parallel-owned banking organization is created when at least one U.S. depository institution and one foreign bank are controlled, either directly or indirectly, by the same person or group of persons who are closely associated in their business dealings or otherwise acting in concert. Parallel-owned banking organizations do not include structures in which one depository institution is a subsidiary of the other, or in which the organization is controlled by a company subject to the Bank Holding Company Act (12 USC 1841).
4200.1	This new section provides supervisory guidance on fiduciary activities. It discusses the Federal Reserve's integration of its supervisory assessment of a bank's fiduciary activities into the overall safety-and-soundness supervision process, thus focusing supervisory resources on areas of greatest potential risk. The Federal Reserve has integrated the examination-frequency mandates for trust and transfer-agency examinations with safety-and-soundness examinations. (See SR-01-5.) Supervisory risk profiles, risk assessments, and supervisory plans are to reflect fiduciary activities. (See SR-96-10.) Fiduciary activities and other related services generally include traditional trust services, such as personal trust, corporate trust, and transfer-agent services and employee benefit account products and services, as well as custody and securities-lending services, clearing and settlement, asset management, and investment advisory activities. (See SR-01-5.) For banks with significant or complex fiduciary activities, the examination frequency should be determined based on the impact of fiduciary activities on the organization's risk profile. At a minimum, all material fiduciary business lines should be subject to examination over a two-year period or examination cycle as part of the continuous-supervision process, with higher-risk areas generally reviewed annually. Fiduciary activities at other banks should be reviewed, at a minimum, during every other routine safety-and-soundness examination. Under SR-01-5, alternative examination programs conducted by state banking authorities may continue to be performed in accordance with those arrangements. Organizations whose fiduciary activities have raised supervisory concerns should be subject to an additional level of supervisory attention. The composite Uniform Interagency Trust Rating System (UITRS) and transfer-agent ratings reflect the overall condition of the fiduciary function at each bank. The UITRS, and any component ratings considered relevant, should be assigned or updated in a timely manner, based on the results of examinations, targeted reviews, or other assessments of fiduciary activities.

Section number	*Description of the change*
	For organizations that have significant or complex fiduciary activities, composite UITRS and transfer-agent ratings should be updated annually. (See SR-01-5.) The section fully discusses the UITRS rating system. (See SR-98-37.) The section also discusses the Federal Reserve's supervisory concerns regarding direct or indirect financial incentives for banks and trust institutions that place trust assets with particular mutual funds. The incentives banks and trust institutions may receive from these arrangements include fees for using nonaffiliated fund families, as well as incentives for using an institution's proprietary mutual funds. Institutions should ensure that they perform and document an appropriate level of due diligence before entering into any such compensation arrangements. (See SR-99-7.)
5040.1	This section on formal and informal corrective actions was revised to discuss the enforcement provisions involving prompt-corrective-action directives and the potential assessment of civil money penalties against a bank or company, or any of its institution-affiliated parties, for noncompliance. Also discussed are the Federal Reserve's supervisory concerns and guidance that focus on the FDIC's regulations pertaining to indemnification agreements and payments. (See SR-02-17.)
7040.1, 7040.2, 7040.3, 7040.4	The international—transfer-risk section is substantially revised to include new interagency (Federal Reserve, FDIC, and OCC) supervisory and examiner guidance on an effective country-risk management process for banking organizations, which was issued on February 22, 2002. Country risk is the risk that economic, social, or political conditions in a foreign country might adversely affect an organization's financial condition, primarily through impaired credit quality or transfer risk. (Transfer risk is a subset of country risk.) The new guidance supplements and strengthens existing guidance on country risk. The section discusses examiners' responsibilities for ensuring that a bank's management of the country risks that arise from its international activities is appropriately addressed during the bank examination process. Country risk can occur in many different forms, and the nature of specific risks can change over time. A U.S. banking organization with significant direct or indirect international exposure must have in place an effective country-risk management process that is commensurate with the volume and complexity of its international activities. Examiners should continue to evaluate the adequacy of the country-risk management process at internationally active institutions, and they should augment their assessments using this new guidance. The institution's country-risk management process should include, at a minimum, (1) effective oversight by the board of directors, (2) adequate risk-management policies and procedures, (3) an accurate country-exposure reporting system, (4) an effective country-risk analysis process, (5) a country-risk rating system, (6) country-exposure limits, (7) ongoing monitoring of country conditions, (8) periodic stress testing of foreign exposures, and (9) adequate internal controls and an audit function. An institution's country-risk management process should give particular attention to any concentrations of country risk. The examination

Section number	*Description of the change*
	objectives, procedures, and internal-control questionnaire have been revised for the change. (See SR-02-5.)

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Commercial Bank Examination Manual
Supplement 16—May 2002

This supplement reflects changes since the publication of the November 2001 supplement.

LIST OF CHANGES

Section number	*Description of the change*
1000.1	The section discusses the Regulation H requirement that a state member bank notify the Federal Reserve System of changes in the general character of a bank's business or the scope of its corporate powers. (See Regulation H, sections 208.3(d)(1) and (2) and SR-02-9.) Included is a discussion on individual- or multiple-branch applications, expedited-processing criteria, and a bank's investment in premises for branches. Branch-closing requirements are discussed in relation to section 42 of the Federal Deposit Insurance Act, section 208.6 of Regulation H, and the June 29, 1999, joint policy statement regarding branch closings. Customers and the Federal Reserve must be notified of branch closings (branch relocations are not considered branch closings). The definition of "eligible bank" (within footnote 1) is supplemented with an expanded discussion of Community Reinvestment Act ratings and whether expedited-processing procedures apply to a bank's membership or branch application. (See Regulation H, section 208.2(e).)
2020.1 2020.3	The list of permitted stock holdings by member banks (table 4) has been revised to reflect the Regulation H definition of "capital stock and surplus," which pertains to the Board's authority to approve a state member bank's limited investment of up to 10 percent of its capital and surplus in a community development corporation. (See Regulation H, section 208.2(d).) Also included is a discussion on the investment limitations for public welfare or other such investments, as found in section 9 of the Federal Reserve Act. Changes have also been made for the Board's October 16, 2001, revision to Regulation K, authorizing limited portfolio investments in foreign companies without prior Board notice (see sections 211.8 and 211.9) and investments in Edge and agreement corporations (see section 211.5). (See also SR-02-03.)
2190.1	The bank premises and equipment section has been revised to reflect previous changes to section 24 of the Federal Reserve Act and section 208.21(a) of Regulation H. A state member bank that is well rated and well capitalized must give at least 15 days' notice before it invests in bank premises in an amount of 150 percent or less of its perpetual preferred stock and related surplus plus common stock plus surplus. The bank may make the investment provided that it has not received notice from the Federal Reserve that the investment is subject to further review. State member banks that have a CAMELS rating of 1 or 2 as of the most recent examination and that are well capitalized may make such investments in premises without providing notice to the Board. Banks that are not well capitalized or well rated may have investments in bank premises only up to 100 percent or less of those amounts, and only with the prior notice indicated above.
3000.1	The deposit accounts section is revised to better reflect Regulation CC as it pertains to banking hours and the processing of demand deposits. Deposited funds must be made available for withdrawal during a certain period after the

Section number	*Description of the change*
	banking day on which they were received. Cutoff hours can be established, after which the bank will deem funds to be received on the next banking day. Different cutoff-hour limits can apply to different types of deposits. Revised information is provided for pass-through deposit insurance involving an employee benefit plan (EBP). The $100,000 limit on FDIC insurance does not apply to the entire EBP account balance. Instead, the FDIC insurance ''passes through'' to each owner or beneficiary, and the deposited funds of each individual EBP participant are insured up to $100,000. EBP deposits are entitled to pass-through insurance when the depository institution meets the requirements of the FDIC rules (at 12 CFR 330.14), based on the institution's prompt-corrective-action capital category when a deposit is accepted. Certain disclosures are required regarding EBP accounts and their deposits.
3020.1 4030.1	The sections on the assessment of capital adequacy and asset securitization have been revised to reflect multiple changes to the capital adequacy standard (risk-based measure). The November 8, 2001, Regulation H change, effective January 1, 2002, addressed the treatment of recourse obligations, residual interests, and direct-credit substitutes that expose banking organizations primarily to credit risk. New standards have been added for the treatment of residual interests, including a concentration limit for credit-enhancing interest-only strips. Credit ratings from rating agencies and certain limited alternative-credit-rating approaches can be used by banks to match the risk-based capital requirement more closely to their relative risk of loss for certain positions in asset securitizations. The change is intended to result in a more consistent treatment for similar transactions, particularly among the federal banking agencies; a more consistent regulatory capital treatment for certain transactions involving similar risk; and capital requirements that more closely reflect a bank's relative exposure to credit risk. (See SR-02-12, SR-02-14, SR-02-15, and SR-02-16.) The January 8, 2002, Regulation H change to the risk-based capital adequacy requirements (risk-based measure), effective April 1, 2002, established special minimum capital requirements for equity investments in nonfinancial companies. The new capital requirements apply symmetrically to equity investments and impose a series of marginal capital charges on such authorized covered equity investments that increase with the level of a bank's overall exposure to equity investments relative to its tier 1 capital. The highest marginal capital charge requires a 25 percent deduction from tier 1 capital for covered investments that aggregate more than 25 percent of a bank's tier 1 capital. Equity investments through small business investment companies are exempt to the extent that such investments, in the aggregate, do not exceed 15 percent of the bank's tier 1 capital. The Federal Reserve will apply heightened supervision to the banking organizations it supervises as their level of concentration in equity investments increases. (See SR-02-4.) The last change involves the risk-based capital treatment for state member banks' forward equity transactions relating to the repurchase of their common stock. Some banking organizations have continued to treat shares

Section number	*Description of the change*
	under such arrangements as tier 1 capital. These transactions can impair the permanence of shares, typically have certain features that are undesirable from a supervisory perspective, and are inconsistent with tier 1 capital status. The Federal Reserve has determined that any banking organization's common stock that is covered by forward equity transactions entered into after the issuance of SR-01-27 (November 9, 2001) will be excluded from a state member bank's tier 1 capital, other than those transactions specified for deferred compensation or other employee benefit plans.
4040.1 4040.2 4040.3 4040.4	The section on the management of insurable risks is substantially revised to reflect certain bank insurance that is available within the banking industry. Bank management responsibilities are discussed, which include coordinating the management of the bank's various types of risk exposures in conjunction with an insurance program or making a decision to selectively self-insure (alternative risk transfer) when permissible and appropriate. Common insurance policy coverages (such as the fidelity insurance bond and its included or optional riders, liability insurance, property insurance, aircraft insurance, and others) are discussed, in addition to common insurance components and concepts. The section also discusses examiners' responsibilities for reviewing a bank's risk management and management of its insurance program. The examination objectives, examination procedures, and internal control questionnaire have been updated.
4050.1 4050.4	Two of the bank-related organizations sections have been revised to reference the Board's October 16, 2001, revision of Regulation K (effective November 26, 2001), which pertains to the limited investment procedures for investing in foreign companies. (See Regulation K, sections 211.8 and 211.9.)
4125.1 4125.2 4125.3 4125.4	The payment systems risk and electronic funds transfer section has been substantially revised to include the Board's December 11, 2001, revision of its policy statement on payments system risk (PSR policy). The PSR policy was revised to modify the net debit cap calculation for U.S. branches and agencies of foreign banks, as well as the time that electronic check presentments are posted to depository institutions' Federal Reserve accounts for purposes of measuring daylight overdrafts. The PSR policy incorporates, with minor modifications, the Board's interim policy that allows certain depository institutions to pledge collateral to the Federal Reserve to access additional daylight-overdraft capacity above their net debit caps. The $50 million limit on the value of book-entry securities transfers was retained. The section discusses the examiner's responsibilities with regard to payment system risk and electronic funds transfer. The examination objectives, examination procedures, and internal control questionnaire have also been updated.
4150.1	The section on the review of regulatory reports has been updated for changes in reports filed by banks and other banking organizations, including the new FR Y-10 report, the revised FR Y-6 report, and the internal recordkeeping requirements for FR 2064 (see SR-02-2 and its discussion of the examiner's responsibilities). Among other items, the FR Y-10 report collects structure information on foreign investments and information on the commencement

Section number	*Description of the change*
	of new foreign activities. (See Regulation K, sections 211.8 through 211.10.) The SEC reporting requirements for certain banking and bank-related organizations are also briefly discussed.
5020.1 6010.1	The sections on the overall conclusions regarding the condition of the bank and on other types of examinations have been updated for Regulation H provisions regarding the requirements for prior Federal Reserve approval for changes in the bank's business or in the scope of the corporate powers that it exercises. (See SR-02-9 and Regulation H, section 208.3(d)(1) and (2).)

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Commercial Bank Examination Manual
Supplement 15—November 2001

Summary of Changes

Assets

Section 2020.1, ''Investment Securities and End-User Activities,'' and section 2030.1, ''Bank Dealer Activities,'' have been revised because, effective March 13, 2000, the Gramm-Leach-Bliley Act (GLB Act) authorized well-capitalized state member banks to deal in, underwrite, purchase, and sell municipal revenue bonds without any limitations relative to the bank's capital. Before the amendment, banks were limited to only underwriting, dealing in, or investing in, without limitation, general obligation municipal bonds backed by the full faith and credit of an issuer with general powers of taxation. Member banks could invest in, but not underwrite or deal in, municipal revenue bonds, but the purchases and sales of such investment securities for any obligor were limited to 10 percent of a member bank's capital and surplus. As a result of the GLB Act amendment, the Office of the Comptroller of the Currency revised its investment securities rule (12 CFR 1) on July 2, 2001, to treat municipal revenue bonds as the equivalent of type I securities for well-capitalized member banks. See SR-01-13.

Section 2070.1, ''Allowance for Loan and Lease Losses (ALLL),'' was revised to incorporate a brief summary about an interagency Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions. The policy statement, issued by the Federal Financial Institutions Examination Council on July 2, 2001, clarifies the agencies' expectations for documentation that supports the ALLL methodology. The statement further emphasizes the need for appropriate ALLL policies and procedures, which should include an effective loan-review system. The guidance provides examples of appropriate supporting documentation, as well as illustrations of how to implement this guidance. See SR-01-17.

A new section 2115.1, ''Leveraged Financing,'' sets forth the April 9, 2001, federal bank interagency guidance concerning sound risk-management practices for institutions. Guidance about risk-rating leveraged-finance loans and how the imputed value of a business (enterprise value) should be evaluated in the risk-rating process is provided. Many leveraged transactions are underwritten with reliance on the imputed value, which is often highly volatile. Sound valuation methodologies must be used in addition to ongoing stress testing and monitoring of those values. Institutions that are substantively engaged in leveraged financing are expected to adequately risk-rate, track, and monitor these transactions and to maintain policies specifying conditions that would require a change in risk rating, accrual status, loss recognition, or reserves. Institutions should have comprehensive credit-analysis processes, frequent monitoring, and detailed portfolio reports to better understand and manage the inherent risk in leveraged-finance portfolios. New examination objectives and examination procedures, sections 2115.2 and 2115.3, respectively, have also been provided. See SR-01-9.

Other Examination Areas

Section 4050.1, ''Bank-Related Organizations,'' has been revised to include a final rule for financial subsidiaries of state member banks. The final rule for financial subsidiaries (1) clarifies that a financial subsidiary includes any of its direct or indirect subsidiaries and (2) allows state member banks to continue and retain new operations subsidiaries, permitted under state law and the Board's interpretations, without complying with the requirements of the rule. The Board approved the rule on August 13, 2001.

The revised section also outlines several interim or final rules, exemptions, and interpretations for certain transactions that pertain to sections 23A and 23B of the Federal Reserve Act:

- The Board adopted an interim final rule for sections 23A and 23B that pertains to derivative transactions with affiliates and intraday extensions of credit to affiliates. The interim rule, effective January 1, 2002, requires institutions to adopt policies and procedures that are reasonably designed to monitor, manage, and control credit exposures arising out of derivative transactions with affiliates and intraday extensions of credit to affiliates. The rule subjects such transactions to the market-terms requirement of section 23B.

- The Board adopted a final rule, effective June 11, 2001, that provides an interpretation of and exemptions from section 23A for depository institution loans made to customers to purchase a security or other asset through a depository institution affiliate. The interpretation confirms that section 23A does not apply to a depository institution's extensions of credit to customers that use the loan's proceeds to purchase a security or other asset through a depository institution affiliate, so long as the affiliate is acting exclusively as a broker in the transaction and no affiliates retain any portion of the loan proceeds. The Board also exempted from section 23A that portion of the loan to a third party that the affiliate retains as a market-rate brokerage commission or agency fee.

  The Board adopted two other exemptions from section 23A for (1) a depository institution loan that is made to a customer that uses the proceeds to purchase a third-party-issued security through a depository institution broker-dealer affiliate that acts as riskless principal in the transaction and (2) a depository institution loan that is made to a customer that uses the proceeds to purchase a security from a depository institution broker-dealer affiliate, when the loan was made pursuant to a preexisting line of credit not entered into in contemplation of the purchase of securities from a depository institution affiliate.
- The Board adopted a final rule, also effective June 11, 2001, that sets forth an interpretation of section 23A that expands the types of securities that an insured depository institution can purchase that are eligible for exemption under section 23A(d)(6). This provision exempts such purchases from an affiliate if they have a readily identifiable and publicly available market quotation. The interpretation also expands the ability of an insured depository institution to purchase securities from its registered broker-dealer affiliates, while ensuring that the transactions are conducted according to safe and sound banking practices.

Section 4060.1, ''Information Technology,'' has been revised to include the federal banking agency interagency guidelines for financial-institution standards for safeguarding customer information. The guidelines, effective July 1, 2001, implement section 501 of the GLB Act, which required the agencies to establish financial-institution standards for administrative, technical, and physical safeguards relating to customer records and information. Each institution is required to establish an information security program to assess and control the risks to customer information. The program should be appropriate for the institution's size, complexity, and nature and for the scope of its operations. Specific security measures that institutions should consider in developing the security program are outlined. To protect the security of customer information maintained or processed by service providers, financial institutions are required to oversee their service-provider arrangements. The institution's board of directors is responsible for overseeing and approving the written security policies and the program's development, implementation, and maintenance. Examiners should assess compliance with the guidelines during each safety-and-soundness examination or examination cycle. The examination procedures and internal control questionnaire, sections 4060.3 and 4060.4, respectively, have been revised for the guidelines. See SR-01-15.

A new section 4063.1, ''Electronic Banking,'' has been developed to aid in the supervisory review of electronic banking activities. The procedures are based on existing supervisory guidance and the electronic banking examination documentation (ED) module currently used by Federal Reserve and Federal Deposit Insurance Corporation examiners. For each safety-and-soundness examination, examiners should determine the extent to which an on-site review of electronic banking activities is necessary based on the scope and significance of the activities relative to the size and sophistication of the institution. The determination of the examination scope should consider factors such as—

- the implementation of significant new electronic banking products and services since the last examination;
- significant changes in the composition or level of customers, earnings, assets, or liabilities generated or affected by the electronic banking activities;
- new or significantly modified systems or outsourcing relationships for activities related to electronic banking;
- the need for targeted examinations of business

lines that rely heavily on the electronic banking systems or activities; and
- other potential problems or concerns that may have arisen since the last examination or the need to follow up on previous examination or audit issues.

In general, examiners should review electronic banking activities when these services are newly implemented, particularly for institutions that may not have significant experience or expertise in this area, or when an institution is conducting novel activities that may pose a heightened risk. Periodic reviews should be conducted thereafter based on any significant changes to the scope of services, the nature of the operations, or any supervisory concerns. The section is supplemented with examination objectives, examination procedures, and an internal control questionnaire (sections 4063.2, 4063.3, and 4063.4, respectively).

Section 4070.1, ''Dividends,'' discusses dividend limitations and policies for state member banks. The examination procedures, section 4070.3, includes a revised table that may be used as a reference when computing state member banks' dividend limitations. These sections have been revised for Regulation H cites, statutory-language clarifications, and changes in the line-item references of current bank call report schedules.

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Commercial Bank Examination Manual
Supplement 14—May 2001

Summary of Changes

Assets

Section 2020.1, ''Investment Securities and End-User Activities,'' has been revised to include supervisory guidance on (1) investing in limited equities and equity interests in nonpublic companies and (2) lending to private-equity-financed companies. The statutory and regulatory authority for these types of investments is discussed, along with safety-and-soundness issues on the management of equity investments. The section identifies sound investment and risk-management practices and includes guidance on implementing and maintaining adequate internal controls and disclosure practices that is particularly important for an institution's board of directors, management, and supervisors. (See SR-00-9.)

Liabilities and Capital

A new section 3012.1, ''Complex Wholesale Borrowings,'' has been added to supplement and expand on the existing general supervisory guidance on bank funding and borrowing. Some complex wholesale-borrowing funding instruments have embedded options that may significantly increase a bank's sensitivity to market and liquidity risks. Maturity mismatches or the embedded options themselves can, in some circumstances, adversely affect a bank's financial condition. This supervisory guidance collectively calls for an analysis of the purpose, effectiveness, concentration exposure, funding stability, and bank management's understanding of the liquidity and interest-rate risks associated with borrowing and funding strategies. When an institution engages in significant complex wholesale borrowings, examiners should follow the detailed examination guidance provided. Examination objectives and procedures have also been added as sections 3012.2 and 3012.3, respectively. (See SR-01-8.)

Other Examination Areas

''Bank-Related Organizations,'' section 4050.1, was revised to incorporate changes in statutory, regulatory, and supervisory guidance as a result of the Gramm-Leach-Bliley Act of 1999. New information is provided on the ownership and control of financial subsidiaries, financial holding companies (FHCs), and operating subsidiaries of state member banks. The approval requirements and permissible activities are discussed, if applicable, as well as any limitations on and transactions with affiliates (sections 23A and 23B of the Federal Reserve Act). A discussion of the Federal Reserve's supervisory role as the umbrella supervisor for FHCs is included.

Section 4060.1, ''Information Technology,'' has been revised to include the bank FFIEC interagency policy statement on the risk management of outsourced technology services. The guidance focuses on the risk-management process of identifying, measuring, monitoring, and controlling the risks associated with outsourcing technology services. The amended section includes four key supervisory elements to address those risks: risk assessment, service-provider selection, contract provisions and review, and ongoing service-provider monitoring. The policy statement has an appendix that provides examples of considerations that may be relevant when performing due diligence in selecting a service provider, dealing with issues involved in contracting with service providers, and conducting ongoing service-provider monitoring. (See SR-00-17.)

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Examination Planning

Section 1010.1, ''Internal Control,'' has been revised to include the September 1999 FFIEC Interagency Policy Statement on the External Audits of Banks with Less Than $500 Million in Total Assets. Banks and savings associations that have less than $500 million in total assets (small banks) and that are not subject to other audit requirements are encouraged to adopt an external-auditing program as a part of their overall risk-management process. A full-scope annual audit by an independent public accountant is preferable. Such an audit is not feasible for every small bank, however. In such cases, those banks are encouraged to pursue appropriate audit alternatives that are set forth in the policy statement. Small banks are also encouraged to establish an audit committee consisting of outside directors. The policy statement also provides guidance to examiners on the review of external-auditing programs. State member banks subject to this policy are requested to furnish copies of their external-auditing program reports to their supervising Federal Reserve Bank. See SR-99-33.*

Section 1020.1, ''Federal Reserve System Bank Watch List and Surveillance Programs,'' has been revised and renamed to incorporate procedures for assigning state member banks to a watch list. The watch list and its accompanying screen monitoring program identify state member banks that warrant additional off-site surveillance either because of their financial condition or because of recent examination findings. An updated description of the System to Estimate Examination Ratings, or SEER, is included. See SR-00-7. The examination objectives and procedures, sections 1020.2 and 1020.3, respectively, have also been modified.

Assets

Section 2000.1, ''Cash Accounts,'' includes revised references and provisions of section 208.61 of Regulation H (effective October 1, 1998) for bank security procedures. The security requirements for state member banks were previously found in the former Regulation P. The examination procedures and the internal control questionnaire, sections 2000.3 and 2000.4, respectively, have also been revised.

The lending standards outlined in section 2040.1, ''Loan Portfolio Management,'' have been reinforced to address supervisory concerns about the weakening of internal controls in the lending process caused by overreliance on favorable economic conditions. The supervisory guidance focuses on the risks involving overly aggressive lending practices. Supervisors and examiners are to be alert to the following indications of an institution's insufficiently rigorous risk assessment: (1) excessive reliance on strong economic conditions and robust financial markets, such as borrowers whose financial capacity is inadequate to service their debts without access to capital markets on favorable terms; (2) inadequate consideration of stress testing; or (3) weakening of key internal controls in the lending process. Examiners also must be attentive to an institution's monitoring of its own credit practices, making certain that its practices do not lead to a delay in recognizing emerging loan weaknesses. If examiners observe indications of insufficient risk assessments, they should carefully consider downgrading the institution's risk-management, management, and/or asset-quality ratings. If these practices are deemed significant to the institution, examiners should also downgrade the institution's capital adequacy rating. When determining the quality of bank loan portfolios, examiners should review internal risk-management loan-review systems, conduct sufficient loan reviews, and perform transaction testing of the lending function to determine accurately the quality of bank loan portfolios and other credit exposures. See SR-99-23. The examination objectives and procedures, sections 2040.2 and 2040.3, respectively, have also been revised.

Section 2120.1, ''Direct Financing Leases,'' was amended to update the discussion of a bank holding company's leasing of personal or real property. The last revision of Regulation Y removed a number of restrictions from the requirements for leasing. Two types of leasing activities, full-payout leasing or high residual

* Supervisory (SR) letters are the Federal Reserve's primary means of communicating key policy directives to its examiners, supervisory staff, and the banking industry. Supervisory letters can be viewed on the Board's Internet site at www.federalreserve.gov/boarddocs/srletters.

value leasing, are permissible for bank holding companies under section 225.28(b)(3) of Regulation Y.

Section 2130.1, ''Consumer Credit,'' was amended to include the June 2000 FFIEC Uniform Retail-Credit Classification and Account-Management Policy, which supersedes the February 1999 policy. The February 1999 policy updated and expanded the classification policy for retail-credit loans that was issued in 1980. The June 2000 policy changes and clarifies the February 1999 policy in several areas, including the following:

- The explicit limitation on the number and frequency of extensions, deferrals, rewrites, and renewals of closed-end loans is replaced with language that stresses the need for institutions to adopt and adhere to prudential internal standards regarding these practices.
- Open-end accounts that enter a debt-counseling or workout program may be re-aged after receipt of at least three consecutive minimum monthly payments, or the equivalent cumulative amount.
- For loans that are secured by residential real estate, a current assessment of value should be made no later than 180 days past the contractual due date. Any outstanding loan balance in excess of the value of the property, less cost to sell, should be classified loss and charged off.
- Loans with collateral that are due to be charged off under the policy may be written down to the value of the collateral, less cost to sell, rather than being charged off in their entirety.
- Payments received after the applicable charge-off threshold, but before the end of the month in which the charge-off threshold is triggered, may be considered in determining whether a charge-off remains appropriate.

In addition to discussing the revised policy statement, SR-00-8 advises examiners to consider the methodology used for aging retail loans. In accordance with the FFIEC call report instructions, banks and their consumer finance subsidiaries are required to use the contractual method, which ages loans based on the status of contractual payments. The examination procedures, section 2130.3, have also been revised.

Other Examination Areas

Section 4030.1, ''Asset Securitization,'' has been revised to incorporate joint federal bank interagency supervisory guidance from December 1999 on the risk management and valuation of retained interests that arise from securitization activities. These securitization activities present unique and sometimes complex risks that require the attention of senior management and the board of directors. This guidance underscores the importance of sound risk-management practices in all aspects of asset securitization. Retained interests, including interest-only strips receivable, arise when a selling institution keeps an interest in assets sold to a securitization vehicle that, in turn, issues bonds to investors. Supervisory concerns exist about the methods and models banking organizations use to value these interests and the difficulties in managing exposure to these volatile assets. Under generally accepted accounting principles (GAAP), a banking organization recognizes an immediate gain (or loss) on the sale of assets by recording its retained interest at fair value. The valuation of the retained interest is based on the present value of future cash flows in excess of amounts needed to service the bonds and cover credit losses and other fees of the securitization vehicle. The determination of fair value should be based on reasonable, conservative assumptions about such factors as discount rates, projected credit losses, and prepayment rates. The retained interests are to be supported by verifiable documentation of fair value. Otherwise, the retained interests should be charged off. The institution should recognize and hold sufficient capital against the recourse obligations generated by securitizations. There also should be an adequate independent audit function. See SR-99-37. The examination objectives and procedures, sections 4030.2 and 4030.3, respectively, have also been revised.

Section 4060.1, ''Information Technology (IT),'' has been completely revised. The section (formerly ''Computer Services'') includes supervisory guidance that gives greater emphasis to the role of IT and its effect on an organization's safety and soundness. Separate IT examinations have been eliminated. Instead, all examinations should include an assessment and evaluation of IT risks and risk management. See SR-00-3. The scope of the assessment should normally be based on factors such as—

- implementation of new systems or technologies since the last examination;
- significant changes in operations, such as

mergers or systems conversions;
- new or modified outsourcing relationships for critical operations;
- targeted examinations of business lines in which internal controls or risk management is heavily dependent on IT; and
- other potential problems or concerns that may have arisen since the last examination or the need to follow up on previous examination or audit issues.

Examiners must consider IT when developing risk assessments and supervisory plans, and in determining the level of review needed, given the characteristics, size, and business activities of the organization. Safety-and-soundness examiners and IT specialists should closely coordinate their activities and the level of expertise needed during the risk-assessment and planning phase, as well as during on-site examinations. According to SR-98-9, examiners should—

- develop a broad understanding of the organization's approach, strategy, and structure with regard to IT activities within and across business lines;
- incorporate an analysis of IT activities into risk assessments, supervisory plans, and scope memoranda;
- assess the organization's critical systems—those that support its major business activities, and the degree of reliance those activities have on IT systems; and
- determine whether the board of directors and senior management are adequately identifying, measuring, monitoring, and controlling the significant risks associated with IT for the overall organization and its major business activities.

The section includes the revised FFIEC Uniform Rating System for Information Technology (URSIT), effective April 1, 1999, for use in conducting examination ratings of a bank's IT. URSIT's critical components are audit, management, development and acquisition, and support and delivery. These components are used to assess the overall performance of IT within an organization. Examiners evaluate the functions identified within each component to assess the institution's ability to identify, measure, monitor, and control information technology risks. Each organization examined for IT is assigned a summary or composite rating based on the overall results of the evaluation. See SR-99-8. Institutions that outsource core processing functions are exposed to IT-related risks. For these institutions, the examiner's examination assessment of IT activities may be incorporated directly into the safety-and-soundness rating. The examination scope should include an evaluation of the adequacy of the institution's oversight of service providers for critical processing activities, the results of any relevant supervisory reviews of such service providers, and any significant in-house activities. See SR-00-3. When developing an institution's examination scope and risk profile, examiners should determine what outsourced information- and transaction-processing activities are critical to the institution's core operations. During the on-site examination, the adequacy of the institution's risk management for these critical service providers should be assessed. A banking institution's board of directors and senior management should understand the key risks associated with the use of service providers for its critical operations, commensurate with the scope and risks of the outsourced activity and its importance to the institution's business. An institution should ensure that an appropriate oversight program is in place to monitor each service provider's controls, condition, and performance. See SR-00-4. The examination objectives and procedures, sections 4060.2 and 4060.3, respectively, have also been updated.

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Examination Planning

Section 1000.1, ''Examination Strategy and Risk-Focused Examinations,'' has been completely revised:

- The Federal Reserve System's examination frequency guidelines for state member banks have been revised. Section 306 of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 and section 2221 of the Economic Growth and Regulatory Paperwork Reduction Act of 1996 amended the examination frequency guidelines. See SR-97-8. The pre-membership or pre-merger examination guidelines are also revised. See SR-98-28 and section 208.2(e) of Regulation H.
- The section summarizes the Federal Reserve's risk-focused examination program for community banks and large, complex institutions. This program endorses the concept of conducting, when appropriate, a series of targeted examinations during a supervisory cycle, with each examination focusing on an activity, business line, or legal entity. For more detailed supervisory guidance on the program, see SR-97-24 and its handbook, ''Framework for Risk-Focused Supervision of Large, Complex Institutions,'' and the handbook's appendices. See also SR-97-25 and its handbook, ''Framework for Risk-Focused Supervision of Community Banks.''
- The section briefly discusses the Federal Reserve System's ongoing risk-focused supervision program. The program's standards for management, monitoring (maintenance of an institutional overview, risk matrix, and risk assessment), and periodic reporting, as carried out by a designated central point of contact and dedicated supervisory team for each consolidated organization, are explained. See SR-99-15 for more detailed supervisory guidance.

Assets

In section 2060.1, ''Classification of Credits,'' the minimum criteria to be used for loan write-ups are revised. The section sets forth the minimum standards for information categories to be presented in the examination report on assets that are subject to special mention or adverse classifications. Such write-ups are required when management and examiners disagree about the institution's disposition of assets, or when the institution will be assigned a rating of 3, 4, or 5. The write-ups will be used to support classifications presented to management, and, in the case of problem banks, to support follow-up supervisory actions. A full write-up must provide sufficient detail to support the examiner's judgment about the rating assigned. See SR-99-24.

Section 2080.1, ''Commercial and Industrial Loans,'' includes the minimum information that needs to be included on loan line sheets. The examiner must document on the line sheet the loan's disposition, as well as the reasons for its disposition. The examiner's judgment will determine the extent of support needed to document the loan-review decision on the line sheet. The line ticket should state the reasons why a loan is passed, listed for special mention, or adversely classified. Line sheets are also to state what information is not available or is unreliable due to deficient loan administration (especially for loan and collateral documentation and collateral values). See SR-99-25.

Section 2090.1, ''Real Estate Loans,'' provides revised supervisory guidance to be used in evaluating and controlling the risks high LTV loans pose to banks. Further clarification is provided on two exemptions in the 1992 interagency real estate lending standards: the ''abundance of caution'' exemption and the exemption for loans sold promptly without recourse. There is guidance for calculating the LTV ratio when multiple loans and lenders are involved. Supervisory caution emphasizes the monitoring of high LTV limits. Other risk-management issues are discussed, such as loan review and monitoring, sales of high LTV loans, and compliance risk. The real estate loan examination objectives, procedures, and internal control questionnaire, sections 2090.2, 2090.3, and 2090.4, respectively, also reflect the supervisory guidance for risk-management programs involving high LTV loans. See SR-99-26.

Liabilities and Capital

Section 3020.1, ''Assessment of Capital Adequacy,'' has been revised to include the capital treatment for credit derivatives that are used to synthetically replicate collateralized loan obligations (CLOs). The supervisory guidance was developed jointly by the Federal Reserve and the Office of the Comptroller of the Currency. Credit derivatives allow banking institutions to assume or transfer credit risk on a specified or ‘‘referenced’’ asset or pool of assets. CLOs represent asset-backed securities that are supported by various assets such as commercial loans. The capital treatment for three synthetic CLO example transactions is provided: (1) when the entire amount of the referenced portfolio is hedged; (2) when a high-quality senior risk position in the reference portfolio is retained; or (3) when a first-loss position is retained. Minimum conditions are specified for sponsoring institutions wishing to use the transaction 2 synthetic securitization capital treatment. Transaction flow diagrams are provided for each example. See SR-99-32 and its attachment. The examination objectives and procedures, sections 3020.2 and 3020.3, respectively, have been revised to include such synthetic CLOs.

International

The transfer risk examination guidance in section 7040.3 has been significantly revised to incorporate the ‘‘Guide to the Interagency Country Exposure Review Committee’’ (ICERC). The guide was developed to clarify for the public the ICERC’s evaluation process, and to explain further its role in the supervisory process. New information on the application of ICERC transfer risk ratings is provided, including several categories of exposure that may receive a less severe transfer risk rating, such as short-term bank or trade exposures; securities held in trading accounts; and direct equity investments. A discussion on rating Other Transfer Risk Problems now supplements the discussion on classifications due to transfer risk. The criteria for determining exposures for strong, moderately strong, and weaker countries have been enhanced. See SR-99-35.

Statutes and Regulations

Section 8000.1, ‘‘Statutes and Regulations Administered by the Federal Reserve,’’ has been updated. The references listed apply primarily to state member banks. The table is organized in ascending order according to the United States Code title and section number (for example, 12 USC 1, 12 USC 51b-1...15 USC 18, 15 USC 21, etc.).

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Commercial Bank Examination Manual
Supplement 11—November 1999

Internal Control, section 1010.1, has been revised to update information on the characteristics of an effective internal control system, including the directors' responsibilities; its structure, staffing, and scope; and the implementation of an internal audit. New material on internal audit requirements for small financial institutions has been added.

Section 2070.1, Allowance for Loan and Lease Losses, was updated to include interagency guidance issued after the December 1993 interagency policy statement that is printed in the section. The examination procedures, section 2070.3, were also updated.

Consumer credit, section 2130.1, has been updated to incorporate the Uniform Retail-Credit Classification and Account-Management Policy, issued in February 1999. The policy outlines the criteria institutions should use for classifying retail credits and provides examiners with guidance for reviewing loan classifications.

Asset Securitization, section 4030.1, has been updated to add a new subsection on capital adequacy requirements for securitization activities, as well as guidance on sound risk-management practices, including board and senior management oversight and stress testing. The examination guidelines for analyzing credit, reputational, and liquidity and market risks were also revised.

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* Page 19, dated May 1996, should also be removed. (The filing instructions for Supplement 10—May 1999 should have stated to remove this page.)

Commercial Bank Examination Manual
Supplement 10—May 1999

Section 4030.1, Asset Securitization, has been revised to delete outdated material and clarify the treatment of certain student loan–backed securities.

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Commercial Bank Examination Manual
Supplement 9—November 1998

Section 3010.1, Borrowed Funds, was revised to incorporate various organizational and editorial changes. More significant changes include expanded discussion on appropriate and inappropriate uses of the discount window and the types of acceptable custody arrangements, and Reserve Banks' limits in their lending discretion to institutions that are undercapitalized or assigned a composite ''5'' CAMELS rating. The examination procedures (section 3010.3) have also been updated.

Section 3020.1, Assessment of Capital Adequacy, has been updated in serveral areas. Information on the market-risk measure, net unrealized holding gains (losses) on securities available for sale, credit-equivalent computations for derivative contracts, and capital treatment of credit derivatives has been added. The subsections of the intangible assets section on capital adjustments and assets sold with recourse were also revised.

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Commercial Bank Examination Manual
Supplement 8—May 1998

Section 4128.1, Private-Banking Activities, has been added. This new section provides an overview of private banking, describes the critical functions that constitute a private-banking operation, and outlines general guidelines that examiners can use when reviewing these activities at different types and sizes of institutions. Examination objectives for private banking are included as section 4128.2.

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Commercial Bank Examination Manual
Supplement 7—November 1997

Section 2020.1 was revised for this supplement. In addition to renaming the section ‘‘Investment Securities and End-User Activities,’’ the section includes information on the SEC’s new investment-type categories, revises the discussion of unsuitable investment practices, and removes material on structured notes and on zero-coupon and other original-issue discount products. Sections 2020.2, 2020.3, and 2020.4 have been reissued to reflect the name change.

In Section 4090.1, ‘‘Interest-Rate Risk Management,’’ the information on CAMELS ratings was revised to include the new market-risk component and explain the different ratings used.

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Commercial Bank Examination Manual
Supplement 6—May 1997

This supplement updated sections 6000.0 and A.5020.1 to incorporate recent revisions to the Uniform Financial Institutions Rating System. Technical revisions were made in several other sections to add the new component on sensitivity to market risk to the CAMEL (now CAMELS) rating system.

Section 6000.0, Instructions for the Report of Examination, includes a new Sensitivity to Market Risk report page and a discussion of the evaluation factors for this area. Additional changes revise or clarify examiner instructions for other report pages, including the Examination Conclusions and Comments, Asset Quality, Management/Administration, and Earnings pages.

Section A.5020.1, Overall Conclusions Regarding Condition of the Bank: Uniform Financial Institutions Rating System, has been revised to update the definitions of composite ratings and the descriptions and definitions for the six component ratings (capital adequacy, asset quality, management, earnings, liquidity, and sensitivity to market risk).

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Commercial Bank Examination Manual
Supplement 5—November 1996

Section 4090.1, Interest-Rate Risk, has been completely revised for this supplement. The updated section discusses the sources and effects of interest-rate risk, as well as examination considerations for assessing an institution's level of exposure. Examination Objectives, section 4090.2, have also been reissued.

The following sections were updated to reflect guidance contained in SR-letters issued earlier this year:

- Internal Control (section 1010.1)
- Bank Dealer Activities (section 2030.1)
- Deposit Accounts (section 3000.1)
- Payments System Risk and Electronic Funds Transfer Activities (section 4125.1)

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Commercial Bank Examination Manual
Supplement 4—May 1996

This supplement updates the following sections:

- Federal Reserve System Surveillance Program (section 1020.1). An item on the written-analysis requirement for exception-list banks has been added to the list of bank surveillance procedures in the subsection ‘‘Review of Bank Exception List and Reserve Bank Analysis.’’
- Cash Accounts (sections 2000.1 and 2000.2).
- Due from Banks (sections 2010.1 and 2010.2).
- Loan Portfolio Management (section 2040.1). The subsection ‘‘Loan Administration’’ has been expanded to include information on loan applications and approvals, account records, payments, credit files, and collateral.
- Concentrations of Credit (section 2050) replaces the former Concentration of Credits section. Sections 2050.1 and 2050.2 have been updated; sections 2050.3 and 2050.4 have been reissued to reflect the name change.
- Commercial and Industrial Loans (section 2080) replaces the former Commercial Loans section. Sections 2080.1 and 2080.2 have been updated; sections 2080.3 and 2080.4 have been reissued to reflect the name change.
- Real Estate Loans (section 2090.1). A subsection on home equity loans has been added.
- Floor-Plan Loans (sections 2110.1 and 2110.2).
- Direct Financing Leases (section 2120) replaces the former Direct Lease Financing section. Sections 2120.1 and 2120.2 have been revised; sections 2120.3 and 2120.4 have been reissued to reflect the name change.
- Consumer Credit (section 2130) consolidates material from three former sections: Installment Loans (section 2130), Check Credit (section 2140), and Credit Card Plans (section 2150). Sections 2130.1 and 2130.2 have been updated; sections 2130.3 and 2130.4 have been reissued to reflect the name change.
- Asset-Based Lending (section 2160) replaces the former Accounts Receivable Financing section. Sections 2160.1 and 2160.2 have been updated; sections 2160.3 and 2160.4 have been reissued to reflect the name change.
- Securities Broker and Dealer Loans (sections 2170.1 and 2170.2).
- Factoring (sections 2180.1 and 2180.2)
- Bank Premises and Equipment (sections 2190.1 and 2190.2)
- Borrowed Funds (sections 3010.1 and 3010.2).
- Analytical Review and Income and Expense (sections 4010.1 and 4010.2).
- Asset Securitization (sections 4030.1 and 4030.2).
- Management of Insurable Risks (section 4040) replaces the former Bank Insurance section. Sections 4040.1 and 4040.2 have been updated; sections 4040.3 and 4040.4 have been reissued to reflect the name change. The tables from section A.4040.1 have been added to the end of the updated section 4040.1.
- Bank-Related Organizations (sections 4050.1 and 4050.2).
- Computer Services (sections 4060.1 and 4060.2)
- Dividends (sections 4070.1 and 4070.2).
- Employee Benefit Trusts (sections 4080.1 and 4080.2).
- Litigation and Other Legal Matters; Examination-Related Subsequent Events (sections 4100.1 and 4100.2).
- Other Non-Ledger Control Accounts (sections 4120.1 and 4120.2).
- Payments System Risk and Electronic Funds Transfer Activities (section 4125.1). The subsection ‘‘Third-Party Access Arrangements’’ has been revised.
- Private Placements (sections 4130.1 and 4130.2).
- Review of Regulatory Reports (sections 4150.1 and 4150.2).
- Sale of Uninsured Nondeposit Debt Obligations on Bank Premises (sections 4160.1 and 4160.2).
- Retail Sales of Nondeposit Investment Products (section 4170) replaces the former Uninsured Annuities section. Sections 4170.1 and 4170.2 have been updated; section 4170.3 has been reissued to reflect the name change.
- Formal and Informal Corrective Actions (section 5040.1) replaces the former Formal Corrective Actions section.
- Other Types of Examinations (section 6010.1).
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  - — General Introduction (section 7000.1)
  - — Glossary (section 7010.1)
  - — Loan Portfolio Management (sections 7020.1 and 7020.2)
  - — Loans and Current Account Advances (sections 7030.1 and 7030.2)
  - — Transfer Risk (sections 7040.1 and 7040.2)

— Financing Foreign Receivables (sections 7050.1 and 7050.2)
— Banker's Acceptances (sections 7060.1 and 7060.2)
— Due from Banks—Time (sections 7070.1 and 7070.2)
— Letters of Credit (sections 7080.1 and 7080.2)
— Guarantees Issued (sections 7090.1 and 7090.2)

Two new sections have been added:

- Agricultural Loans (sections 2140.1 and 2140.2).
- Energy Lending—Production Loans (sections 2150.1 and 2150.2).

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Commercial Bank Examination Manual
Supplement 3—November 1995

This supplement updates the following sections:

- Federal Reserve System Surveillance Program (sections 1020.1 and 1020.2).
- Acquisition and Management of Nontrading Securities and Derivative Instruments (section 2020) replaces the former Investment Securities section. Sections 2020.1 and 2020.2 have been updated; sections 2020.3 and 2020.4 have been reissued to reflect the name change.
- Bank Dealer Activities (sections 2030.1 and 2030.2)
- Allowance for Loan and Lease Losses (sections 2070.1 and 2070.2)
- Other Real Estate Owned (section 2200.2). The effective date has been corrected.
- Deposit Accounts (section 3000.1). Information on pass-through deposit insurance was added to the Special Deposit-Related Issues subsection. Examination Objectives (section 3000.2) were reviewed and the effective date was updated.
- Assessment of Capital Adequacy (section 3020.1). The introduction was revised and information on deferred-tax assets was added to the Capital Adjustments subsection. The Overall Assessment of Capital Adequacy subsection was revised to include discussions of capital ratios, the impact of management, financial considerations, the adequacy of and compliance with capital-improvement plans, an inadequate allowance for loan and lease losses, ineligible collateral and guarantees, the market value of bank stock, subordinated debt in excess of limits, and unrealized asset values. A new subsection, De Novo Banks, was added. Examination Objectives (section 3020.2) were reviewed and the effective date was updated.
- Contingent Claims from Off-Balance-Sheet Credit Activities (section 4110.1) replaces the former Off-Balance-Sheet Activities section. Examination Objectives (section 4110.2) have also been issued.
- Real Estate Appraisals and Evaluations (section 4140.1). A new paragraph on real estate formerly pledged as collateral to secure an extension of credit acquired through foreclosure proceedings was added to the beginning of the Reappraisals and Reevaluations subsection. Examination Objectives (section 4140.2) were reviewed and the effective date was updated.
- Wire Transfer, section 4180, has been renamed and renumbered as Payments System Risk and Electronic Funds Transfer Activity, section 4125. Sections 4125.1 and 4125.2 have been updated; sections 4125.3 and 4125.4 have been reissued to reflect the name change. Material previously contained in appendix sections A.4180.1 and A.4180.2, Wire Transfer: Automated Funds Transfer Systems and Wire Transfer: Payments System Risk, has also been incorporated into the new section.
- Duties and Responsibilities of Directors (sections 5000.1 and 5000.2)
- Instructions for the Report of Examination (section 6000.1)
- Bank Insurance: Financial Institution Bond and Other Insurance Coverage (section A.4040.1)

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Commercial Bank Examination Manual
Supplement 2—May 1995

Supplement 2 (May 1995) to the *Commercial Bank Examination Manual* is attached. This supplement updates the following sections of the manual:

- Federal Reserve System Surveillance Program (section 1020.1)
- Loan Portfolio Management (section 2040.1)
- Other Real Estate Owned (section 2200.1)
- Meetings with Board of Directors (section 5030.1)

Changes were also made to the following sections:

- Commercial Loans: Examination Procedures (section 2080.3)
  A reference to section 3500.0, ''Tie-In Considerations of the BHC Act,'' of the *Bank Holding Company Supervision Manual* was added under step e. on page 4.

- Real Estate Construction Loans (section 2100.1)
  The last sentence and the first footnote in the partial paragraph at the top of page 3 were deleted. A new sentence on construction loans without permanent takeout commitments was added, and the footnotes on pages 4–11 were renumbered.

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Commercial Bank Examination Manual
Supplement 1—November 1994

Supplement 1 (November 1994) to the *Commercial Bank Examination Manual* is attached. This supplement updates the following sections of the manual:

- Internal Control (section 1010.1)
- Classification of Credits (section 2060.1)
- Real Estate Loans (section 2090.1)
- Assessment of Capital Adequacy (section 3020.1)
- Asset Securitization (section 4030.1)
- Real Estate Appraisals and Evaluations (section 4140.1)

A new section has been added:

- Prompt Corrective Action (section 4133.1 and 4133.2)

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Preface

The bank examination process is the Federal Reserve's fact-finding arm in discharging its regulatory and supervisory responsibilities. The essential objectives of an examination are (1) to provide an objective evaluation of a bank's soundness and compliance with banking laws and regulations, (2) to permit the Federal Reserve to appraise the quality of management and directors, and (3) to identify those areas where corrective action is required to strengthen the bank, improve the quality of its performance, and enable it to comply with applicable laws, rulings, and regulations.

To accomplish these objectives, the examiner should evaluate the prudency of the bank's practices, the bank's adherence to laws and regulations, the adequacy of the bank's liquidity and capital, the quality of the bank's assets and earnings, the nature of the bank's operations, and the adequacy of the bank's internal control and internal audit. The scope of an examination may cover every phase of banking activity, or it may concentrate on specific areas that deserve greater emphasis because of their potential effect on a bank's soundness.

ABOUT THIS MANUAL

The goal of the *Commercial Bank Examination Manual* is to organize and formalize longstanding examination objectives and procedures that provide guidance to the examiner, and to enhance the quality and consistent application of examination procedures. The manual provides specific guidelines for—

- determining the scope of an examination;
- determining the procedures to be used in examining all areas of a bank, including those procedures that may lead to the early detection of trends that, if continued, might result in a deterioration in the condition of a bank;
- evaluating the adequacy of the bank's written policies and procedures, the degree of compliance with them, and the adequacy of its internal controls;
- evaluating the work performed by internal and external auditors;
- evaluating the performance and activities of management and the board of directors;
- preparing workpapers that support examination reports and aid in evaluating the work performed; and
- using objective criteria as a basis for the overall conclusion, and for the resulting comments and criticism, regarding the condition and quality of the bank and its management.

The examiner-in-charge must properly plan and organize the examination before work begins. Initial decisions concerning examination scope can usually be made based on the nature of the bank's operations; its size; the past experience of the examiner-in-charge with the bank; information in the previous examination report, including the condition of the bank at that examination; communications with the bank between examinations; and analysis from the Uniform Bank Performance Report. The planning of work and preexamination procedures are covered in the Examination Planning section of this manual.

Examiners should view the manual as a working tool rather than as a reference manual. In most sections of the manual, examination procedures and internal control questionnaires are provided to form the basis for the examination of a bank. These procedures should lead to consistent and objective examinations of varying scopes. The bank's condition is disclosed by the performance of examination procedures, including review of internal controls and audit function, and the evaluation of the results therefrom, not by the examiner's judgment alone.

For larger banks, additional examination procedures need to be incorporated into the process to effectively examine those institutions' complex organizational reporting and accounting systems. Conversely, some of the procedures contained in this manual do not apply to smaller-sized banks. Additionally, state laws and local characteristics necessitate supplemental procedures. For example, specific procedures relating to various types of agricultural lending have not been developed in this manual. Similarly, state banking laws must be considered when applying the procedures to various areas, such as lending, capital adequacy, and pledging requirements. When modifying the procedures, the examiner-in-charge is responsible for determining that the examination objectives are met and that the examination meets the needs of the individual bank.

The manual is also intended to guide examiners in their efforts to encourage banks to develop written policies and related procedures in all areas where none exist, and to correct situations where there are deficiencies in or a lack of compliance with existing procedures. To aid the examiner, this manual includes topics such as loan portfolio management, investment portfolio management, asset and liability management, earnings analysis, capital analysis, and service area analysis. A section on the appraisal of bank management guides the examiner in assembling and evaluating information from all other manual sections and helps uncover inconsistencies in the application of bank policies among various management groups. Examiners should be able to increase the level of professionalism and the soundness of the banking system by encouraging all banks to follow the best practices that currently exist in the banking industry. In no case, however, should this approach discourage the development and implementation of conceptually sound and innovative practices by individual banks.

Although this manual is designed to provide guidance to the examiner in planning and conducting bank examinations, it should not be considered a legal reference. Questions concerning the applicability of and compliance with federal laws and regulations should be referred to appropriate legal counsel. In addition, the manual should not be viewed as a comprehensive training guide. Separate training programs provide more detailed instructions to assist the examiner in better understanding banking operations and applying examination procedures.

HOW TO USE THIS MANUAL

Organization

The *Commercial Bank Examination Manual* is divided into nine major parts, each set off by a divider tab:

- Part 1000—Examination Planning
- Part 2000—Assets
- Part 3000—Liabilities and Capital
- Part 4000—Other Examination Areas
- Part 5000—Assessment of the Bank
- Part 6000—Federal Reserve Examinations
- Part 7000—International
- Part 8000—Statutes and Regulations
- Appendix

Sections in each part are made up of four subsections, where applicable. They are—

- an overview
- examination objectives
- examination procedures
- internal control questionnaire

The overviews, for the most part, summarize the respective topics. This information is expanded on and reinforced through the Federal Reserve's educational programs and the examiner's experience on the job.

The examination objectives describe the goals that should be of primary interest to the examiner. Two of the objectives determine the scope of the examination for the specific area of examination interest. They are (1) the evaluation of the system of internal control and of bank policies, practices, and procedures, and (2) the evaluation of the scope and adequacy of the audit function. Other common objectives are to determine compliance with laws, regulations, and rulings, and to determine the need for corrective action.

The examination procedures include procedures to be performed during a full-scope, comprehensive examination. In some instances not all of the procedures apply to all banks; examiners may exercise some flexibility depending on the particular characteristics of the bank under examination. The materiality and significance of a given area of bank operations are the examiner's primary considerations in deciding the scope of the examination and the procedures to be performed. Examiner flexibility results in examinations tailored to fit the operations of the bank.

The evaluation of a bank's internal control environment should encompass a review of the internal audit activities and the implementation of selected internal control questionnaires (ICQs), which set forth standards for operational control. Due to the difference between an examination and an audit, it is not contemplated that all ICQs will be implemented in any one examination. The body of ICQs used during the course of the examination should be made up of three elements: (1) those mandated for all examinations, (2) those selected by the examiner-in-charge based upon experience, knowledge of problems within the bank, and perception of risk, and (3) those that focus on areas where on-site evaluation of operational control appears warranted in light of the results of the examination of internal audit activities. In addition to serving as a guide during on-site evaluations, the ICQs can be used in the appraisal of operational audit techniques in banks where the scope of internal auditing includes such considerations. The ICQ steps marked with an asterisk require substantiation by observation or testing; they are considered to be fundamental to any control program regardless of the size of the institution. These steps should be incorporated in management control programs in smaller banks to compensate for the absence of internal auditing.

Following the main parts are a listing of statutes and regulations administered by the Federal Reserve and an appendix that includes various forms, checklists, statements, and guidelines, which provide the examiner with additional information regarding certain topics.

Numbering System

The manual is arranged using a numbering system based on the manual's sections and subsections. For example, the overview subsection of the Internal Control section is numbered 1010.1. 1010 is the section number for Internal Control, and .1 is the number for the overview. The examination objectives subsection for that section is numbered 1010.2, and so on. Subsections are always numbered consecutively regardless of the number of subsections within a particular section.

The appendix sections begin with the letter A, followed by the number of the section to which the item relates. For example, the Supplement on Internal Auditing for the Internal Control section is numbered A.1010.1. Should the Internal Control section have more than one appendix item, the numbering would appear as A.1010.1, A.1010.2, etc.

Updates

Beginning with the March 1994 reprint of the *Commercial Bank Examination Manual*, all manual pages are dated March 1994. Succeeding updates will be dated the month and year in which they are issued. There is an effective date at the top of the first page of each subsection that shows the last time that subsection was updated.

The manual is usually updated in the spring and fall of each year; special supplements are issued as needed. On the back of the title page is a checklist so you can record when an update has been filed. For this manual to be most useful, it is essential that updated pages be filed as soon as possible. If you have any questions about receiving updates, please contact Publications Services, Mail Stop 127, Board of Governors of the Federal Reserve System, Washington, D.C. 20551; 202-452-3244.

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EXAMINATION-FREQUENCY GUIDELINES FOR STATE MEMBER BANKS

The Federal Reserve is required to conduct a full-scope, on-site examination of every insured member bank at least once during each 12-month period, with the exception that certain small institutions can be examined once during each 18-month period. The 18-month examination period can be applied to those banks that—

- have total assets of $250 million or less;
- are well capitalized;
- were found to be well managed at the most recent Federal Reserve examination;
- were determined to be in outstanding or good condition at the most recent Federal Reserve examination; that is, they received a composite rating of 1 or 2 under the Uniform Financial Institutions Rating System;
- are not subject to a formal enforcement proceeding or action; and
- have not had a change in control during the preceding 12-month period in which a full-scope, on-site examination would have been required but for the above exceptions.

The exceptions do not limit the authority of the Federal Reserve to examine any insured member bank as frequently as deemed necessary. (See SR-97-8.) The examination frequency is also affected by the alternate-year examination program. Banks that are excluded from this program are those institutions that are $10 billion or greater in size and rated a composite 3 or worse, and de novo banks until they are rated 1 or 2 for two consecutive examinations after they have commenced operations. Also, a bank that undergoes a change in control must be examined by the Federal Reserve within 12 months of the change in control. Under the alternate-examination program, those banks that qualify are examined in alternate examination cycles by the Reserve Bank and the state. Thus, a particular bank would be examined by the Reserve Bank in one examination cycle, the state in the next, and so on. Any bank may be removed from the program and examined at any time by either agency, and either agency can meet with a bank's management or board of directors or initiate supervisory action whenever deemed necessary.

EXAMINATION OF INSURED DEPOSITORY INSTITUTIONS BEFORE THEY BECOME OR MERGE INTO STATE MEMBER BANKS

Premembership examinations of state nonmember banks, national banks, and savings associations seeking to convert to state-membership status will not be required if the bank or savings association seeking membership meets the criteria for ‘‘eligible bank,’’ as defined in section 208.2(e) of Regulation H.[1] Additionally, examinations of state nonmember banks, national banks, and savings associations seeking to merge into a state member bank will not be required so long as the state member bank, on an existing and pro forma basis, meets the criteria for eligible bank.

For those institutions not subject to a premembership or premerger examination, risk assessments and supervisory strategies should be completed no later than 30 days after the conversion or merger. To the extent issues or concerns arise, targeted or, if warranted, full-scope examinations of the converted or merged institution should be conducted as soon as possible after the conversion or merger. For a state member bank that was formerly a savings asso-

1. ‘‘Eligible bank’’ is defined to mean a member bank that (1) is well capitalized; (2) has a composite CAMELS rating of 1 or 2; (3) has a CRA rating of outstanding or satisfactory; (4) has a rating of 1 or 2 as of its most recent consumer compliance examination; and (5) has no major unresolved supervisory issues outstanding, as determined by the Board or appropriate Federal Reserve Bank in its discretion. A major unresolved supervisory issue could also arise from significant trust or fiduciary activities that are found to be conducted in a less-than-satisfactory manner.

If a bank has not yet received compliance or CRA ratings from a bank regulatory authority, the Federal Reserve Board will look to the bank's holding company to determine whether the bank's application should receive expedited processing. If the bank's holding company meets the criteria for expedited processing under section 225.14(c) of Regulation Y, the bank's membership or branch application will be eligible for expedited processing. Banks that (1) have not yet received compliance or CRA ratings and (2) either are not owned by a bank holding company or are owned by a bank holding company that does not meet the criteria for expedited processing are not eligible for expedited treatment.

ciation or that acquired a savings association, the risk assessment and supervisory strategy should pay particular attention to activities conducted by a service corporation subsidiary that may not be permissible activities for a state member bank.

Premembership or premerger examinations should generally be conducted for an insured depository institution that does not meet the criteria for eligible bank. Consistent with a risk-focused approach, these examinations can be targeted, as appropriate, to the identified area (or areas) of weakness. The Reserve Bank may, in its discretion, waive the examination requirement if it is determined that conducting an examination would be (1) inconsistent with a risk-focused approach or (2) unlikely to provide information that would assist materially in evaluating the statutory and regulatory factors that the Federal Reserve is required to consider in acting on the membership or merger application.[2] If an examination is waived, the Reserve Bank should prepare and maintain documentation supporting its decision.

In all circumstances, each Reserve Bank is responsible for ensuring that the examination-frequency time frames established by Federal Reserve policy and section 111 of the Federal Deposit Insurance Corporation Improvement Act (FDICIA) are adhered to. When the statutory deadline for an examination of a depository institution seeking membership is approaching or has passed, a Federal Reserve examination of the institution should be conducted as soon as practicable after the institution becomes a state member bank. (See SR-98-28.)

OBJECTIVES OF THE SUPERVISORY PROCESS

The Federal Reserve is committed to ensuring that the supervisory process for all institutions under its purview meets the following objectives:

- *Provides flexible and responsive supervision.* The supervisory process is dynamic and forward looking, so it responds to technological advances, product innovation, and new risk-management systems and techniques, as well as to changes in the condition of an individual financial institution and to market developments.
- *Fosters consistency, coordination, and communication among the appropriate supervisors.* Seamless supervision, which reduces regulatory burden and duplication, is promoted. The supervisory process uses examiner resources effectively by using the institution's internal and external risk-assessment and -monitoring systems; making appropriate use of joint and alternating examinations; and tailoring supervisory activities to an institution's condition, risk profile, and unique characteristics.
- *Promotes the safety and soundness of financial institutions.* The supervisory process effectively evaluates the safety and soundness of banking institutions, including the assessment of risk-management systems, financial condition, and compliance with laws and regulations.
- *Provides a comprehensive assessment of the institution.* The supervisory process integrates specialty areas (for example, information technology systems, trust, capital markets, and consumer compliance) and functional risk assessments and reviews, in cooperation with interested supervisors, into a comprehensive assessment of the institution.

RISK-FOCUSED EXAMINATIONS

Historically, examinations relied significantly on transaction-testing procedures when assessing a bank's condition and verifying its adherence to internal policies, procedures, and controls. In a highly dynamic banking market, however, transaction testing by itself is not sufficient for ensuring the continued safe and sound operation of a banking organization. Evolving financial instruments and markets have enabled banking organizations to rapidly reposition their portfolio risk exposures. Therefore, periodic assessments of the condition of a financial institution based on transaction testing alone cannot keep pace with the moment-to-moment changes occurring in financial risk profiles.

2. Since membership in the Federal Reserve System does not confer deposit insurance, the membership applications do not include the requirements of the Community Reinvestment Act (CRA). Nevertheless, a less-than-satisfactory CRA rating, especially if it reflects a chronic record of weak CRA performance, would presumably reflect poorly upon the abilities of the institution's management. Consequently, a determination whether or not to conduct a premembership CRA examination should be based on a risk-focused assessment of the issues involved, with an institution's CRA performance being only one of the factors considered from a risk-focused perspective.

To ensure that institutions have in place the processes necessary to identify, measure, monitor, and control risk exposures, examinations have increasingly emphasized evaluating the appropriateness of these processes, evolving away from a high degree of transaction testing. Under a risk-focused examination approach, the degree of transaction testing should be reduced when internal risk-management processes are determined to be adequate or when risks are minimal. However, when risk-management processes or internal controls are considered inappropriate, such as by an inadequate segregation of duties or when on-site testing determines processes to be lacking, additional transaction testing must be performed. Testing should be sufficient to fully assess the degree of risk exposure in a particular function or activity. In addition, if an examiner believes that a banking organization's management is being less than candid, has provided false or misleading information, or has omitted material information, then substantial on-site transaction testing should be performed.

Compliance with Laws and Regulations

Compliance with relevant laws and regulations should be assessed at every examination. The steps taken to complete these assessments will vary depending on the circumstances of the institution subject to review. When an institution has a history of satisfactory compliance with relevant laws and regulations or has an effective compliance function, only a relatively limited degree of transaction testing need be conducted to assess compliance. At institutions with a less satisfactory compliance record or that lack a compliance function, more extensive review will be necessary.

Changes in the General Character of a Bank's Business

In conjunction with assessing overall compliance with relevant laws and regulations, examiners should review for compliance with the requirements of Regulation H. Regulation H sets forth the requirements for membership of state-chartered banks in the Federal Reserve System and imposes certain conditions of membership on applicant banks. Under the regulation, a member bank must ''at all times conduct its business and exercise its powers with due regard to safety and soundness'' and ''may not, without the permission of the Board, cause or permit any change in the general character of its business or in the scope of the corporate powers it exercises at the time of admission to membership.'' (See SR-02-9 and section 208.3(d)(1) and (2) of Regulation H (12 CFR 208.3(d)(1) and (2)).)

State member banks must receive the prior approval of the Board before making any significant change in business plans. The trend toward more diverse; more complex; and, at times, riskier activities at some banks has raised the importance of this prior-approval requirement.

Changes in the general character of a bank's business would include, for example, becoming a primarily Internet-focused or Internet-only operation, or concentrating solely on subprime-lending or leasing activities. Depending on how they are conducted and managed, these activities can present novel risks for banking organizations, and may also present risks to the deposit insurance fund. In many cases, these activities involve aggressive growth plans and may give rise to significant financial, managerial, and other supervisory issues.

In applications for membership in the Federal Reserve System, careful consideration is given to a bank's proposed business plan to ensure, at a minimum, that appropriate financial and managerial standards are met. Likewise, the other federal banking agencies consider a bank's business plan when they review applications for federal deposit insurance, in the case of the Federal Deposit Insurance Corporation (FDIC), or applications for a national bank or federal thrift charter, in the case of the Office of the Comptroller of the Currency (OCC) or Office of Thrift Supervision (OTS). The OCC, FDIC, and OTS have been conditioning their approvals of applications for a requirement that, during the first three years of operations, the bank or thrift provides prior notice or obtains prior approval of any proposed significant deviations or changes from its original operating plan. Rather than use similar commitments, the Federal Reserve has relied on the provisions of Regulation H to address situations in which a state member bank proposes to materially change its core business plan.

Federal Reserve supervisors will be monitoring changes in the general character of a state member bank's business as part of the Federal Reserve's normal supervisory process to ensure compliance with the requirements of Regulation H and with safe and sound banking practices. This review should be conducted at least annually by the Reserve Bank. A significant change in a bank's business plan without the Board's prior approval would be considered a violation of Regulation H and would be addressed through follow-up supervisory action.

Branches

When reviewing domestic-branch applications, the guidelines in section 208.6(b) of Regulation H are followed. The Board reviews the financial condition and management of the applying bank, the adequacy of the bank's capital and its future earning prospects, the convenience and needs of the community to be served, CRA and Regulation BB performance for those branches that will be accepting deposits, and whether the bank's investment in premises for the branch is consistent with section 208.21 of Regulation H. A state member bank that desires to establish a new branch facility may be eligible for expedited processing of its application by the Reserve Bank if it is an eligible bank, as defined in section 208.2(e) of Regulation H.

A member bank may also choose to submit an application that encompasses multiple branches that it proposes to establish within one year of the approval date. Unless notification is waived, the bank must notify the appropriate Reserve Bank within 30 days of opening any branch approved under a consolidated application. Although banks are not required to open an approved branch, approvals remain valid for one year. During this period, the Board or appropriate Reserve Bank may notify the bank that in its judgment, based on reports of condition, examinations, or other information, there has been a change in the bank's condition, financial or otherwise, that warrants reconsideration of the approval. (See Regulation H, section 208.6(d).)

Insured depository institutions that intend to close branches must comply with the requirements detailed in section 42 of the Federal Deposit Insurance Act (FDI Act) (12 USC 1831r-1). Section 42(e) requires that banks provide 90 days' notice to both customers and, in the case of insured state member banks, the Federal Reserve Board, before the date of the proposed branch closings. The notice must include a detailed statement of the reasons for the decision to close the branch and statistical and other information in support of those stated reasons. A similar notice to customers must be posted in a conspicuous manner on the premises of the branch to be closed, at least 30 days before the proposed closing. There are additional notice, meeting, and consultation requirements for proposed branch closings by interstate banks in low- or moderate-income areas. Finally, the law requires each insured depository institution to adopt policies for branch closings. (See the revised joint policy statement concerning insured depository institutions' branch-closing notices and policies, effective June 29, 1999,[2a] at *Federal Reserve Regulatory Service* 3–1503.5.) Examiners and supervisors need to be mindful of the section 42 statutory requirements and this joint policy.

Section 208.6(f) of Regulation H states that a branch relocation, defined as a movement that occurs within the immediate neighborhood and does not substantially affect the nature of the branch's business or customers served, is not considered a branch closing. Section 208.2(c)(2)(ii) of Regulation H states (in one of six exclusions) that a branch does not include an office of an affiliated or unaffiliated institution that provides services to customers of the member bank on behalf of the member bank, so long as the institution is not "established or operated" by the bank. For example, a bank could contract with an unaffiliated or affiliated institution to receive deposits; cash and issue checks, drafts, and money orders; change money; and receive payments of existing indebtedness without becoming a branch of that bank. The bank could also (1) have no ownership or leasehold interest in the institution's offices, (2) have no employees who work for the institution, and (3) not exercise any authority or control over the institution's employees or methods of operation.

Section 109 of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (the Interstate Act) (12 USC 1835a) prohibits any bank from establishing or acquiring a branch or branches outside of its home state primarily for the purpose of deposit production. In 1997, the banking agencies published a joint final rule implementing section 109. (See 62 *Fed. Reg.* 47728 (September 10, 1997).) Section 106 of

2a. See also 64 *Fed. Reg.* 34844.

the Gramm-Leach-Bliley Act of 1999 expanded the coverage of section 109 of the Interstate Act to include any branch of a bank controlled by an out-of-state bank holding company. On June 6, 2002, the Board and the other banking agencies published an amendment to their joint final rule (effective October 1, 2002) to conform the uniform rule to section 109. (See 67 *Fed. Reg.* 38844.) The amendment expands the regulatory prohibition against interstate branches being used as deposit-production offices to include any bank or branch of a bank controlled by an out-of-state bank holding company, including a bank consisting only of a main office. (See Regulation H, section 208.7(b)(2).)

Section 109 sets forth a process to test compliance with the statutory requirements. First, a bank's statewide loan-to-deposit ratio[2b] is compared with the host-state loan-to-deposit ratio[2c] for banks in a particular state. If the bank's statewide loan-to-deposit ratio is at least one-half of the published host-state loan-to-deposit ratio, then it has complied with section 109. A second step is conducted if a bank's statewide loan-to-deposit ratio is less than one-half of the published ratio for that state or if data are not available at the bank to conduct the first step. The second step involves determining whether the bank is reasonably helping to meet the credit needs of the communities served by its interstate branches. If a bank fails both of these steps, it has violated section 109 and is subject to sanctions.

RISK-MANAGEMENT PROCESSES AND INTERNAL CONTROLS

The Federal Reserve has always placed significant supervisory emphasis on the adequacy of an institution's management of risk, including its system of internal controls, when assessing the condition of an organization. An institution's failure to establish a management structure that adequately identifies, measures, monitors, and controls the risks involved in its various products and lines of business has long been considered unsafe and unsound conduct. Principles of sound management should apply to the entire spectrum of risks facing a banking institution, including, but not limited to, credit, market, liquidity, operational, legal, and reputational risk. (See SR-97-24 and SR-97-25.)

- *Credit risk* arises from the potential that a borrower or counterparty will fail to perform on an obligation.
- *Market risk* is the risk to a financial institution's condition resulting from adverse movements in market rates or prices, such as interest rates, foreign-exchange rates, or equity prices.
- *Liquidity risk* is the potential that an institution will be unable to meet its obligations as they come due because of an inability to liquidate assets or obtain adequate funding (referred to as ''funding-liquidity risk''), or the potential that the institution cannot easily unwind or offset specific exposures without significantly lowering market prices because of inadequate market depth or market disruptions (referred to as ''market-liquidity risk'').
- *Operational risk* arises from the potential that inadequate information systems, operational problems, breaches in internal controls, fraud, or unforeseen catastrophes will result in unexpected losses.
- *Legal risk* arises from the potential that unenforceable contracts, lawsuits, or adverse judgments can disrupt or otherwise negatively affect the operations or condition of a banking organization.
- *Reputational risk* is the potential that negative publicity regarding an institution's business practices, whether true or not, will cause a decline in the customer base, costly litigation, or revenue reductions.

In practice, an institution's business activities present various combinations and concentrations of these risks depending on the nature and scope of the particular activity. The following discussion provides guidelines for determining the quality of bank management's formal or informal systems for identifying, measuring, and containing these risks.

Elements of Risk Management

When evaluating the quality of risk management as part of the evaluation of the overall quality of

2b. The statewide loan-to-deposit ratio relates to an individual bank and is the ratio of a bank's loans to its deposits in a particular state where the bank has interstate branches.

2c. The host-state loan-to-deposit ratio is the ratio of total loans in a state to total deposits from the state for all banks that have that state as their home state. For state-chartered banks, the home state is the state where the bank was chartered.

management, examiners should consider findings relating to the following elements of a sound risk-management system:

- active board and senior management oversight
- adequate policies, procedures, and limits
- adequate risk-measurement, -monitoring, and management information systems
- comprehensive internal controls

Adequate risk-management programs can vary considerably in sophistication, depending on the size and complexity of the banking organization and the level of risk that it accepts. For smaller institutions engaged solely in traditional banking activities and whose senior managers and directors are actively involved in the details of day-to-day operations, relatively basic risk-management systems may be adequate. However, large, multinational organizations will require far more elaborate and formal risk-management systems to address their broader and typically more complex range of financial activities, and to provide senior managers and directors with the information they need to monitor and direct day-to-day activities. In addition to the banking organization's market and credit risks, risk-management systems should encompass the organization's trust and fiduciary activities, including investment advisory services, mutual funds, and securities lending.

Active Board and Senior Management Oversight

When assessing the quality of the oversight by boards of directors and senior management, examiners should consider whether the institution follows policies and practices such as those described below:

- The board and senior management have identified and have a clear understanding and working knowledge of the types of risks inherent in the institution's activities, and they make appropriate efforts to remain informed about these risks as financial markets, risk-management practices, and the institution's activities evolve.
- The board has reviewed and approved appropriate policies to limit risks inherent in the institution's lending, investing, trading, trust, fiduciary, and other significant activities or products.
- The board and management are sufficiently familiar with and are using adequate record-keeping and reporting systems to measure and monitor the major sources of risk to the organization.
- The board periodically reviews and approves risk-exposure limits to conform with any changes in the institution's strategies, reviews new products, and reacts to changes in market conditions.
- Management ensures that its lines of business are managed and staffed by personnel whose knowledge, experience, and expertise is consistent with the nature and scope of the banking organization's activities.
- Management ensures that the depth of staff resources is sufficient to operate and soundly manage the institution's activities, and ensures that employees have the integrity, ethical values, and competence that are consistent with a prudent management philosophy and operating style.
- Management at all levels provides adequate supervision of the day-to-day activities of officers and employees, including management supervision of senior officers or heads of business lines.
- Management is able to respond to risks that may arise from changes in the competitive environment or from innovations in markets in which the organization is active.
- Before embarking on new activities or introducing new products, management identifies and reviews all risks associated with the activities or products and ensures that the infrastructure and internal controls necessary to manage the related risks are in place.

Adequate Policies, Procedures, and Limits

Examiners should consider the following when evaluating the adequacy of a banking organization's policies, procedures, and limits:

- The institution's policies, procedures, and limits provide for adequate identification, measurement, monitoring, and control of the risks posed by its lending, investing, trading, trust, fiduciary, and other significant activities.
- The policies, procedures, and limits are consistent with management's experience level, the institution's stated goals and objectives, and the overall financial strength of the organization.

- Policies clearly delineate accountability and lines of authority across the institution's activities.
- Policies provide for the review of new activities to ensure that the financial institution has the necessary infrastructures to identify, monitor, and control risks associated with an activity before it is initiated.

Adequate Risk Monitoring and Management Information Systems

When assessing the adequacy of an institution's risk measurement and monitoring, as well as its management reports and information systems, examiners should consider whether these conditions exist:

- The institution's risk-monitoring practices and reports address all of its material risks.
- Key assumptions, data sources, and procedures used in measuring and monitoring risk are appropriate and adequately documented, and are tested for reliability on an ongoing basis.
- Reports and other forms of communication are consistent with the banking organization's activities; are structured to monitor exposures and compliance with established limits, goals, or objectives; and, as appropriate, compare actual versus expected performance.
- Reports to management or to the institution's directors are accurate and timely, and contain sufficient information for decision makers to identify any adverse trends and to evaluate adequately the level of risk faced by the institution.

Adequate Internal Controls

When evaluating the adequacy of a financial institution's internal controls and audit procedures, examiners should consider whether these conditions are met:

- The system of internal controls is appropriate to the type and level of risks posed by the nature and scope of the organization's activities.
- The institution's organizational structure establishes clear lines of authority and responsibility for monitoring adherence to policies, procedures, and limits.
- Reporting lines for the control areas are independent from the business lines, and there is adequate separation of duties throughout the organization—such as duties relating to trading, custodial, and back-office activities.
- Official organizational structures reflect actual operating practices.
- Financial, operational, and regulatory reports are reliable, accurate, and timely, and, when applicable, exceptions are noted and promptly investigated.
- Adequate procedures exist for ensuring compliance with applicable laws and regulations.
- Internal audit or other control-review practices provide for independence and objectivity.
- Internal controls and information systems are adequately tested and reviewed. The coverage of, procedures for, and findings and responses to audits and review tests are adequately documented. Identified material weaknesses are given appropriate and timely high-level attention, and management's actions to address material weaknesses are objectively verified and reviewed.
- The institution's audit committee or board of directors reviews the effectiveness of internal audits and other control-review activities regularly.

RISK-FOCUSED SUPERVISION OF COMMUNITY BANKS

Understanding the Bank

The risk-focused supervision process for community banks involves a continuous assessment of the bank, which leads to an understanding of the bank that enables examiners to tailor their examination to the bank's risk profile. In addition to examination reports and correspondence files, each Reserve Bank maintains various surveillance reports that identify outliers when a bank is compared to its peer group. Review of this information helps examiners identify a bank's strengths and vulnerabilities, and is the foundation for determining the examination activities to be conducted.

Contact with the organization is encouraged to improve the examiners' understanding of the institution and the market in which it operates. A pre-examination interview or visit should be conducted as a part of each examination. This meeting gives examiners the opportunity to learn about any changes in bank management and changes to the bank's policies, strategic direction, management information systems, and other activities. During this meeing, particular emphasis should be placed on learning about the bank's new products or new markets it may have entered. The pre-examination interview or visit also provides examiners with (1) management's view of local economic conditions,

(2) an understanding of the bank's regulatory compliance practices, and (3) its management information systems and internal and/or external audit function. In addition, Reserve Banks should contact the state banking regulator to determine whether it has any special areas of concern that examiners should focus on.

Reliance on Internal Risk Assessments

As previously discussed in the subsection ''Risk-Management Processes and Internal Controls,'' the entire spectrum of risks facing an institution should be considered when assessing a bank's risk portfolio. Internal audit, loan-review, and compliance functions are integral to a bank's own assessment of its risk profile. If applicable, it may be beneficial to discuss with the bank's external auditor the results of its most recent audit for the bank. Such a discussion gives the examiner the opportunity to review the external auditor's frequency, scope, and reliance on internal audit findings. Examiners should consider the adequacy of these functions in determining the risk profile of the bank, and be alert to opportunities to reduce regulatory burden by testing rather than duplicating the work of internal and external audit functions. See the subsection ''Risk-Focused Examinations'' for a discussion on transaction testing.

Preparation of a Scope Memorandum

An integral product in the risk-focused methodology, the scope memorandum identifies the central objectives of the examination. The memorandum also ensures that the examination strategy is communicated to appropriate examination staff, which is of key importance, as the scope will likely vary from examination to examination. Examination procedures should be tailored to the characteristics of each bank, keeping in mind its size, complexity, and risk profile. Procedures should be completed to the degree necessary to determine whether the bank's management understands and adequately controls the levels and types of risk that are assumed. In addition, the scope memorandum should address the general banking environment, economic conditions, and any changes foreseen by bank management that could affect the bank's condition. Some of the key factors that should be addressed in the scope memorandum are described below.

Preliminary Risk Assessment

A summary of the risks associated with the bank's activities should be based on a review of all available sources of information on the bank, including, but not limited to, prior examination reports, surveillance reports, correspondence files, and audit reports. The scope memorandum should include a preliminary assessment of the bank's condition and major risk areas that will be evaluated through the examination process. For detailed discussion of risk assessments and risk matrices, see the subsection ''Risk-Focused Supervision of Large, Complex Institutions.''

Summary of Pre-Examination Meeting

The results of the pre-examination meeting should be summarized. Meeting results that affect examination coverage should be emphasized.

Summary of Audit and Internal Control Environment

A summary of the scope and adequacy of the audit environment should be prepared, which may result in a modification of the examination procedures initially expected to be performed. Activities that receive sufficient coverage by the bank's audit system can be tested through the examination process. Certain examination procedures could be eliminated if their audit and internal control areas are deemed satisfactory.

Summary of Examination Procedures

As discussed below, examination modules have been developed for the significant areas reviewed during an examination. The modules are categorized as primary or supplemental. The primary modules must be included in each examination. However, procedures within the primary modules can be eliminated or enhanced based on the risk assessment or the adequacy of the audit and internal control environment. The scope memorandum should specifically detail the areas within each module to be emphasized during the examination process. In addition, any supplemental modules used should be discussed.

Summary of Loan Review

Based on the preliminary risk assessment, the anticipated loan coverage should be detailed in the scope memorandum. In addition to stating the percentage of commercial and commercial real estate loans to be reviewed, the scope memorandum should identify which specialty loan reference modules of the general loan module are to be completed. The memorandum should specify activities within the general loan module to be reviewed, as well as the depth of any specialty reviews.

Job Staffing

The staffing for the examination should be detailed. Particular emphasis should be placed on ensuring that appropriate personnel are assigned to the high-risk areas identified in the bank's risk assessment.

Examination Modules

Standardized electronic community bank examination modules have been developed and designed to define common objectives for the review of important activities within institutions and to assist in the documentation of examination work. It is expected that full-scope examinations will use these modules.

The modules establish a three-tiered approach for the review of a bank's activities: the first tier is the core analysis, the second tier is the expanded review, and the final tier is the impact analysis. The core analysis includes a number of decision factors which should be considered collectively, as well as individually, when evaluating the potential risk to the bank. To help the examiner determine whether risks are adequately managed, the core analysis section contains a list of procedures that may be considered for implementation. Once the relevant procedures are performed, the examiner should document conclusions in the core analysis decision factors. When significant deficiencies or weaknesses are noted in the core analysis review, the examiner is required to complete the expanded analysis for those decision factors that present the greatest degree of risk for the bank. On the other hand, if the risks are properly managed, the examiner can conclude the review.

The expanded analysis provides guidance for determining if weaknesses are material to the bank's condition and if they are adequately managed. If the risks are material or inadequately managed, the examiner is directed to perform an impact analysis to assess the financial impact to the bank and whether any enforcement action is necessary.

The use of the modules should be tailored to the characteristics of each bank based on its size, complexity, and risk profile. As a result, the extent to which each module should be completed will vary from bank to bank. The individual procedures presented for each level are meant only to serve as a guide for answering the decision factors. Not every procedure requires an individual response, and not every procedure may be applicable at every community bank. Examiners should continue to use their discretion when excluding any items as unnecessary in their evaluation of decision factors.

RISK-FOCUSED SUPERVISION OF LARGE, COMPLEX INSTITUTIONS

The Federal Reserve recognizes a difference in the supervisory requirements for community banks and large, complex banking organizations (LCBOs). The complexity of financial products, sophistication of risk-management systems (including audit and internal controls), management structure, and geographic dispersion of operations are but a few of the areas in which large institutions may be distinguished from community banks. While close coordination with state banking departments, the Office of the Comptroller of the Currency (OCC), and the Federal Deposit Insurance Corporation (FDIC) is important for fostering consistency among banking supervisors and reducing the regulatory burden for community banks, it is critical for large, complex banking organizations.

The examination approaches for both large, complex institutions and community banks are risk-focused processes that rely on an understanding of the institution, the performance of risk assessments, development of a supervisory plan, and examination procedures tailored to the risk profile. However, the two approaches are implemented differently: the process for complex institutions relies more heavily on a central point of contact and detailed risk assessments and supervisory plans before the on-site examination or inspection. In comparison, for small or noncomplex institutions and community banks, risk assessments and examination activities may be adequately described in the scope memorandum.

Key Elements

To meet the supervisory objectives discussed previously and to respond to the characteristics of large institutions, the framework for risk-focused supervision of large, complex institutions contains the following key elements:

- *Designation of a central point of contact.* Large institutions typically have operations in several jurisdictions, multiple charters, and diverse product lines. Consequently, the supervisory program requires that a ‘‘central point of contact’’ be designated for each institution to facilitate coordination and communication among the numerous regulators and specialty areas.
- *Review of functional activities.* Large institutions are generally structured along business lines or functions, and some activities are managed on a centralized basis. As a result, a single type of risk may cross several legal entities. Therefore, the supervisory program incorporates assessments along functional lines to evaluate risk exposure and its impact on safety and soundness. These functional reviews will be integrated into the risk assessments for specific legal entities and used to support the supervisory ratings for individual legal entities.[3]
- *Focus on risk-management processes.* Large institutions generally have highly developed risk-management systems, such as internal audit, loan review, and compliance. The supervisory program emphasizes each institution’s responsibility to be the principal source for detecting and deterring abusive and unsound practices through adequate internal controls and operating procedures. The program incorporates an approach that focuses on and evaluates the institution’s risk-management systems, yet retains transaction testing and supervisory rating systems such as CAMELS, BOPEC, and ROCA. This diagnostic perspective is more dynamic and forward looking because it provides insight into how effectively an institution is managing its operations and how well it is positioned to meet future business challenges.
- *Tailoring of supervisory activities.* Large institutions are unique, but all possess the ability to quickly change their risk profiles. To deliver effective supervision, the supervisory program incorporates an approach that tailors supervisory activities to the risk profile of an institution. By concentrating on an institution’s major risk areas, examiners can achieve a more relevant and penetrating understanding of the institution’s condition.
- *Emphasis on ongoing supervision.* Large institutions face a rapidly changing environment. Therefore, the supervisory program emphasizes ongoing supervision through increased planning and off-site monitoring. Ongoing supervision allows for timely adjustments to the supervisory strategy as conditions change within the institution and economy.

Covered Institutions

For purposes of the risk-focused supervision framework, large, complex institutions generally have (1) a functional management structure, (2) a broad array of products, (3) operations that span multiple supervisory jurisdictions, and (4) consolidated assets of $1 billion or more.[4] These institutions may be state member banks, bank holding companies (including their nonbank and foreign subsidiaries), and branches and agencies of foreign banking organizations. However, if an institution with consolidated assets totaling $1 billion or more does not have these characteristics, the supervisory process adopted for community banks may be more appropriate. Conversely, the complex-institution process may be appropriate for some organiza-

3. When functions are located entirely in legal entities that are not primarily supervised by the Federal Reserve, the results of supervisory activities conducted by the primary regulator will be used to the extent possible to avoid duplication of activities.

4. Large institutions are defined differently in other regulatory guidance for regulatory reports and examination mandates.

tions with consolidated assets less than $1 billion.

Nonbank subsidiaries of large, complex domestic institutions are covered by the supervisory program. These institutions include nonbank subsidiaries of the parent bank holding company and those of the subsidiary state member banks; the significant branch operations, primarily foreign branches, of state member banks; and subsidiary foreign banks of the holding company. The level of supervisory activity to be conducted for nonbank subsidiaries and foreign branches and subsidiaries of domestic institutions should be based on their individual risk levels relative to the consolidated organization or the state member bank. The risk associated with significant nonbank subsidiaries or branches should be identified as part of the consolidated risk-assessment process. The scope of Edge Act corporation examinations should also be determined through the risk-assessment process. In addition, specialty areas should be included in the planning process in relation to their perceived level of risk to the consolidated organization or to any state member bank subsidiary.

Coordination of Supervisory Activities

Many large, complex institutions have interstate operations; therefore, close cooperation with the other federal and state banking agencies is critical. To facilitate coordination between the Federal Reserve and other regulators, district Reserve Banks have been assigned roles and responsibilities that reflect their status as either the responsible Reserve Bank (RRB) with the central point of contact or the local Reserve Bank (LRB).

LRBs and host states will not routinely examine branches of state member banks or issue separate ratings and reports of examination. Similar to the relationship between the RRBs and LRBs, home-state supervisors[5] will coordinate the activities of all state banking departments and will be the state's principal source of contact with federal banking agencies and with the bank itself. Also, host states will not unilaterally examine branches of interstate banks.

The RRB is responsible for designating the central point of contact and for ensuring that all aspects of the supervisory process are fully coordinated with LRB and home-state supervisors. To the extent possible, the RRB should rely on LRBs to provide the resources to conduct examinations of out-of-district subsidiaries of a parent organization, its state member bank subsidiaries, or the out-of-district offices of foreign banking organizations (FBOs). Close coordination among the Reserve Banks and other appropriate regulators for each organization is critical to ensure a consistent, risk-focused approach to supervision.

In general, LRBs are responsible for the direct supervision of state member banks located in their district. In addition, the LRB provides the resources to the RRB to conduct the inspections of second-tier, domestic bank holding companies; nonbank subsidiaries; and branches and agencies of FBOs for top-tier holding companies located in the RRB's district. If the functional management of a banking organization is headquartered in its district, the LRB may also be called upon to conduct a functional business-line review. However, if a state member bank is owned by an out-of-district domestic holding company or if responsibility for supervision of the overall U.S. operations of the FBO lies with another Reserve Bank, the supervision of that entity should be coordinated by the RRB.

If the banking organization prefers to have supervisory contact with only one Reserve Bank, every effort should be made to centralize communication and coordination with the RRB for that organization. On the other hand, if the organization prefers more localized contact and communication, the coordination process can be adapted accordingly.

Central Point of Contact and Supervisory Teams

A central point of contact is critical to fulfilling the objectives of seamless, risk-focused supervision. The RRB should designate a central point of contact for each large, complex institu-

5. The State/Federal Supervisory Protocol and Agreement established definitions for home and host states. The home-state supervisor is defined as the state that issued the charter. It will act on behalf of itself and all host-state supervisors (states into which the bank branches) and will be the single state contact for a particular institution.

tion it supervises. Generally, all activities and duties of other areas within the Federal Reserve, as well as with other supervisors, should be coordinated through this contact. The central point of contact should—

- be knowledgeable, on an ongoing basis, about the institution's financial condition, management structure, strategic plan and direction, and overall operations;
- remain up-to-date on the condition of the assigned institution and be knowledgeable regarding all supervisory activities; monitoring and surveillance information; applications issues; capital-markets activities; meetings with management; and enforcement issues, if applicable;
- ensure that the objective of seamless, risk-focused supervision is achieved for each institution and that the supervisory products described later are prepared in a timely manner;
- ensure appropriate follow-up and tracking of supervisory concerns, corrective actions, or other matters which come to light through ongoing communications or surveillance; and
- participate in the examination process, as needed, to ensure consistency with the institution's supervisory plan and to ensure effective allocation of resources, including coordination of on-site efforts with specialty examination areas and other supervisors, as appropriate, and to facilitate requests for information from the institution, whenever possible.

A dedicated supervisory team composed of individuals with specialized skills based upon the organization's particular business lines and risk profile will be assigned to each institution. This full-time, dedicated cadre will be supplemented by other specialized System staff, as necessary, to participate in examinations and targeted reviews.

In addition to designing and executing the supervisory strategy for an organization, the central point of contact is responsible for managing the supervisory team. The supervisory team's major responsibilities are to maintain a high level of knowledge of the banking organization and to ensure that supervisory strategies and priorities are consistent with the identified risks and institutional profile.

Sharing of Information

To further promote seamless, risk-focused supervision, information related to a specific institution should be provided, as appropriate, to other interested supervisors. The information to be shared includes the products described in the "Process and Products" subsection. However, sharing these products with the institution itself should be carefully evaluated on a case-by-case basis.

Functional Approach and Targeted Examinations

Traditionally, the examination process has been driven largely by a legal-entity approach to banking companies. The basis for risk-focused supervision of large, complex institutions relies more heavily on a functional, business-line approach to supervising institutions, while effectively integrating the functional approach into the legal-entity assessment.

The functional approach focuses principally on the key business activities (for example, lending, Treasury, retail banking) rather than on reviewing the legal entity and its balance sheet. This approach does not mean that the responsibility for a legal-entity assessment is ignored, nor should the Federal Reserve perform examinations of institutions that other regulators are primarily responsible for supervising.[6] Rather, Federal Reserve examiners should integrate the findings of a functional review into the legal-entity assessment and coordinate closely with the primary regulator to gather sufficient information to form an assessment of the consolidated organization. Nonetheless, in some cases, effective supervision of the consolidated organization may require Federal Reserve examiners to perform process reviews and possibly transaction testing at all levels of the organization.

Functional risk-focused supervision is to be achieved by—

6. For U.S. banks owned by FBOs, it is particularly important to review the U.S. bank on a legal-entity basis and to review the risk exposure to the U.S. bank of its parent foreign bank since U.S. supervisory authorities do not supervise or regulate the parent bank.

- planning and conducting joint examinations with the primary regulator in areas of mutual interest, such as nondeposit investment products, interest-rate risk, liquidity, and mergers and acquisitions;
- leveraging off, or working from, the work performed by the primary regulator and the work performed by the institution's internal and external auditors by reviewing and using their workpapers and conclusions to avoid duplication of effort and to lessen the burden on the institution;
- reviewing reports of examinations and other communications to the institution issued by other supervisors; and
- conducting a series of functional reviews or targeted examinations of business lines, relevant risk areas, or areas of significant supervisory concern during the supervisory cycle. Functional reviews and targeted examinations are increasingly necessary to evaluate the relevant risk exposure of a large, complex institution and the effectiveness of related risk-management systems.

The relevant findings of functional reviews or targeted examinations should be—

- incorporated into the annual summary supervisory report, with follow-up on deficiencies noted in the functional reviews or targeted examinations;
- conveyed to the institution's management during a close-out or exit meeting with the relevant area's line management; and
- communicated in a formal written report to the institution's management or board of directors when significant weaknesses are detected or when the finding results in a downgrade of any rating component.

The functional approach to risk assessments and to planning supervisory activities should include a review of the parent company and its significant nonbank subsidiaries. However, the level of supervisory review should be appropriate to the risk profile of the parent company or its nonbank subsidiary in relation to the consolidated organization. Intercompany transactions should continue to be reviewed as part of the examination procedures performed to ensure that these transactions comply with laws and regulations and do not pose safety-and-soundness concerns.

Process and Products

The risk-focused methodology for the supervision program for large, complex institutions reflects a continuous and dynamic process. The methodology consists of six steps, each of which uses certain written products to facilitate communication and coordination.

Table 1—Steps and Products

Steps	*Products*
1. Understanding the institution	1. Institutional overview
2. Assessing the institution's risk	2. Risk matrix 3. Risk assessment
3. Planning and scheduling supervisory activities	4. Supervisory plan 5. Examination program
4. Defining examination activities	6. Scope memorandum 7. Entry letter
5. Performing examination procedures	8. Functional examination modules
6. Reporting the findings	9. Examination report(s)

The focus of the products should be on fully achieving a risk-focused, seamless, and coordinated supervisory process, not simply on completing the products. The content and format of the products are flexible and should be adapted to correspond to the supervisory practices of the agencies involved and to the structure and complexity of the institution.

Understanding the Institution

The starting point for risk-focused supervision is developing an understanding of the institution. This step is critical to tailoring the supervision program to meet the characteristics of the organization and to adjusting that program on an ongoing basis as circumstances change. Furthermore, understanding the Federal Reserve's supervisory role in relation to an institution and its affiliates is essential.

Through increased emphasis on planning and monitoring, supervisory activities can focus on the significant risks to the institution and on related supervisory concerns. The technological and market developments within the financial sector and the speed with which an institution's financial condition and risk profile can change make it critical for supervisors to keep abreast of events and changes in risk exposure and strategy. Accordingly, the central point of contact for each large, complex institution should review certain information on an ongoing basis and prepare an institution overview that will communicate his or her understanding of that institution.

Information generated by the Federal Reserve, other supervisory agencies, the institution, and public organizations may assist the central point of contact in forming and maintaining an ongoing understanding of the institution's risk profile and current condition. In addition, the central point of contact should hold periodic discussions with the institution's management to cover, among other topics, credit-market conditions, new products, divestitures, mergers and acquisitions, and the results of any recently completed internal and external audits. When other agencies have supervisory responsibilities for the organization, joint discussions should be considered.

The principal risk-focused supervisory tools and documents, including an institutional overview, risk matrix, and risk assessment for the organization, should be current. Accordingly, the central point of contact should distill and incorporate significant new information into these documents at least quarterly. Factors such as emerging risks; new products; and significant changes in business strategy, management, condition, or ownership may warrant more frequent updates. In general, the more dynamic the organization's operations and risks, the more frequently the central point of contact should update the risk assessment, strategies, and plans.

Preparation of the Institutional Overview

The institutional overview should contain a concise executive summary that demonstrates an understanding of the institution's present condition and its current and prospective risk profiles, as well as highlights key issues and past supervisory findings. General types of information that may be valuable to present in the overview include—

- a brief description of the organizational structure;
- a summary of the organization's business strategies as well as changes in key business lines, growth areas, new products, etc., since the prior review;
- key issues for the organization, either from external or internal factors;
- an overview of management;
- a brief analysis of the consolidated financial condition and trends;
- a description of the future prospects of the organization;
- descriptions of internal and external audit;
- a summary of supervisory activity performed since the last review; and
- considerations for conducting future examinations.

Assessing the Institution's Risks

To focus supervisory activities on the areas of greatest risk to an institution, the central point of contact should perform a risk assessment. The risk assessment highlights both the strengths and vulnerabilities of an institution and provides a foundation for determining the supervisory activities to be conducted. Further, the assessment should apply to the entire spectrum of risks facing an institution (as previously discussed in the subsection ''Risk-Management Processes and Internal Controls'').

An institution's business activities present various combinations and concentrations of the noted risks depending on the nature and scope of the particular activity. Therefore, when conducting the risk assessment, consideration must be given to the institution's overall risk environment, the reliability of its internal risk management, the adequacy of its information technology systems, and the risks associated with each of its significant business activities.

Assessment of the Overall Risk Environment

The starting point in the risk-assessment process is an evaluation of the institution's risk tolerance and of management's perception of the organization's strengths and weaknesses. This evaluation should entail discussions with management and review of supporting documents, strategic plans, and policy statements. In general, management is expected to have a clear understanding of both the institution's markets and the general banking environment, as well as how these factors affect the institution.

The institution should have a clearly defined risk-management structure, which may be formal or informal, centralized or decentralized. However, the greater the risk assumed by the institution, the more sophisticated its risk-management system should be. Regardless of the approach, the types and levels of risk an institution is willing to accept should reflect its risk appetite, as determined by the board of directors.

To assess the overall risk environment, the central point of contact should make a preliminary evaluation of the institution's internal risk management, considering the adequacy of its internal audit, loan-review, and compliance functions. External audits also provide important information on the institution's risk profile and condition, which may be used in the risk assessment.

In addition, the central point of contact should review risk assessments developed by the internal audit department for significant lines of business, and compare those results with the supervisory risk assessment. Management's ability to aggregate risks on a global basis should also be evaluated. This preliminary evaluation can be used when developing the scope of examination activities to determine the level of examiner reliance on the institution's internal risk management.

Risk-monitoring activities must be supported by management information systems that provide senior managers and directors with timely and reliable reports on the financial condition, operating performance, and risk exposure of the consolidated organization. These systems must also provide managers engaged in the day-to-day management of the organization's activities with regular and sufficiently detailed reports for their areas of responsibility. Moreover, in most large, complex institutions, management information systems not only provide reporting systems, but also support a broad range of business decisions through sophisticated risk-management and decision-making tools such as credit-scoring and asset/liability models and automated trading systems. Accordingly, the institution's risk assessment must consider the adequacy of its information technology systems.

Preparation of the Risk Matrix

A risk matrix is used to identify significant activities, the type and level of inherent risks in these activities, and the adequacy of risk management over these activities, as well as to determine composite-risk assessments for each of these activities and the overall institution. A risk matrix can be developed for the consolidated organization, for a separate affiliate, or along functional business lines. The matrix is a flexible tool that documents the process followed to assess the overall risk of an institution and is a basis for preparation of the narrative risk assessment.

Activities and their significance can be identified by reviewing information from the institution, the Reserve Bank, or other supervisors. After the significant activities are identified, the type and level of risk inherent in them should be determined. Types of risk may be categorized as previously described or by using categories defined either by the institution or other supervisory agencies. If the institution uses risk categories that differ from those defined by the supervisory agencies, the examiner should determine if all relevant types of risk are appropriately captured. If risks are appropriately captured by the institution, the examiner should use the categories identified by the institution.

For the identified functions or activities, the inherent risk involved in that activity should be described as high, moderate, or low for each type of risk associated with that type of activity. The following definitions apply:

- *High inherent risk* exists when the activity is significant or positions are large in relation to the institution's resources or its peer group, when the number of transactions is substantial, or when the nature of the activity is inherently more complex than normal. Thus, the activity potentially could result in a significant and harmful loss to the organization.
- *Moderate inherent risk* exists when positions are average in relation to the institution's resources or its peer group, when the volume of transactions is average, and when the activity is more typical or traditional. Thus, while the activity potentially could result in a

loss to the organization, the loss could be absorbed by the organization in the normal course of business.
- *Low inherent risk* exists when the volume, size, or nature of the activity is such that even if the internal controls have weaknesses, the risk of loss is remote, or, if a loss were to occur, it would have little negative impact on the institution's overall financial condition.

This risk-assessment is made without considering management processes and controls; those factors are considered when evaluating the adequacy of the institution's risk-management systems.

Assessing Adequacy of Risk Management

When assessing the adequacy of an institution's risk-management systems for identified functions or activities, the focus should be on findings related to the key elements of a sound risk-management system: active board and senior management oversight; adequate policies, procedures, and limits; adequate risk-management, monitoring, and management information systems; and comprehensive internal controls. (These elements are described in the earlier subsection ''Elements of Risk Management.'')

Taking these key elements into account, the contact should assess the relative strength of the risk-management processes and controls for each identified function or activity. Relative strength should be characterized as strong, acceptable, or weak as defined below:

- *Strong risk management* indicates that management effectively identifies and controls all major types of risk posed by the relevant activity or function. The board and management participate in managing risk and ensure that appropriate policies and limits exist, which the board understands, reviews, and approves. Policies and limits are supported by risk-monitoring procedures, reports, and management information systems that provide the necessary information and analysis to make timely and appropriate responses to changing conditions. Internal controls and audit procedures are appropriate to the size and activities of the institution. There are few exceptions to established policies and procedures, and none of these exceptions would likely lead to a significant loss to the organization.
- *Acceptable risk management* indicates that the institution's risk-management systems, although largely effective, may be lacking to some modest degree. It reflects an ability to cope successfully with existing and foreseeable exposure that may arise in carrying out the institution's business plan. While the institution may have some minor risk-management weaknesses, these problems have been recognized and are being addressed. Overall, board and senior management oversight, policies and limits, risk-monitoring procedures, reports, and management information systems are considered effective in maintaining a safe and sound institution. Risks are generally being controlled in a manner that does not require more than normal supervisory attention.
- *Weak risk management* indicates risk-management systems that are lacking in important ways and, therefore, are a cause for more than normal supervisory attention. The internal control system may be lacking in important respects, particularly as indicated by continued control exceptions or by the failure to adhere to written policies and procedures. The deficiencies associated in these systems could have adverse effects on the safety and soundness of the institution or could lead to a material misstatement of its financial statements if corrective actions are not taken.

The composite risk for each significant activity is determined by balancing the overall level of inherent risk of the activity with the overall strength of risk-management systems for that activity. For example, commercial real estate loans usually will be determined to be inherently high risk. However, the probability and the magnitude of possible loss may be reduced by having very conservative underwriting standards, effective credit administration, strong internal loan review, and a good early warning system. Consequently, after accounting for these mitigating factors, the overall risk profile and level of supervisory concern associated with commercial real estate loans may be moderate.

To facilitate consistency in the preparation of the risk matrix, general definitions of the composite level of risk for significant activities are provided as follows:

- A *high composite risk* generally would be assigned to an activity in which the risk-management system does not significantly mitigate the high inherent risk of the activity. Thus, the activity could potentially result in a financial loss that would have a significant negative impact on the organization's overall condition, in some cases, even when the systems are considered strong. For an activity with moderate inherent risk, a risk-management system that has significant weaknesses could result in a high-composite-risk assessment because management appears to have an insufficient understanding of the risk and uncertain capacity to anticipate and respond to changing conditions.

- A *moderate composite risk* generally would be assigned to an activity with moderate inherent risk, which the risk-management systems appropriately mitigate. For an activity with low inherent risk, significant weaknesses in the risk-management system may result in a moderate-composite-risk assessment. On the other hand, a strong risk-management system may reduce the risks of an inherently high-risk activity so that any potential financial loss from the activity would have only a moderate negative impact on the financial condition of the organization.
- A *low composite risk* generally would be assigned to an activity that has low inherent risks. An activity with moderate inherent risk may be assessed a low composite risk when internal controls and risk-management systems are strong, and when they effectively mitigate much of the risk.

Once the composite-risk assessment of each identified significant activity or function is completed, an overall composite-risk assessment should be made for off-site analytical and planning purposes. This assessment is the final step in the development of the risk matrix, and the evaluation of the overall composite risk is incorporated into the written risk assessment.

Preparation of the Risk Assessment

A written risk assessment is used as an internal supervisory planning tool and to facilitate communication with other supervisors. The goal is to develop a document that presents a comprehensive, risk-focused view of the institution, delineating the areas of supervisory concern and serving as a platform for developing the supervisory plan.

The format and content of the written risk assessment are flexible and should be tailored to the individual institution. The risk assessment reflects the dynamics of the institution; therefore, it should consider the institution's evolving business strategies and be amended as significant changes in the risk profile occur. Input from other affected supervisors and specialty units should be included to ensure that all the institution's significant risks are identified. The risk assessment should—

- include an overall risk assessment of the organization;
- describe the types of risk (credit, market, liquidity, reputational, operational, legal) and their level (high, moderate, low) and direction (increasing, stable, decreasing);
- identify all major functions, business lines, activities, products, and legal entities from which significant risks emanate, as well as the key issues that could affect the risk profile;
- consider the relationship between the likelihood of an adverse event and its potential impact on an institution; and
- describe the institution's risk-management systems. Reviews and risk assessments performed by internal and external auditors should be discussed, as should the institution's ability to take on and manage risk prospectively.

The central point of contact should attempt to identify the cause of unfavorable trends, not just report the symptoms. The risk assessment should reflect a thorough analysis that leads to conclusions about the institution's risk profile, rather than just reiterating the facts.

Planning and Scheduling Supervisory Activities

The supervisory plan forms a bridge between the institution's risk assessment, which identifies significant risks and supervisory concerns, and the supervisory activities to be conducted. In developing the supervisory plan and examination schedule, the central point of contact should minimize disruption to the institution and, whenever possible, avoid duplicative examination efforts and requesting similar information from the other supervisors.

The institution's organizational structure and complexity are significant considerations when planning the specific supervisory activities to be conducted. Additionally, interstate banking and branching activities have implications for planning on-site and off-site review. The scope and location of on-site work for interstate banking operations will depend upon the significance and risk profile of local operations, the location of the supervised entity's major functions, and the degree of its centralization. The bulk of safety-and-soundness examinations for branches of an interstate bank would likely be conducted at the head office or regional offices, supplemented by periodic reviews of branch operations and internal controls. The supervisory plan should reflect the need to coordinate these reviews of branch operations with other supervisors.

Preparation of the Supervisory Plan

A comprehensive supervisory plan should be developed annually, and reviewed and revised at least quarterly to reflect any significant new information or emerging banking trends or risks. The supervisory plan and any revisions should be periodically discussed with representatives of the principal regulators of major affiliates to reconfirm their agreement on the overall plan for coordinating its implementation, when warranted.

The plan should demonstrate that supervisory concerns identified through the risk-assessment process and that the deficiencies noted in the previous examination are being or will be addressed. To the extent that the institution's risk-management systems are adequate, the level of supervisory activity may be adjusted. The plan should generally address all supervisory activities to be conducted, the scope of those activities (full or targeted), the objectives of those activities (for example, review of specific business lines, products, support functions, legal entities), and specific concerns regarding those activities, if any. Consideration should be given to—

- prioritizing supervisory resources on areas of higher risk;
- pooling examiner resources to reduce the regulatory burden on institutions as well as examination redundancies;
- maximizing the use of examiners who are located where the activity is being conducted;
- coordinating examinations of different disciplines;
- determining compliance with, or the potential for, supervisory action;
- balancing mandated requirements with the objectives of the plan;
- providing general logistical information (for exammple, a timetable of supervisory activities, the participants, and expected resource requirements); and
- assessing the extent to which internal and external audit, internal loan review, compliance, and other risk-management systems will be tested and relied upon.

Generally, the planning horizon to be covered is 18 months for domestic institutions.[7] The overall supervisory objectives and basic framework need to be outlined by midyear to facilitate preliminary discussions with other supervisors and to coincide with planning for the Federal Reserve's annual scheduling conferences. The plan should be finalized by the end of the year, for execution in the following year.

Preparation of the Examination Program

The examination program should provide a comprehensive schedule of examination activities for the entire organization and aid in the coordination and communication of responsibilities for supervisory activities. An examination program provides a comprehensive listing of all examination activities to be conducted at an institution for the given planning horizon. To prepare a complete examination program and reflect the institution's current conditions and activities, and the activities of other supervisors, the central point of contact needs to be the focal point for communications on a particular institution. The role includes any communications with the Federal Reserve, the institution's management, and other supervisors. The examination program generally incorporates the following logistical elements:

- a schedule of activities, period, and resource estimates for planned projects

7. The examination plans and assessments of condition of U.S. operations that are used for FBO supervision use a 12-month period.

- an identification of the agencies conducting and participating in the supervisory activity (when there are joint supervisors, indicate the lead agency and the agency responsible for a particular activity) and resources committed by all participants to the area(s) under review
- the planned product for communicating findings (indicate whether it will be a formal report or supervisory memorandum)
- the need for special examiner skills and the extent of participation of individuals from specialty functions

Defining Examination Activities

Scope Memorandum

The scope memorandum is an integral product in the risk-focused methodology because it identifies the key objectives of the on-site examination. The focus of on-site examination activities, identified in the scope memorandum, follow a top-down approach that includes a review of the organization's internal risk-management systems and an appropriate level of transaction testing. The risk-focused methodology is flexible regarding the amount of on-site transaction testing used. Although the focus of the examination is on the institution's processes, an appropriate level of transaction testing and asset review will be necessary to verify the integrity of internal systems.

After the areas to be reviewed have been identified in the supervisory plan, a scope memorandum should be prepared that documents specific objectives for the projected examinations. This document is of key importance, as the scope of the examination will likely vary from year to year. Thus, it is necessary to identify the specific areas chosen for review and the extent of those reviews. The scope memorandum will help ensure that the supervisory plan for the institution is executed, and will communicate the specific examination objectives to the examination staff.

The scope memorandum should be tailored to the size, complexity, and current rating of the institution subject to review. For large but less complex institutions, the scope memorandum may be combined with the supervisory plan or the risk assessment. The scope memorandum should define the objectives of the examination, and generally should include—

- a statement of the objectives;
- an overview of the activities and risks to be evaluated;
- the level of reliance on internal risk-management systems and internal or external audit findings;
- a description of the procedures that are to be performed, indicating any sampling process to be used and the level of transaction testing, when appropriate;
- identification of the procedures that are expected to be performed off-site; and
- a description of how the findings of targeted reviews, if any, will be used on the current examination.

Entry Letter

The entry letter should be tailored to fit the specific character and profile of the institution to be examined and the scope of the activities to be performed. Thus, effective use of entry letters depends on the planning and scoping of a risk-focused examination. To eliminate duplication and minimize the regulatory burden on an institution, entry letters should not request information that is regularly provided to designated central points of contact or that is available within each Federal Reserve Bank. When needed for examinations of larger or more complex organizations, the entry letter should be supplemented by requests for information on specialty activities. The specific items selected for inclusion in the entry letter should meet the following guidelines:

- reflect risk-focused supervision objectives and the examination scope
- facilitate efficiency in the examination process and lessen the burden on financial institutions
- limit, to the extent possible, requests for special management reports
- eliminate items used for audit-type procedures (for example, verifications)
- distinguish between information to be mailed to the examiner-in-charge for off-site examination procedures and information to be held at the institution for on-site procedures
- allow management sufficient lead time to prepare the requested information

Examination Procedures

Examination procedures should be tailored to the characteristics of each institution, keeping in mind size, complexity, and risk profile. They should focus on developing appropriate documentation to adequately assess management's ability to identify, measure, monitor, and control risks. Procedures should be completed to the degree necessary to determine whether the institution's management understands and adequately controls the levels and types of risks that are assumed. For transaction testing, the volume of loans to be tested should be adjusted according to management's ability to accurately identify problems and potential problem credits, and to measure, monitor, and control the institution's exposure to overall credit risk. Likewise, the level of transaction testing for compliance with laws and regulations should take into account the effectiveness of management systems to monitor, evaluate, and ensure compliance with applicable laws and regulations.

During the supervisory cycle, the 10 functional areas listed below will be evaluated in most full-scope examinations. To evaluate these functional areas, procedures need to be tailored to fit the risk assessment that was prepared for the institution and the scope memorandum that was prepared for the examination. These functional areas represent the primary business activities and functions of large, complex institutions, as well as common sources of significant risk to them. Additionally, other areas of significant sources of risk to an institution or areas that are central to the examination assignment will need to be evaluated. The functional areas include the following:

- loan portfolio analysis
- Treasury activities
- trading and capital-markets activities
- internal controls and audit
- supervisory ratings
- information systems
- fiduciary activities
- private banking
- retail banking activities
- payments system risk

Reporting the Findings

At least annually, a comprehensive summary supervisory report should be prepared that supports the organization's assigned ratings and encompasses the results of the entire supervisory cycle. This report should (1) convey the Federal Reserve's view of the condition of the organization and its key risk-management processes, (2) communicate the composite supervisory ratings, (3) discuss each of the major business risks, (4) summarize the supervisory activities conducted during the supervisory cycle and the resulting findings, and (5) assess the effectiveness of any corrective actions taken by the organization. This report will satisfy supervisory and legal requirements for a full-scope examination. Reserve Bank management, as well as Board officials, when warranted, will meet with the organization's board of directors to present and discuss the contents of the report and the Federal Reserve's assessment of the condition of the organization. (See SR-99-15.)

This section sets forth the principal aspects of effective internal control and audit and discusses some pertinent points relative to the internal control questionnaires (ICQs). It assists the examiner in understanding and evaluating the objectives of and the work performed by internal and external auditors. It also sets forth the general criteria the examiner should consider to determine if the work of internal and external auditors can be relied on in the performance of the examination. To the extent that audit records can be relied on, they should be used to complete the ICQs implemented during the examination. In most cases, only those questions not fully supported by audit records would require the examiner to perform a detailed review of the area in question.

Effective internal control is a foundation for the safe and sound operation of a financial institution. The board of directors and senior managers of an institution are responsible for ensuring that the system of internal control is effective. Their responsibility *cannot* be delegated to others within or outside the organization. An internal audit function is an important element of an effective system of internal control. When properly structured and conducted, internal audit provides directors and senior management with vital information about the condition of the system of internal control, and it identifies weaknesses so that management can take prompt, remedial action. Examiners are to review an institution's internal audit function and recommend improvements if needed. In addition, under the Interagency Guidelines Establishing Standards for Safety and Soundness,[1] pursuant to section 39 of the Federal Deposit Insurance Act (FDI Act) (12 USC 1831p-1), each institution is required to have an internal audit function that is appropriate to its size and the nature and scope of its activities.

In summary, internal control is a process designed to provide reasonable assurance that the institution will achieve the following objectives: efficient and effective operations, including safeguarding of assets; reliable financial reporting; and compliance with applicable laws and regulations. Internal control consists of five components that are a part of the management process: control environment, risk assessment, control activities, information and communication, and monitoring activities. The effective functioning of these components, which is brought about by an institution's board of directors, management, and other personnel, is essential to achieving the internal control objectives. This description of internal control is consistent with the Committee of Sponsoring Organizations of the Treadway Commission (COSO) report *Internal Control—Integrated Framework.* In addition, under the COSO framework, financial reporting is defined in terms of published financial statements, which, for these purposes, encompasses financial statements prepared in accordance with generally accepted accounting principles and regulatory reports (such as the Reports of Condition and Income). Institutions are encouraged to evaluate their internal control against the COSO framework.

1. For state member banks, appendix D-1 to 12 CFR 208.

AUDIT COMMITTEE OVERSIGHT

Internal and external auditors will not, in all likelihood, feel free to assess the bank's operations if their independence is compromised. This can sometimes happen when internal and external auditors report solely to senior management instead of to the board of directors.

The independence of internal and external auditors is increased when they report to an independent audit committee (one made up of external directors who are not members of the bank's management). The auditors' independence is enhanced when the audit committee takes an active role in approving the internal and external audit scope and plan.

The role of the independent audit committee is growing in importance. The audit committee's duties may include overseeing the internal audit function; approving or recommending the appointment of external auditors and the scope of external audits and other services; providing the opportunity for auditors to meet and discuss findings apart from management; reviewing with management and external auditors the year-end financial statements; and meeting with regulatory authorities.

Public Company Accounting Oversight Board

The Sarbanes-Oxley Act of 2002 (the act) became law on July 30, 2002 (Pub. L. No.

107-204). The act addresses weaknesses in corporate governance and the accounting and auditing professions and includes provisions addressing audits, financial reporting and disclosure, conflicts of interest, and corporate governance at publicly owned companies. The act, among other things, requires public companies to have an audit committee composed entirely of independent directors. Publicly owned banking organizations that are listed on the New York Stock Exchange (NYSE) and Nasdaq must also comply with those exchanges' listing requirements, which include audit committee requirements.

The act also established a Public Company Accounting Oversight Board (PCAOB) that has the authority to set and enforce auditing, attestation, quality-control, and ethics (including independence) standards for auditors of public companies (subject to Securities and Exchange Commission (SEC) review). (See SR-02-20.) Accounting firms that conduct audits of public companies (registered accounting firms) must register with the PCAOB and be subject to its supervision. The PCAOB is also empowered to inspect the auditing operations of public accounting firms that audit public companies, as well as impose disciplinary and remedial sanctions for violations of its rules, securities laws, and professional auditing and accounting standards.

In May 2003, the Federal Reserve, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision announced that they did not expect to take actions to apply the corporate-governance and other requirements of the Sarbanes-Oxley Act generally to nonpublic banking organizations that are not otherwise subject to them.[2] (See SR-03-08.) The agencies, however, encouraged nonpublic banking organizations to periodically review their policies and procedures relating to corporate-governance and auditing matters. This review should ensure that such policies and procedures are consistent with applicable law, regulations, and supervisory guidance and remain appropriate in light of the organization's size, operations, and resources. Furthermore, the agencies stated that a banking organization's policies and procedures for corporate governance, internal controls, and auditing will be assessed during the supervisory process, and the agencies may take appropriate supervisory action if there are deficiencies or weaknesses in these areas that are inconsistent with sound corporate-governance practices or safety-and-soundness considerations.

2. As discussed below, some aspects of the auditor-independence rules established by the Sarbanes-Oxley Act apply to all federally insured depository institutions with $500 million or more in total assets. See part 363 of the FDIC's regulations.

OBJECTIVES OF INTERNAL CONTROL

In general, good internal control exists when no one is in a position to make significant errors or perpetrate significant irregularities without timely detection. Therefore, a system of internal control should include those procedures necessary to ensure timely detection of failure of accountability, and such procedures should be performed by competent persons who have no incompatible duties. The following standards are encompassed within the description of internal control:

Existence of procedures. Existence of prescribed internal control procedures is necessary but not sufficient for effective internal control. Prescribed procedures that are not actually performed do nothing to establish control. Consequently, the examiner must give thoughtful attention not only to the prescribed set of procedures but also to the practices actually followed. This attention can be accomplished through inquiry, observation, testing, or a combination thereof.

Competent performance. For internal control to be effective, the required procedures must be performed by competent persons. Evaluation of competence undoubtedly requires some degree of subjective judgment because attributes such as intelligence, knowledge, and attitude are relevant. Thus, the examiner should be alert for indications that employees have failed so substantially to perform their duties that a serious question is raised concerning their abilities.

Independent performance. If employees who have access to assets also have access to the related accounting records or perform related review operations (or immediately supervise the activities of other employees who maintain the records or perform the review operations), they may be able to both perpetrate and conceal defalcations. Therefore, duties concerned with the custody of assets are incompatible with recordkeeping duties for those assets, and duties concerned with the performance of activities are incompatible with the authorization or review of those activities.

In judging the independence of a person, the examiner must avoid looking at that person as an individual and presuming the way in which that individual would respond in a given situation. For example, an individual may be the sole check signer and an assistant may prepare monthly bank reconcilement. If the assistant appears to be a competent person, it may seem that an independent reconcilement would be performed and anything amiss would be reported. Such judgments are potentially erroneous. There exist no established tests by which the psychological and economic independence of an individual in a given situation can be judged. The position must be evaluated, not the person. If the position in which the person acts is not an independent one in itself, then the work should not be presumed to be independent, regardless of the apparent competence of the person in question. In the example cited above, the function performed by the assistant should be viewed as if it were performed by the supervisor. Hence, incompatible duties are present in that situation.

PROCEDURES FOR COMPLETING ICQs

The implementation of selected ICQs and the evaluation of internal audit activities provide a basis for determining the adequacy of the bank's control environment. To reach conclusions required by the questionnaires, the examiner assigned to review a given internal control routine or area of bank operations should use any source of information necessary to ensure a full understanding of the prescribed system, including any potential weaknesses. Only when the examiner completely understands the bank's system can an assessment and evaluation be made of the effects of internal controls on the examination.

To reach conclusions concerning a specific section of an ICQ, the examiner should document and review the bank's operating systems and procedures by consulting all available sources of information and discussing them with appropriate bank personnel. Sources of information might include organization charts, procedural manuals, operating instructions, job specifications, directives to employees, and other similar sources of information. Also, the examiner should not overlook potential sources such as job descriptions, flow charts, and other documentation contained in internal audit workpapers. A primary objective in the review of the system is to efficiently reach a conclusion about the overall adequacy of existing controls. Any existing source of information that will enable the examiner to quickly gain an understanding of the procedures in effect should be used in order to minimize the time required to formulate the conclusions. The review should be documented in an organized manner through the use of narrative descriptions, flow charts, or other diagrams. If a system is properly documented, the documentation will provide a ready reference for any examiner performing work in the area, and it often may be carried forward for future examinations, which will save time.

Although narrative descriptions can often provide an adequate explanation of systems of internal control, especially in less complex situations, they may have certain drawbacks, such as the following:

- They may be cumbersome and too lengthy.
- They may be unclear or poorly written.
- Related points may be difficult to integrate.
- Annual changes may be awkward to record.

To overcome these problems, the examiner should consider using flow charts, which reduce narrative descriptions to a picture. Flow charts often reduce a complex situation to an easily understandable sequence of interrelated steps.

In obtaining and substantiating the answers to the questions contained in the ICQ, the examiner should develop a plan to obtain the necessary information efficiently. Such a plan would normally avoid a direct question-and-answer session with bank officers. A suggested approach to completion of the ICQ is to—

- become familiar with the ICQ,
- review related internal audit procedures, reports, and responses,
- review any written documentation of a bank's system of controls,
- find out what the department does and what the functions of personnel within the department are through conversations with appropriate individuals, and

- answer as many individual questions as possible from information gained in the preceding steps and fill in the remaining questions by direct inquiry.

An effective way to begin an on-site review of internal control is to identify the various key functions applicable to the area under review. For each position identified, the following questions should then be asked:

- Is this a critical position? That is, can a person in this position either make a significant error that will affect the recording of transactions or perpetrate material irregularities of some type?
- If an error is made or an irregularity is perpetrated, what is the probability that normal routines will disclose it on a timely basis? That is, what controls exist that would prevent or detect significant errors or the perpetration of significant irregularities?
- What are the specific opportunities open to the individual to conceal any irregularity, and are there any mitigating controls that will reduce or eliminate these opportunities?

Although all employees within an organization may be subject to control, not all have financial responsibilities that can influence the accuracy of the accounting and financial records or have access to assets. The examiner should be primarily concerned with those positions that have the ability to influence the records and that have access to assets. Once those positions have been identified, the examiners must exercise their professional knowledge of bank operations to visualize the possibilities open to any person holding a particular position. The question is not whether the individual is honest, but rather whether situations exist that might permit an error to be concealed. By directing attention to such situations, an examiner will also consider situations that may permit unintentional errors to remain undetected.

The evaluation of internal control should include consideration of other existing accounting and administrative controls or other circumstances that might counteract or mitigate an apparent weakness or impair an established control. Controls that mitigate an apparent weakness may be a formal part of the bank's operating system, such as budget procedures that include a careful comparison of budgeted and actual amounts by competent management personnel. Mitigating controls also may be informal. For example, in small banks, management may be sufficiently involved in daily operations to know the purpose and reasonableness of all expense disbursements. That knowledge, coupled with the responsibility for signing checks, may make irregularities by nonmanagement personnel unlikely, even if disbursements are otherwise under the control of only one person.

When reviewing internal controls, an essential part of the examination is being alert to indications that adverse circumstances may exist. Adverse circumstances may lead employees or officers into courses of action they normally would not pursue. An adverse circumstance to which the examiner should be especially alert exists when the personal financial interests of key officers or employees depend directly on operating results or financial condition. Although the review of internal control does not place the examiner in the role of an investigator or detective, an alert attitude toward possible conflicts of interest should be maintained throughout the examination. Also, offices staffed by members of the same family, branches completely dominated by a strong personality, or departments in which supervisors rely unduly on their assistants require special alertness on the part of the examiner. Those circumstances and other similar ones should be considered in preparing the ICQ. It is not the formality of the particular factor that is of importance but rather its effect on the overall operation under review. Circumstances that may affect answers to the basic questions should be noted along with conclusions concerning their effect on the examination.

The ICQs were designed so that answers could be substantiated by (1) inquiry to bank personnel, (2) observation, or (3) testing. However, certain questions are marked with an asterisk to indicate that they require substantiation through observation or testing. Those questions are deemed so critical that substantiation by inquiry is not sufficient. For those questions substantiated through testing, the nature and extent of the test performed should be indicated adjacent to the applicable step in the ICQ.

The examiner should be alert for deviations by bank personnel from established policies, practices, and procedures. This applies not only to questions marked with an asterisk but also to every question in the ICQ. Examples of such deviations include situations when (1) instructions and directives are frequently not revised to reflect current practices, (2) employees find shortcuts for performing their tasks, (3) changes in organization and activities may influence operating procedures in unexpected ways, or (4) employees' duties may be rotated in ways that have not been previously considered. These and other circumstances may serve to modify or otherwise change prescribed procedures, thus giving the examiner an inadequate basis for evaluating internal control.

Sometimes, when a substantial portion of the accounting work is accomplished by computer, the procedures are so different from conventional accounting methods that the principles discussed here seem inapplicable. Care should be taken to resist drawing this conclusion. This discussion of internal control and its evaluation is purposely stated in terms sufficiently general to apply to any system. Perpetration of defalcations requires direct or indirect access to appropriate documents or accounting records. As such, perpetration requires the involvement of people and, under any system, computerized or not, there will be persons who have access to assets and records. Those with access may include computer operators, programmers, and their supervisors and other related personnel.

The final question in each section of the ICQ requires a composite evaluation of existing internal controls in the applicable area of the bank. The examiner should base that evaluation on answers to the preceding questions within the section, the review and observation of the systems and controls within the bank, and discussion with appropriate bank personnel.

The composite evaluation does, however, require some degree of subjective judgment. The examiner should use all information available to formulate an overall evaluation, fully realizing that a high degree of professional judgment is required.

Applying the ICQ to Different Situations

The ICQs are general enough to apply to a wide range of systems, so not all sections or questions will apply to every situation, depending on factors such as bank size, complexity and type of operations, and organizational structure. When completing the ICQs, the examiner should include a brief comment stating the reason a section or question is not applicable to the specific situation.

For large banking institutions or when multiple locations of a bank are being examined, it may be necessary to design supplements to the ICQs to adequately review all phases of the bank's operations and related internal controls. Because certain functions described in this manual may be performed by several departments in some banks, it also may be necessary to redesign a particular section of the ICQ so that each department receives appropriate consideration. Conversely, functions described in several different sections of this handbook may be performed in a single department in smaller banks. If the ICQ is adapted to fit a specific situation, care should be taken to ensure that its scope and intent are not modified. That requires professional judgment in interpreting and expanding the generalized material. Any such modifications should be completely documented and filed in the workpapers.

LEGAL REQUIREMENTS AFFECTING BANKS AND THE AUDIT FUNCTION

On May 11, 1993, the board of directors of the Federal Deposit Insurance Corporation (FDIC) approved the regulations and guidelines implementing the audit requirements of section 112 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), which is codified as section 36 of the FDI Act (12 USC 1831m). Since that date, the FDIC has adopted amendments to its regulations and guidelines primarily in response to changes made to the original statute. These regulations and guidelines require institutions that must comply with FDICIA section 112 to file with the FDIC and the primary regulator (1) audited financial statements, (2) a report on the effectiveness of internal controls over financial reporting, and (3) a report on compliance with designated laws and regulations. Institutions subject to FDICIA section 112 are referred to as covered institutions and include domestic insured depository institutions as well as foreign branches and agencies.

Effective for fiscal years beginning after December 31, 1992, federally insured depository institutions with total assets of $500 million or more must comply with the provisions of section 112 of FDICIA. (See SR-94-3.) Among other things, this section requires—

- a covered institution to assess the effectiveness of its internal control structure over financial reporting and to file a report with both the FDIC and the institution's primary bank regulator,
- independent public accountants to attest to the accuracy of management's assertions on the internal control structure over financial reporting,
- a covered institution to assess its compliance with designated safety-and-soundness laws and regulations and to provide a report to both the FDIC and the institution's primary bank regulator,
- independent public accountants to perform agreed-upon procedures to objectively determine the accuracy of management's assertions on compliance with safety-and-soundness laws and regulations, and
- each covered institution to have an audit committee composed solely of independent outside directors. The audit committees of large institutions must have at least two members with banking or related financial management expertise who have access to outside legal counsel, and committees shall not include individuals who are large customers of the institution. The audit committee may also be required to satisfy other audit committee membership criteria.

With regard to the first three bullets (requirements) and effective April 1, 1996, any covered institution with a composite CAMELS rating of 1 or 2 may file the reports discussed above through its parent holding company on a consolidated basis. The FDIC's guidelines implementing section 112 provide that one of the duties of a covered institution's audit committee should include oversight of the internal audit function and its operations. (See SR-96-4.)

INTERAGENCY POLICY STATEMENT ON THE INTERNAL AUDIT FUNCTION AND ITS OUTSOURCING

The Federal Reserve and other federal banking agencies[3] (the agencies) adopted on March 17, 2003, an interagency policy statement addressing the internal audit function and its outsourcing. The policy statement revises and replaces the former 1997 policy statement and incorporates recent developments in internal auditing. In addition, the revised policy incorporates guidance on the independence of accountants who provide institutions with both internal and external audit services in light of the Sarbanes-Oxley Act of 2002 (the act) and associated SEC rules.

The act prohibits an accounting firm from acting as the external auditor of a public company during the same period that the firm provides internal audit services to the company. The policy statement discusses the applicability of this prohibition to institutions that are public companies, to insured depository institutions with assets of $500 million or more that are subject to the annual audit and reporting requirements of section 36 of the FDI Act, and to nonpublic institutions that are not subject to section 36.

The statement recognizes that many institutions have engaged independent public accounting firms and other outside professionals (outsourcing vendors) to perform work that traditionally has been done by internal auditors. These arrangements are often called "internal audit outsourcing," "internal audit assistance," "audit co-sourcing," and "extended audit services" (hereafter collectively referred to as outsourcing). Typical outsourcing arrangements are more fully described below.

Outsourcing may be beneficial to an institution if it is properly structured, carefully conducted, and prudently managed. However, the structure, scope, and management of some internal audit outsourcing arrangements may not contribute to the institution's safety and soundness. Furthermore, arrangements with outsourcing vendors should not leave directors and senior management with the erroneous impression that they have been relieved of their responsibility for maintaining an effective system of internal control and for overseeing the internal audit function.

Internal Audit Function (Part I)

Board and Senior Management Responsibilities

The board of directors and senior management

3. The Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, and Office of Thrift Supervision.

are responsible for having an effective system of internal control and an effective internal audit function in place at their institution. They are also responsible for ensuring that the importance of internal control is understood and respected throughout the institution. This overall responsibility cannot be delegated to anyone else. They may, however, delegate the design, implementation, and monitoring of specific internal controls to lower-level management and delegate the testing and assessment of internal controls to others. Accordingly, directors and senior management should have reasonable assurance that the system of internal control prevents or detects significant inaccurate, incomplete, or unauthorized transactions; deficiencies in the safeguarding of assets; unreliable financial reporting (which includes regulatory reporting); and deviations from laws, regulations, and the institution's policies.[4]

Some institutions have chosen to rely on so-called management self-assessments or control self-assessments, wherein business-line managers and their staff evaluate the performance of internal controls within their purview. Such reviews help to underscore management's responsibility for internal control, but they are not impartial. Directors and members of senior management who rely too much on these reviews may not learn of control weaknesses until they have become costly problems, particularly if directors are not intimately familiar with the institution's operations. Therefore, institutions generally should also have their internal controls tested and evaluated by units without business-line responsibilities, such as internal audit groups.

Directors should be confident that the internal audit function addresses the risks of and meets the demands posed by the institution's current and planned activities. To accomplish this objective, directors should consider whether their institution's internal audit activities are conducted in accordance with professional standards, such as the Institute of Internal Auditors' (IIA) *Standards for the Professional Practice of Internal Auditing.* These standards address independence, professional proficiency, scope of work, performance of audit work, management of internal audit, and quality-assurance reviews. Furthermore, directors and senior management should ensure that the following matters are reflected in their institution's internal audit function.

Structure. Careful thought should be given to the placement of the audit function in the institution's management structure. The internal audit function should be positioned so that the board has confidence that the internal audit function will perform its duties with impartiality and not be unduly influenced by managers of day-to-day operations. The audit committee,[5] using objective criteria it has established, should oversee the internal audit function and evaluate its performance.[6] The audit committee should assign responsibility for the internal audit function to a member of management (that is, the manager of internal audit or internal audit manager) who understands the function and has no responsibility for operating the system of internal control. The ideal organizational arrangement is for this manager to report directly and solely to the audit committee regarding both audit issues and administrative matters, for example, resources, budget, appraisals, and compensation. Institutions are encouraged to consider the IIA's *Practice Advisory 2060-2: Relationship with the Audit Committee,* which provides more guidance on the roles and relationships between the audit committee and the internal audit manager.

Many institutions place the manager of internal audit under a dual reporting arrangement: the manager is functionally accountable to the audit committee on issues discovered by the internal audit function, while reporting to another

4. As noted above, under section 36 of the FDI Act, as implemented by part 363 of the FDIC's regulations (12 CFR 363), FDIC-insured depository institutions with total assets of $500 million or more must submit an annual management report signed by the chief executive officer (CEO) and chief accounting or chief financial officer. This report must discuss management's responsibility for financial reporting controls and assess the effectiveness of those controls as well as the institution's compliance with designated laws and regulations.

5. Depository institutions subject to section 36 of the FDI Act and part 363 of the FDIC's regulations must maintain independent audit committees (i.e., consisting of directors who are not members of management). Consistent with the 1999 Interagency Policy Statement on External Auditing Programs of Banks and Savings Associations, the agencies also encourage the board of directors of each depository institution that is not otherwise required to do so to establish an audit committee consisting entirely of outside directors. Where the term ''audit committee'' is used in this policy statement, the board of directors may fulfill the audit committee responsibilities if the institution is not subject to an audit committee requirement.

6. For example, the performance criteria could include the timeliness of each completed audit, comparison of overall performance to plan, and other measures.

senior manager on administrative matters. Under a dual reporting relationship, the board should consider the potential for diminished objectivity on the part of the internal audit manager with respect to audits concerning the executive to whom he or she reports. For example, a manager of internal audit who reports to the chief financial officer (CFO) for performance appraisal, salary, and approval of department budgets may approach audits of the accounting and treasury operations controlled by the CFO with less objectivity than if the manager were to report to the chief executive officer. Thus, the chief financial officer, controller, or other similar officer should ideally be excluded from overseeing the internal audit activities even in a dual role. The objectivity and organizational stature of the internal audit function are best served under such a dual arrangement if the internal audit manager reports administratively to the CEO.

Some institutions seek to coordinate the internal audit function with several risk-monitoring functions (for example, loan review, market-risk assessment, and legal compliance departments) by establishing an administrative arrangement under one senior executive. Coordination of these other monitoring activities with the internal audit function can facilitate the reporting of material risk and control issues to the audit committee, increase the overall effectiveness of these monitoring functions, better utilize available resources, and enhance the institution's ability to comprehensively manage risk. Such an administrative reporting relationship should be designed so as to not interfere with or hinder the manager of internal audit's functional reporting to and ability to directly communicate with the institution's audit committee. In addition, the audit committee should ensure that efforts to coordinate these monitoring functions do not result in the manager of internal audit conducting control activities nor diminish his or her independence with respect to the other risk-monitoring functions. Furthermore, the internal audit manager should have the ability to independently audit these other monitoring functions.

In structuring the reporting hierarchy, the board should weigh the risk of diminished independence against the benefit of reduced administrative burden in adopting a dual reporting organizational structure. The audit committee should document its consideration of this risk and mitigating controls. The IIA's *Practice Advisory 1110-2: Chief Audit Executive Reporting Lines* provides additional guidance regarding functional and administrative reporting lines.

Management, staffing, and audit quality. In managing the internal audit function, the manager of internal audit is responsible for control risk assessments, audit plans, audit programs, and audit reports.

- A control risk assessment (or risk-assessment methodology) documents the internal auditor's understanding of the institution's significant business activities and their associated risks. These assessments typically analyze the risks inherent in a given business line, the mitigating control processes, and the resulting residual risk exposure of the institution. They should be updated regularly to reflect changes to the system of internal control or work processes and to incorporate new lines of business.
- An internal audit plan is based on the control risk assessment and typically includes a summary of key internal controls within each significant business activity, the timing and frequency of planned internal audit work, and a resource budget.
- An internal audit program describes the objectives of the audit work and lists the procedures that will be performed during each internal audit review.
- An audit report generally presents the purpose, scope, and results of the audit, including findings, conclusions, and recommendations. Workpapers that document the work performed and support the audit report should be maintained.

Ideally, the internal audit function's only role should be to independently and objectively evaluate and report on the effectiveness of an institution's risk-management, control, and governance processes. Internal auditors increasingly have taken a consulting role within institutions on new products and services and on mergers, acquisitions, and other corporate reorganizations. This role typically includes helping design controls and participating in the implementation of changes to the institution's control activities. The audit committee, in its oversight of the internal audit staff, should ensure that the function's consulting activities do not interfere or conflict with the objectivity it should have with respect to monitoring the institution's system of internal control. In order to maintain its independence, the internal audit function should not assume a business-line management role over control activities, such as approving or implementing operating policies or procedures, including those it has helped design in connection with its consulting activities. The agencies encourage internal auditors to follow the IIA's standards, including guidance related to the internal audit function acting in an advisory capacity.

The internal audit function should be competently supervised and staffed by people with sufficient expertise and resources to identify the risks inherent in the institution's operations and assess whether internal controls are effective. The manager of internal audit should oversee the staff assigned to perform the internal audit work and should establish policies and procedures to guide the audit staff. The form and content of these policies and procedures should be consistent with the size and complexity of the department and the institution. Many policies and procedures may be communicated informally in small internal audit departments, while larger departments would normally require more formal and comprehensive written guidance.

Scope. The frequency and extent of internal audit review and testing should be consistent with the nature, complexity, and risk of the institution's on- and off-balance-sheet activities. At least annually, the audit committee should review and approve internal audit's control risk assessment and the scope of the audit plan, including how much the manager relies on the work of an outsourcing vendor. It should also periodically review internal audit's adherence to the audit plan. The audit committee should consider requests for expansion of basic internal audit work when significant issues arise or when significant changes occur in the institution's environment, structure, activities, risk exposures, or systems.[7]

Communication. To properly carry out their responsibility for internal control, directors and senior management should foster forthright communications and critical examination of issues to better understand the importance and severity of internal control weaknesses identified by the internal auditor and operating management's solutions to these weaknesses. Internal auditors should report internal control deficiencies to the appropriate level of management as soon as they are identified. Significant matters should be promptly reported directly to the board of directors (or its audit committee) and senior management. In periodic meetings with management and the manager of internal audit, the audit committee should assess whether management is expeditiously resolving internal control weaknesses and other exceptions. Moreover, the audit committee should give the manager of internal audit the opportunity to discuss his or her findings without management being present.

Furthermore, each audit committee should establish and maintain procedures for employees of their institution to confidentially and anonymously submit concerns to the committee about questionable accounting, internal accounting control, or auditing matters.[8] In addition, the audit committee should set up procedures for the timely investigation of complaints received and the retention for a reasonable time period of documentation concerning the complaint and its subsequent resolution.

Contingency planning. As with any other function, the institution should have a contingency plan to mitigate any significant discontinuity in audit coverage, particularly for high-risk areas. Lack of contingency planning for continuing internal audit coverage may increase the institution's level of operational risk.

Small Financial Institution's Internal Audit Function

An effective system of internal control and an independent internal audit function form the foundation for safe and sound operations, regardless of an institution's size. Each institution should have an internal audit function that is appropriate to its size and the nature and scope of its activities. The procedures assigned to this function should include adequate testing

7. Major changes in an institution's environment and conditions may compel changes to the internal control system and also warrant additional internal audit work. These changes include (1) new management; (2) areas or activities experiencing rapid growth or rapid decline; (3) new lines of business, products, or technologies or disposals thereof; (4) corporate restructurings, mergers, and acquisitions; and (5) an expansion or acquisition of foreign operations (including the impact of changes in the related economic and regulatory environments).

8. When the board of directors fulfills the audit committee responsibilities, the procedures should provide for the submission of employee concerns to an outside director.

and review of internal controls and information systems.

It is the responsibility of the audit committee and management to carefully consider the extent of auditing that will effectively monitor the internal control system, after taking into account the internal audit function's costs and benefits. For institutions that are large or have complex operations, the benefits derived from a full-time manager of internal audit or an auditing staff likely outweigh the cost. For small institutions with few employees and less complex operations, however, these costs may outweigh the benefits. Nevertheless, a small institution without an internal auditor can ensure that it maintains an objective internal audit function by implementing a comprehensive set of independent reviews of significant internal controls. The key characteristic of such reviews is that the persons directing and/or performing the review of internal controls are *not* also responsible for managing or operating those controls. A person who is competent in evaluating a system of internal control should design the review procedures and arrange for their implementation. The person responsible for reviewing the system of internal control should report findings directly to the audit committee. The audit committee should evaluate the findings and ensure that senior management has or will take appropriate action to correct the control deficiencies.

Internal Audit Outsourcing Arrangements (Part II)

Examples of Internal Audit Outsourcing Arrangements

An outsourcing arrangement is a contract between an institution and an outsourcing vendor to provide internal audit services. Outsourcing arrangements take many forms and are used by institutions of all sizes. Some institutions consider entering into these arrangements to enhance the quality of their control environment by obtaining the services of a vendor with the knowledge and skills to critically assess, and recommend improvements to, their internal control systems. The internal audit services under contract can be limited to helping internal audit staff in an assignment for which they lack expertise. Such an arrangement is typically under the control of the institution's manager of internal audit, and the outsourcing vendor reports to him or her. Institutions often use outsourcing vendors for audits of areas requiring more technical expertise, such as electronic data processing and capital-markets activities. Such uses are often referred to as "internal audit assistance" or "audit co-sourcing."

Some outsourcing arrangements may require an outsourcing vendor to perform virtually all the procedures or tests of the system of internal control. Under such an arrangement, a designated manager of internal audit oversees the activities of the outsourcing vendor and typically is supported by internal audit staff. The outsourcing vendor may assist the audit staff in determining risks to be reviewed and may recommend testing procedures, but the internal audit manager is responsible for approving the audit scope, plan, and procedures to be performed. Furthermore, the internal audit manager is responsible for the results of the outsourced audit work, including findings, conclusions, and recommendations. The outsourcing vendor may report these results jointly with the internal audit manager to the audit committee.

Additional Considerations for Internal Audit Outsourcing Arrangements

Even when outsourcing vendors provide internal audit services, the board of directors and senior management of an institution are responsible for ensuring that both the system of internal control and the internal audit function operate effectively. In any outsourced internal audit arrangement, the institution's board of directors and senior management must maintain ownership of the internal audit function and provide active oversight of outsourced activities. When negotiating the outsourcing arrangement with an outsourcing vendor, an institution should carefully consider its current and anticipated business risks in setting each party's internal audit responsibilities. The outsourcing arrangement should not increase the risk that a breakdown of internal control will go undetected.

To clearly distinguish its duties from those of the outsourcing vendor, the institution should have a written contract, often taking the form of an engagement letter.[9] Contracts between the

9. The engagement-letter provisions described are comparable to those outlined by the American Institute of Certified Public Accountants (AICPA) for financial statement audits.

institution and the vendor typically include provisions that—

- define the expectations and responsibilities under the contract for both parties;
- set the scope and frequency of, and the fees to be paid for, the work to be performed by the vendor;
- set the responsibilities for providing and receiving information, such as the type and frequency of reporting to senior management and directors about the status of contract work;
- establish the process for changing the terms of the service contract, especially for expansion of audit work if significant issues are found, and stipulations for default and termination of the contract;
- state that internal audit reports are the property of the institution, that the institution will be provided with any copies of the related workpapers it deems necessary, and that employees authorized by the institution will have reasonable and timely access to the workpapers prepared by the outsourcing vendor;
- specify the locations of internal audit reports and the related workpapers;
- specify the period of time (for example, seven years) that vendors must maintain the workpapers;[10]
- state that outsourced internal audit services provided by the vendor are subject to regulatory review and that examiners will be granted full and timely access to the internal audit reports and related workpapers prepared by the outsourcing vendor;
- prescribe a process (arbitration, mediation, or other means) for resolving disputes and for determining who bears the cost of consequential damages arising from errors, omissions, and negligence; and
- state that the outsourcing vendor will not perform management functions, make management decisions, or act or appear to act in a capacity equivalent to that of a member of management or an employee and, if applicable, will comply with AICPA, U.S. Securities and Exchange Commission (SEC), PCAOB, or regulatory independence guidance.

Vendor competence. Before entering an outsourcing arrangement, the institution should perform due diligence to satisfy itself that the outsourcing vendor has sufficient staff qualified to perform the contracted work. The staff's qualifications may be demonstrated, for example, through prior experience with financial institutions. Because the outsourcing arrangement is a personal-services contract, the institution's internal audit manager should have confidence in the competence of the staff assigned by the outsourcing vendor and receive timely notice of key staffing changes. Throughout the outsourcing arrangement, management should ensure that the outsourcing vendor maintains sufficient expertise to effectively perform its contractual obligations.

Management of the outsourced internal audit function. Directors and senior management should ensure that the outsourced internal audit function is competently managed. For example, larger institutions should employ sufficient competent staff members in the internal audit department to assist the manager of internal audit in overseeing the outsourcing vendor. Small institutions that do not employ a full-time audit manager should appoint a competent employee who ideally has no managerial responsibility for the areas being audited to oversee the outsourcing vendor's performance under the contract. This person should report directly to the audit committee for purposes of communicating internal audit issues.

Communication when an outsourced internal audit function exists. Communication between the internal audit function and the audit committee and senior management should not diminish because the institution engages an outsourcing vendor. All work by the outsourcing vendor should be well documented and all findings of control weaknesses should be promptly reported to the institution's manager of internal audit. Decisions not to report the outsourcing vendor's findings to directors and senior management should be the mutual decision of the internal audit manager and the outsourcing vendor. In deciding what issues should be brought to the board's attention, the

(See AICPA Professional Standards, AU section 310.) These provisions are consistent with the provisions customarily included in contracts for other outsourcing arrangements, such as those involving data processing and information technology. Therefore, the federal banking agencies consider these provisions to be usual and customary business practices.

10. If the workpapers are in electronic format, contracts often call for the vendor to maintain proprietary software that enables the bank and examiners to access the electronic workpapers for a specified time period.

concept of "materiality," as the term is used in financial statement audits, is generally not a good indicator of which control weakness to report. For example, when evaluating an institution's compliance with laws and regulations, any exception may be important.

Contingency planning to ensure continuity of outsourced audit coverage. When an institution enters into an outsourcing arrangement (or significantly changes the mix of internal and external resources used by internal audit), it may increase its operational risk. Because the arrangement may be terminated suddenly, the institution should have a contingency plan to mitigate any significant discontinuity in audit coverage, particularly for high-risk areas.

Independence of the Independent Public Accountant (Part III)

The following discussion applies only when a financial institution is considering using a public accountant to provide both external audit and internal audit services to the institution.

When one accounting firm performs both the external audit and the outsourced internal audit function, the firm risks compromising its independence. These concerns arise because, rather than having two separate functions, this outsourcing arrangement places the independent public accounting firm in the position of appearing to audit, or actually auditing, its own work. For example, in auditing an institution's financial statements, the accounting firm will consider the extent to which it may rely on the internal control system, including the internal audit function, in designing audit procedures.

Applicability of the SEC's Auditor Independence Requirements

Institutions that are public companies. To strengthen auditor independence, Congress passed the Sarbanes-Oxley Act of 2002 (the act). Title II of the act applies to any public company—that is, any company that has a class of securities registered with the SEC or the appropriate federal banking agency under section 12 of the Securities Exchange Act of 1934 or that is required to file reports with the SEC under section 15(d) of that act.[11] The act prohibits an accounting firm from acting as the external auditor of a public company during the same period that the firm provides internal audit outsourcing services to the company.[12] In addition, if a public company's external auditor will be providing auditing services and permissible nonaudit services, such as tax services, the company's audit committee must preapprove each of these services.

According to the SEC's final rules (effective May 6, 2003) implementing the act's nonaudit-service prohibitions and audit committee preapproval requirements, an accountant is not independent if, at any point during the audit and professional engagement period, the accountant provides internal audit outsourcing or other prohibited nonaudit services to the public company audit client. The SEC's final rules generally become effective on May 6, 2003, although there is a one-year transition period if the accountant is performing prohibited nonaudit services and external audit services for a public company pursuant to a contract in existence on May 6, 2003. The services provided during this transition period must not have impaired the auditor's independence under the preexisting independence requirements of the SEC, the Independence Standards Board, and the AICPA. Although the SEC's pre-Sarbanes-Oxley independence requirements (issued in November 2000, effective August 2002) did not prohibit the outsourcing of internal audit services to a public company's independent public accoun-

11. 15 USC 78*l* and 78o(d).

12. In addition to prohibiting internal audit outsourcing, the Sarbanes-Oxley Act (15 USC 78j-1) also identifies other nonaudit services that an external auditor is prohibited from providing to a public company whose financial statements it audits. The legislative history of the act indicates that three broad principles should be considered when determining whether an auditor should be prohibited from providing a nonaudit service to an audit client. These principles are that an auditor should not (1) audit his or her own work, (2) perform management functions for the client, or (3) serve in an advocacy role for the client. To do so would impair the auditor's independence. Based on these three broad principles, the other nonaudit services that an auditor is prohibited from providing to a public company audit client include bookkeeping or other services related to the client's accounting records or financial statements; financial information systems design and implementation; appraisal or valuation services, fairness opinions, or contribution-in-kind reports; actuarial services; management or human resources functions; broker or dealer, investment adviser, or investment banking services; legal services and expert services unrelated to the audit; and any other service determined to be impermissible by the PCAOB.

tant, they did place conditions and limitations on internal audit outsourcing.

Depository institutions subject to the annual audit and reporting requirements of section 36 of the FDI Act. Under section 36, as implemented by part 363 of the FDIC's regulations, each FDIC-insured depository institution with total assets of $500 million or more is required to have an annual audit performed by an independent public accountant.[13] The part 363 guidelines address the qualifications of an independent public accountant engaged by such an institution by stating that "[t]he independent public accountant should also be in compliance with the AICPA's *Code of Professional Conduct* and meet the independence requirements and interpretations of the SEC and its staff."[14]

Thus, the guidelines provide for each FDIC-insured depository institution with $500 million or more in total assets, whether or not it is a public company, and its external auditor to comply with the SEC's auditor independence requirements that are in effect during the period covered by the audit. These requirements include the nonaudit-service prohibitions and audit committee preapproval requirements implemented by the SEC's January 2003 auditor independence rules once these rule come into effect.[15]

Institutions not subject to section 36 of the FDI Act that are neither public companies nor subsidiaries of public companies. The agencies have long encouraged each institution not subject to section 36 of the FDI Act that is neither a public company nor a subsidiary of a public company[16] to have its financial statements audited by an independent public accountant.[17] The agencies also encourage each such institution to follow the internal audit outsourcing prohibition in the Sarbanes-Oxley Act, as discussed above for institutions that are public companies.

As previously mentioned, some institutions seek to enhance the quality of their control environment by obtaining the services of an outsourcing vendor who can critically assess their internal control system and recommend improvements. The agencies believe that a small nonpublic institution with less complex operations and limited staff can, in certain circumstances, use the same accounting firm to perform both an external audit and some or all of the institution's internal audit activities. These circumstances include, but are not limited to, situations in which—

- splitting the audit activities poses significant costs or burden;
- persons with the appropriate specialized knowledge and skills are difficult to locate and obtain;
- the institution is closely held and investors are not solely reliant on the audited financial statements to understand the financial position and performance of the institution; and
- the outsourced internal audit services are limited in either scope or frequency.

In circumstances such as these, the agencies view an internal audit outsourcing arrangement between a small nonpublic institution and its external auditor as not being inconsistent with their safety-and-soundness objectives for the institution.

When a small nonpublic institution decides to hire the same firm to perform internal and external audit work, the audit committee and the external auditor should pay particular attention to preserving the independence of both the internal and external audit functions. Furthermore, the audit committee should document both that it has preapproved the internal audit outsourcing to its external auditor and has considered the independence issues associated with this arrangement.[18] In this regard, the audit

13. 12 CFR 363.3(a). (See FDIC Financial Institutions Letter FIL-17-2003 (Corporate Governance, Audits, and Reporting Requirements), attachment II, March 5, 2003.)

14. Appendix A to part 363, Guidelines and Interpretations, paragraph 14, Independence.

15. If a depository institution subject to section 36 and part 363 satisfies the annual independent audit requirement by relying on the independent audit of its parent holding company, once the SEC's January 2003 regulations prohibiting an external auditor from performing internal audit outsourcing services for an audit client take effect May 6, 2003, or May 6, 2004, depending on the circumstances, the holding company's external auditor cannot perform internal audit outsourcing work for that holding company or the subsidiary institution.

16. FDIC-insured depository institutions with less than $500 million in total assets are not subject to section 36 of the FDI Act. Section 36 does not apply directly to holding companies but provides that, for an insured depository institution that is a subsidiary of a holding company, the audited financial statements requirement and certain of the statute's other requirements may be satisfied by the holding company.

17. See, for example, the 1999 Interagency Policy Statement on External Auditing Programs of Banks and Savings Institutions.

18. If a small nonpublic institution is considering having its external auditor perform other nonaudit services, its audit committee may wish to discuss the implications of the

committee should consider the independence standards described in parts I and II of the policy statement, the AICPA guidance discussed below, and the broad principles that the auditor should not perform management functions or serve in an advocacy role for the client.

Accordingly, the agencies will not consider an auditor who performs internal audit outsourcing services for a small nonpublic audit client to be independent unless the institution and its auditor have adequately addressed the associated independence issues. In addition, the institution's board of directors and management must retain ownership of and accountability for the internal audit function and provide active oversight of the outsourced internal audit relationship.

A small nonpublic institution may be required by another law or regulation, an order, or another supervisory action to have its financial statements audited by an independent public accountant. In this situation, if warranted for safety-and-soundness reasons, the institution's primary federal regulator may require that the institution and its independent public accountant comply with the auditor-independence requirements of the act.[19]

AICPA guidance. As noted above, the independent public accountant for a depository institution subject to section 36 of the FDI Act also should be in compliance with the AICPA's *Code of Professional Conduct.* This code includes professional ethics standards, rules, and interpretations that are binding on all certified public accountants (CPAs) who are members of the AICPA in order for the member to remain in good standing. Therefore, this code applies to each member CPA who provides audit services to an institution, regardless of whether the institution is subject to section 36 or is a public company.

The AICPA has issued guidance indicating that a member CPA would be deemed not independent of his or her client when the CPA acts or appears to act in a capacity equivalent to a member of the client's management or as a client employee. The AICPA's guidance includes illustrations of activities that would be considered to compromise a CPA's independence. Among these are activities that involve the CPA authorizing, executing, or consummating transactions or otherwise exercising authority on behalf of the client. For additional details, refer to Interpretation 101-3, Performance of Other Services, and Interpretation 101-13, Extended Audit Services, in the AICPA's *Code of Professional Conduct.*

performance of these services on the auditor's independence.

19. 15 USC 78j-1.

Examination Guidance (Part IV)

Review of the Internal Audit Function and Outsourcing Arrangements

Examiners should have full and timely access to an institution's internal audit resources, including personnel, workpapers, risk assessments, work plans, programs, reports, and budgets. A delay may require examiners to widen the scope of their examination work and may subject the institution to follow-up supervisory actions.

Examiners should assess the quality and scope of an institution's internal audit function, regardless of whether it is performed by the institution's employees or by an outsourcing vendor. Specifically, examiners should consider whether—

- the internal audit function's control risk assessment, audit plans, and audit programs are appropriate for the institution's activities;
- the internal audit activities have been adjusted for significant changes in the institution's environment, structure, activities, risk exposures, or systems;
- the internal audit activities are consistent with the long-range goals and strategic direction of the institution and are responsive to its internal control needs;
- the audit committee promotes the internal audit manager's impartiality and independence by having him or her directly report audit findings to it;
- the internal audit manager is placed in the management structure in such a way that the independence of the function is not impaired;
- the institution has promptly responded to significant identified internal control weaknesses;
- the internal audit function is adequately managed to ensure that audit plans are met, programs are carried out, and the results of audits are promptly communicated to senior management and members of the audit committee and board of directors;

- workpapers adequately document the internal audit work performed and support the audit reports;
- management and the board of directors use reasonable standards, such as the IIA's *Standards for the Professional Practice of Internal Auditing*, when assessing the performance of internal audit; and
- the audit function provides high-quality advice and counsel to management and the board of directors on current developments in risk management, internal control, and regulatory compliance.

The examiner should assess the competence of the institution's internal audit staff and management by considering the education, professional background, and experience of the principal internal auditors. In addition, when reviewing outsourcing arrangements, examiners should determine whether—

- the arrangement maintains or improves the quality of the internal audit function and the institution's internal control;
- key employees of the institution and the outsourcing vendor clearly understand the lines of communication and how any internal control problems or other matters noted by the outsourcing vendor are to be addressed;
- the scope of the outsourced work is revised appropriately when the institution's environment, structure, activities, risk exposures, or systems change significantly;
- the directors have ensured that the outsourced internal audit activities are effectively managed by the institution;
- the arrangement with the outsourcing vendor satisfies the independence standards described in this policy statement and thereby preserves the independence of the internal audit function, whether or not the vendor is also the institution's independent public accountant; and
- the institution has performed sufficient due diligence to satisfy itself of the vendor's competence before entering into the outsourcing arrangement and has adequate procedures for ensuring that the vendor maintains sufficient expertise to perform effectively throughout the arrangement.

Examination concerns about the adequacy of the internal audit function. If the examiner concludes that the institution's internal audit function, whether or not it is outsourced, does not sufficiently meet the institution's internal audit needs; does not satisfy the Interagency Guidelines Establishing Standards for Safety and Soundness, if applicable; or is otherwise inadequate, he or she should determine whether the scope of the examination should be adjusted. The examiner should also discuss his or her concerns with the internal audit manager or other person responsible for reviewing the system of internal control. If these discussions do not resolve the examiner's concerns, he or she should bring these matters to the attention of senior management and the board of directors or audit committee. If the examiner finds material weaknesses in the internal audit function or the internal control system, he or she should discuss them with appropriate agency staff in order to determine the appropriate actions the agency should take to ensure that the institution corrects the deficiencies. These actions may include formal and informal enforcement actions.

The institution's management and composite ratings should reflect the examiner's conclusions regarding the institution's internal audit function. The report of examination should contain comments concerning the adequacy of this function, significant issues or concerns, and recommended corrective actions.

Concerns about the independence of the outsourcing vendor. An examiner's initial review of an internal audit outsourcing arrangement, including the actions of the outsourcing vendor, may raise questions about the institution's and its vendor's adherence to the independence standards described in parts I and II of the policy statement, whether or not the vendor is an accounting firm, and in part III if the vendor provides both external and internal audit services to the institution. In such cases, the examiner first should ask the institution and the outsourcing vendor how the audit committee determined that the vendor was independent. If the vendor is an accounting firm, the audit committee should be asked to demonstrate how it assessed that the arrangement has not compromised applicable SEC, PCAOB, AICPA, or other regulatory standards concerning auditor independence. If the examiner's concerns are not adequately addressed, the examiner should discuss the matter with appropriate agency staff prior to taking any further action.

If the agency staff concurs that the independence of the external auditor or other vendor appears to be compromised, the examiner will discuss his or her findings and the actions the agency may take with the institution's senior management, board of directors (or audit committee), and the external auditor or other vendor. In addition, the agency may refer the external auditor to the state board of accountancy, the AICPA, the SEC, the PCAOB, or other authorities for possible violations of applicable independence standards. Moreover, the agency may conclude that the institution's external auditing program is inadequate and that it does not comply with auditing and reporting requirements, including sections 36 and 39 of the FDI Act and related guidance and regulations, if applicable. *Issued jointly by the Board, FDIC, OCC, and OTS on March 17, 2003.*

INDEPENDENCE OF INTERNAL AUDITORS

The ability of the internal audit function to achieve its audit objectives depends, in large part, on the independence maintained by audit personnel. Frequently, the independence of internal auditing can be determined by its reporting lines within the organization and by the person or level to whom these results are reported. In most circumstances, the internal audit function is under the direction of the board of directors or a committee thereof, such as the audit committee. This relationship enables the internal audit function to assist the directors in fulfilling their responsibilities.

The auditor's responsibilities should be addressed in a position description, with reporting lines delineated in personnel policy, and audit results should be documented in audit committee and board of directors' minutes. Examiners should review these documents, as well as the reporting process followed by the auditor, in order to subsequently evaluate the tasks performed by the internal audit function. The internal auditor should be given the authority necessary to perform the job, including free access to any records necessary for the proper conduct of the audit. Furthermore, internal auditors generally should not have responsibility for the accounting system, other aspects of the institution's accounting function, or any operational function not subject to independent review.

Competence of Internal Auditors

The responsibilities and qualifications of internal auditors vary depending on the size and complexity of a bank's operations and on the emphasis placed on the internal audit function by the directorate and management. In many banks, the internal audit function is performed by an individual or group of individuals whose sole responsibility is internal auditing. In other banks, particularly small ones, internal audit may be performed on a part-time basis by an officer or employee.

The qualifications discussed below should not be viewed as minimum requirements but should be considered by the examiner in evaluating the work performed by the internal auditors or audit departments. Examples of the type of qualifications an internal audit department manager should have are—

- academic credentials comparable to other bank officers who have major responsibilities within the organization,
- commitment to a program of continuing education and professional development,
- audit experience and organizational and technical skills commensurate with the responsibilities assigned, and
- oral and written communication skills.

The internal audit department manager must be properly trained to fully understand the flow of data and the underlying operating procedures. Training may come from college courses, courses sponsored by industry groups such as the Bank Administration Institute (BAI), or in-house training programs. Significant work experience in various departments of a bank also may provide adequate training. Certification as a chartered bank auditor, certified internal auditor, or certified public accountant meets educational and other professional requirements. In addition to prior education, the internal auditor should be committed to a program of continuing education, which may include attending technical meetings and seminars and reviewing current literature on auditing and banking.

The internal auditor's organizational skills should be reflected in the effectiveness of the bank's audit program. Technical skills may be demonstrated through internal audit techniques, such as internal control and other questionnaires, and an understanding of the operational and financial aspects of the organization.

In considering the competence of the internal audit staff, the examiner should review the educational and experience qualifications required by the bank for filling the positions in the internal audit department and the training available for that position. In addition, the examiner must be assured that any internal audit supervisor understands the audit objectives and procedures performed by the staff.

In a small bank, it is not uncommon to find that internal audit, whether full- or part-time, is a one-person department. The internal auditor may plan and perform all procedures personally or may direct staff borrowed from other departments. In either case, the examiner should expect, at a minimum, that the internal auditor possesses qualifications similar to those of an audit department manager, as previously discussed.

The final measure of the competence of the internal auditor is the quality of the work performed, the ability to communicate the results of that work, and the ability to follow up on deficiencies noted during the audit work. Accordingly, the examiner's conclusions with respect to an auditor's competence should also reflect the adequacy of the audit program and the audit reports.

IMPLEMENTATION OF THE INTERNAL AUDIT FUNCTION

The annual audit plan and budgets should be set by the internal audit manager and approved by the board, audit committee, or senior management. In many organizations, the internal audit manager reports to a senior manager for administrative purposes. The senior manager appraises the audit manager's performance, and the directors or an audit committee approves the evaluation.

Risk Assessment

In setting the annual audit plan, a risk assessment should be made that documents the internal audit function's understanding of the institution's various business activities and their inherent risks. In addition, the assessment also evaluates control risk, or the potential that deficiencies in the system of internal control would expose the institution to potential loss. The assessment should be periodically updated to reflect changes in the system of internal control, work processes, business activities, or the business environment. The risk-assessment methodology of the internal audit function should identify all auditable areas, give a detailed basis for the auditors' determination of relative risks, and be consistent from one audit area to another. The risk assessment can quantify certain risks, such as credit risk, market risk, and legal risk. It can also include qualitative aspects, such as the timeliness of the last audit and the quality of management. Although there is no standard approach to making a risk assessment, it should be appropriate to the size and complexity of the institution. While smaller institutions may not have elaborate risk-assessment systems, some analysis should still be available to explain why certain areas are more frequently audited than others.

Within the risk assessment, institutions should clearly identify auditable units along business activities or product lines, depending on how the institution is managed. There should be evidence that the internal audit manager is regularly notified of new products, departmental changes, and new general ledger accounts, all of which should be factored into the audit schedule. Ratings of particular business activities or corporate functions may change with time as the internal audit function revises its method for assessing risk. These changes should be incremental. Large-scale changes in the priority of audits should trigger an investigation into the reasonableness of changes to the risk-assessment methodology.

Audit Plan

The audit plan is based on the risk assessment. The plan should include a summary of key internal controls within each significant business activity, the timing and frequency of planned internal audit work, and a resource budget.

A formal, annual audit plan should be developed based on internal audit's risk assessment. The audit plan should include all auditable areas and set priorities based on the rating determined by the risk assessment. The schedule of planned audits should be approved by the board or its audit committee, as should any subsequent changes to the plan. Many organizations develop an audit plan jointly with the external auditors. In this case, the audit plan should clearly indicate what work is being performed by internal and external auditors and what aspects of internal audit work the external auditors are relying on.

Typically, the schedule of audit is cyclic; for example, high risks are audited annually, moderate risks every two years, and low risks every three years. In some cases, the audit cycle may extend beyond three years. In reviewing the annual plan, examiners should determine the appropriateness of the institution's audit cycle. Some institutions limit audit coverage of their low-risk areas. Examiners should review areas the institution has labeled ''low risk'' to determine if the classification is appropriate and if coverage is adequate.

Audit Manual

The internal audit department should have an audit manual that sets forth the standards of work for field auditors and audit managers to use in their assignments. A typical audit manual contains the audit unit's charter and mission, administrative procedures, workpaper-documentation standards, reporting standards, and review procedures. Individual audits should conform to the requirements of the audit manual. As a consequence, the manual should be up-to-date with respect to the audit function's mission and changes to the professional standards it follows.

Performance of Individual Audits

The internal audit manager should oversee the staff assigned to perform the internal audit work and should establish policies and procedures to guide them. The internal audit function should be competently supervised and staffed by people with sufficient expertise and resources to identify the risks inherent in the institution's operations and to assess whether internal controls are effective. While audits vary according to the objective, the area subjected to audit, the standards used as the basis for work performed, and documentation, the audit process generates some common documentation elements, as described below.

Audit Program and Related Workpapers

The audit program documents the audit's objectives and the procedures that were performed. Typically, it indicates who performed the work and who has reviewed it. Workpapers document the evidence gathered and conclusions drawn by the auditor, as well as the disposition of audit findings. The workpapers should provide evidence that the audit program adheres to the requirements specified in the audit manual.

Audit Reports

The audit report is internal audit's formal notice of its assessment of internal controls in the audited areas. The report is given to the area's managers, senior management, and directors. A typical audit report states the purpose of the audit and its scope, conclusions, and recommendations. Reports are usually prepared for each audit. In larger institutions, monthly or quarterly summaries that highlight major audit issues are prepared for senior management and the board.

EXAMINER REVIEW OF INTERNAL AUDIT

The examination procedures section describes the steps the examiner should follow when conducting a review of the work performed by the internal auditor. The examiner's review and evaluation of the internal audit function is a key element in determining the scope of the examination. In most situations, the competence and independence of the internal auditors may be reviewed on an overall basis; however, the adequacy and effectiveness of the audit program should be determined separately for each examination area.

The examiner should assess if the work performed by the internal auditor is reliable. It is often more efficient for the examiner to determine the independence or competence of the internal auditor before addressing the adequacy or effectiveness of the audit program. If the examiner concludes that the internal auditor possesses neither the independence nor the competence deemed appropriate, the examiner must also conclude that the internal audit work performed is not reliable.

The examiner should indicate in the report of examination any significant deficiencies concerning the internal audit function. Furthermore, the examiner should review with management any significant deficiencies noted in the previous report of examination to determine if these concerns have been appropriately addressed.

Program Adequacy and Effectiveness

An examiner should consider the following factors when assessing the adequacy of the internal audit program—

- scope and frequency of the work performed,
- content of the programs,
- documentation of the work performed, and
- conclusions reached and reports issued.

The scope of the internal audit program must be sufficient to attain the audit objectives. The frequency of the audit procedures performed should be based on an evaluation of the risk associated with each targeted area under audit. Among the factors that the internal auditor should consider in assessing risk are the nature of the operation of the specific assets and liabilities under review, the existence of appropriate policies and internal control standards, the effectiveness of operating procedures and internal controls, and the potential materiality of errors or irregularities associated with the specific operation.

To further assess the adequacy and effectiveness of the internal audit program, an examiner needs to obtain audit workpapers. Workpapers should contain, among other things, audit work programs and analyses that clearly indicate the procedures performed, the extent of the testing, and the basis for the conclusions reached.

Although audit work programs are an integral part of the workpapers, they are sufficiently important to deserve separate attention. Work programs serve as the primary guide to the audit procedures to be performed. Each program should provide a clear, concise description of the work required, and individual procedures should be presented logically. The detailed procedures included in the program vary depending on the size and complexity of the bank's operations and the area subject to audit. In addition, an individual audit work program may encompass several departments of the bank, a single department, or specific operations within a department. Most audit programs include procedures such as—

- surprise examinations, where appropriate;
- maintenance of control over records selected for audit;
- review and evaluation of the bank's policies and procedures and the system of internal control;
- reconciliation of detail to related control records; and
- verification of selected transactions and balances through procedures such as examination of supporting documentation, direct confirmation and appropriate follow-up of exceptions, and physical inspection.

The internal auditor should follow the specific procedures included in all work programs to reach audit conclusions that will satisfy the related audit objectives. Audit conclusions should be supported by report findings; such reports should include, when appropriate, recommendations by the internal auditor for any required remedial actions.

The examiner should also analyze the internal reporting process for the internal auditor's findings, since required changes in the bank's internal controls and operating procedures can be made only if appropriate officials are informed of the deficiencies. This means that the auditor must communicate all findings and recommendations clearly and concisely, pinpointing problems and suggesting solutions. The auditor also should submit reports as soon as practical, and the reports should be routed to those authorized to implement the suggested changes.

The final measure of the effectiveness of the audit program is a prompt and effective management response to the auditor's recommendations. The audit department should determine the reasonableness, timeliness, and completeness of management's response to their recommendations, including follow-up, if necessary. Examiners should assess management's response and follow up when the response is either incomplete or unreasonable.

EXTERNAL AUDITS

The Federal Reserve requires bank holding companies with total consolidated assets of $500 million or more to have annual independent audits. Generally, banks must have external audits for the first three years after obtaining FDIC insurance (an FDIC requirement) and upon becoming a newly chartered national bank (an OCC requirement). The SEC also has a longstanding audit requirement for all public companies, which applies to bank holding companies that are SEC registrants and to state member banks that are subject to SEC reporting requirements pursuant to the Federal Reserve's Regulation H.

For insured depository institutions with fiscal years beginning after December 31, 1992, FDICIA, through its amendments to section 36 of the FDI Act, requires annual independent audits for all FDIC-insured banks that have total assets in excess of $500 million. (See SR-94-3 and SR-96-4.) In September 1999, the Federal Financial Institutions Examination Council (FFIEC) issued an interagency policy statement on external auditing programs of banks and savings associations.[20] The policy encourages banks and savings associations that have *less than* $500 million in total assets and that are not subject to other audit requirements to adopt an external auditing program as a part of their overall risk-management process. (See the following subsection for the complete text of the interagency policy statement.)

Independent audits enhance the probability that financial statements and reports to the FRB and other financial-statement users will be accurate and will help detect conditions that could adversely affect banking organizations, the FRB, or the public. The independent audit process also subjects the internal controls and the accounting policies, procedures, and records of each banking organization to periodic review.

Banks often employ external auditors and other specialists to assist management in specialized fields, such as taxation and management information systems. External auditors and consultants often conduct in-depth reviews of the operations of specific bank departments; the reviews might focus on operational procedures, personnel requirements, or other specific areas of interest. After completing the reviews, the auditors may recommend that the bank strengthen controls or improve efficiency.

External auditors provide services at various times during the year. Financial statements are examined annually. Generally, the process commences in the latter part of the year, with the report issued as soon thereafter as possible. Other types of examinations or reviews are performed at various dates on an as-required basis.

The examiner is interested in the work performed by external auditors for three principal reasons. First, situations will arise when internal audit work is not being performed or when such work is deemed to be of limited value to the examiner. Second, the work performed by external auditors may affect the amount of testing the examiner must perform. Third, external audit reports often provide the examiner with information pertinent to the examination of the bank.

The major factors that should be considered in evaluating the work of external auditors are similar to those applicable to internal auditors, namely, the competence and independence of the auditors and the adequacy of the audit program.

The federal banking agencies view a full-scope annual audit of a bank's financial statements by an independent public accountant as preferable to other types of external auditing programs. The September 1999 policy statement recognizes that a full-scope audit may not be feasible for every small bank. It therefore encourages those banks to pursue appropriate alternatives to a full-scope audit. Small banks are also encouraged to establish an audit committee consisting of outside directors. The policy statement provides guidance to examiners on the review of external auditing programs.

The policy statement is consistent with the Federal Reserve's longstanding guidance that encourages the use of external auditing programs, and with its goals for (1) ensuring the accuracy and reliability of regulatory reports, (2) improving the quality of bank internal controls over financial reporting, and (3) enhancing the efficiency of the risk-focused examination process. The Federal Reserve adopted the FFIEC policy statement effective for fiscal years beginning on or after January 1, 2000. (See SR-99-33.)

INTERAGENCY POLICY STATEMENT ON EXTERNAL AUDITING PROGRAMS OF BANKS AND SAVINGS ASSOCIATIONS

Introduction

The board of directors and senior managers of a banking institution or savings association (insti-

20. See 64 *Fed. Reg.* 52319 (September 28, 1999).

tution) are responsible for ensuring that the institution operates in a safe and sound manner. To achieve this goal and meet the safety-and-soundness guidelines implementing section 39 of the Federal Deposit Insurance Act (FDI Act) (12 USC 1831p-1),[21] the institution should maintain effective systems and internal control[22] to produce reliable and accurate financial reports.

Accurate financial reporting is essential to an institution's safety and soundness for numerous reasons. First, accurate financial information enables management to effectively manage the institution's risks and make sound business decisions. In addition, institutions are required by law[23] to provide accurate and timely financial reports (e.g., Reports of Condition and Income [call reports] and Thrift Financial Reports) to their appropriate regulatory agency. These reports serve an important role in the agencies'[24] risk-focused supervision programs by contributing to their pre-examination planning, off-site monitoring programs, and assessments of an institution's capital adequacy and financial strength. Further, reliable financial reports are necessary for the institution to raise capital. They provide data to stockholders, depositors and other funds providers, borrowers, and potential investors on the company's financial position and results of operations. Such information is critical to effective market discipline of the institution.

To help ensure accurate and reliable financial reporting, the agencies recommend that the board of directors of each institution establish and maintain an external auditing program. An external auditing program should be an important component of an institution's overall risk-management process. For example, an external auditing program complements the internal auditing function of an institution by providing management and the board of directors with an independent and objective view of the reliability of the institution's financial statements and the adequacy of its financial-reporting internal controls. Additionally, an effective external auditing program contributes to the efficiency of the agencies' risk-focused examination process. By considering the significant risk areas of an institution, an effective external auditing program may reduce the examination time the agencies spend in such areas. Moreover, it can improve the safety and soundness of an institution substantially and lessen the risk the institution poses to the insurance funds administered by the Federal Deposit Insurance Corporation (FDIC).

This policy statement outlines the characteristics of an effective external auditing program and provides examples of how an institution can use an external auditor to help ensure the reliability of its financial reports. It also provides guidance on how an examiner may assess an institution's external auditing program. In addition, this policy statement provides specific guidance on external auditing programs for institutions that are holding company subsidiaries, newly insured institutions, and institutions presenting supervisory concerns.

The adoption of a financial statement audit or other specified type of external auditing program is generally only required in specific circumstances. For example, insured depository institutions covered by section 36 of the FDI Act (12 USC 1831m), as implemented by part 363 of the FDIC's regulations (12 CFR 363), are required to have an external audit and an audit committee. Therefore, this policy statement is directed toward banks and savings associations which are exempt from part 363 (i.e., institutions with less than $500 million in total assets at the beginning of their fiscal year) or are not otherwise subject to audit requirements by order, agreement, statute, or agency regulations.

Overview of External Auditing Programs

Responsibilities of the Board of Directors

The board of directors of an institution is responsible for determining how to best obtain reasonable assurance that the institution's financial statements and regulatory reports are reliably prepared. In this regard, the board is also responsible for ensuring that its external auditing program is appropriate for the institution and adequately addresses the financial-reporting aspects of the significant risk areas and any other areas of concern of the institution's business.

21. See 12 CFR 30 for national banks; 12 CFR 364 for state nonmember banks; 12 CFR 208 for state member banks; and 12 CFR 510 for savings associations.

22. This policy statement provides guidance consistent with the guidance established in the Interagency Policy Statement on the Internal Audit Function and Its Outsourcing.

23. See 12 USC 161 for national banks; 12 USC 1817a for state nonmember banks; 12 USC 324 for state member banks; and 12 USC 1464(v) for savings associations.

24. Terms are defined at the end of the policy statement.

To help ensure the adequacy of its internal and external auditing programs, the agencies encourage the board of directors of each institution that is not otherwise required to do so to establish an audit committee consisting entirely of outside directors.[25] However, if this is impracticable, the board should organize the audit committee so that outside directors constitute a majority of the membership.

Audit Committee

The audit committee or board of directors is responsible for identifying at least annually the risk areas of the institution's activities and assessing the extent of external auditing involvement needed over each area. The audit committee or board is then responsible for determining what type of external auditing program will best meet the institution's needs (see the descriptions under "Types of External Auditing Programs").

When evaluating the institution's external auditing needs, the board or audit committee should consider the size of the institution and the nature, scope, and complexity of its operations. It should also consider the potential benefits of an audit of the institution's financial statements or an examination of the institution's internal control structure over financial reporting, or both. In addition, the board or audit committee may determine that additional or specific external auditing procedures are warranted for a particular year or several years to cover areas of particularly high risk or special concern. The reasons supporting these decisions should be recorded in the committee's or board's minutes.

If, in its annual consideration of the institution's external auditing program, the board or audit committee determines, after considering its inherent limitations, that an agreed-upon procedures/state-required examination is sufficient, they should also consider whether an independent public accountant should perform the work. When an independent public accountant performs auditing and attestation services, the accountant must conduct his or her work under, and may be held accountable for departures from, professional standards. Furthermore, when the external auditing program includes an audit of the financial statements, the board or audit committee obtains an opinion from the independent public accountant stating whether the financial statements are presented fairly, in all material respects, in accordance with generally accepted accounting principles (GAAP). When the external auditing program includes an examination of the internal control structure over financial reporting, the board or audit committee obtains an opinion from the independent public accountant stating whether the financial-reporting process is subject to any material weaknesses.

Both the staff performing an internal audit function and the independent public accountant or other external auditor should have unrestricted access to the board or audit committee without the need for any prior management knowledge or approval. Other duties of an audit committee may include reviewing the independence of the external auditor annually, consulting with management, seeking an opinion on an accounting issue, and overseeing the quarterly regulatory reporting process. The audit committee should report its findings periodically to the full board of directors.

External Auditing Programs

Basic Attributes

External auditing programs should provide the board of directors with information about the institution's financial-reporting risk areas, e.g., the institution's internal control over financial reporting, the accuracy of its recording of transactions, and the completeness of its financial reports prepared in accordance with GAAP.

The board or audit committee of each institution at least annually should review the risks inherent in its particular activities to determine the scope of its external auditing program. For most institutions, the lending and investment-securities activities present the most significant risks that affect financial reporting. Thus, external auditing programs should include specific procedures designed to test at least annually the risks associated with the loan and investment portfolios. This includes testing of internal control over financial reporting, such as management's process to determine the adequacy of the

25. Institutions with $500 million or more in total assets must establish an independent audit committee made up of outside directors who are independent of management. See 12 USC 1831m(g)(1) and 12 CFR 363.5.

allowance for loan and lease losses and whether this process is based on a comprehensive, adequately documented, and consistently applied analysis of the institution's loan and lease portfolio.

An institution or its subsidiaries may have other significant financial-reporting risk areas such as material real estate investments, insurance underwriting or sales activities, securities broker-dealer or similar activities (including securities underwriting and investment advisory services), loan-servicing activities, or fiduciary activities. The external auditing program should address these and other activities the board or audit committee determines present significant financial-reporting risks to the institution.

Types of External Auditing Programs

The agencies consider an annual audit of an institution's financial statements performed by an independent public accountant to be the preferred type of external auditing program. The agencies also consider an annual examination of the effectiveness of the internal control structure over financial reporting or an audit of an institution's balance sheet, both performed by an independent public accountant, to be acceptable alternative external auditing programs. However, the agencies recognize that some institutions only have agreed-upon procedures/state-required examinations performed annually as their external auditing program. Regardless of the option chosen, the board or audit committee should agree in advance with the external auditor on the objectives and scope of the external auditing program.

Financial statement audit by an independent public accountant. The agencies encourage all institutions to have an external audit performed in accordance with generally accepted auditing standards (GAAS). The audit's scope should be sufficient to enable the auditor to express an opinion on the institution's financial statements taken as a whole.

A financial statement audit provides assurance about the fair presentation of an institution's financial statements. In addition, an audit may provide recommendations for management in carrying out its control responsibilities. For example, an audit may provide management with guidance on establishing or improving accounting and operating policies and recommendations on internal control (including internal auditing programs) necessary to ensure the fair presentation of the financial statements.

Reporting by an independent public accountant on an institution's internal control structure over financial reporting. Another external auditing program is an independent public accountant's examination and report on management's assertion on the effectiveness of the institution's internal control over financial reporting. For a smaller institution with less complex operations, this type of engagement is likely to be less costly than an audit of its financial statements or its balance sheet. It would specifically provide recommendations for improving internal control, including suggestions for compensating controls, to mitigate the risks due to staffing and resource limitations.

Such an attestation engagement may be performed for all internal controls relating to the preparation of annual financial statements or specified schedules of the institution's regulatory reports.[26] This type of engagement is performed under generally accepted standards for attestation engagements (GASAE).[27]

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26. Since the lending and investment-securities activities generally present the most significant risks that affect an institution's financial reporting, management's assertion and the accountant's attestation generally should cover those regulatory report schedules. If the institution has trading or off-balance-sheet activities that present material financial-reporting risks, the board or audit committee should ensure that the regulatory report schedules for those activities also are covered by management's assertion and the accountant's attestation. For banks and savings associations, the lending, investment-securities, trading, and off-balance-sheet schedules consist of:

Area	*Reports of Condition and Income Schedules*	*Thrift Financial Report Schedules*
Loans and lease-financing receivables	RC-C, Part I	SC, CF
Past-due and nonaccrual loans, leases, and other assets	RC-N	PD
Allowance for credit losses	RI-B	SC, VA
Securities	RC-B	SC, SI, CF
Trading assets and liabilities	RC-D	SO, SI
Off-balance-sheet items	RC-L	SI, CMR

These schedules are not intended to address all possible risks in an institution.

27. An attestation engagement is not an audit. It is performed under different professional standards than an audit of an institution's financial statements or its balance sheet.

Balance-sheet audit performed by an independent public accountant. With this program, the institution engages an independent public accountant to examine and report only on the balance sheet. As with the audit of the financial statements, this audit is performed in accordance with GAAS. The cost of a balance-sheet audit is likely to be less than a financial-statement audit. However, under this type of program, the accountant does not examine or report on the fairness of the presentation of the institution's income statement, statement of changes in equity capital, or statement of cash flows.

Agreed-upon procedures/state-required examinations. Some state-chartered depository institutions are required by state statute or regulation to have specified procedures performed annually by their directors or independent persons.[28] The bylaws of many national banks also require that some specified procedures be performed annually by directors or others, including internal or independent persons. Depending upon the scope of the engagement, the cost of agreed-upon procedures or a state-required examination may be less than the cost of an audit. However, under this type of program, the independent auditor does not report on the fairness of the institution's financial statements or attest to the effectiveness of the internal control structure over financial reporting. The findings or results of the procedures are usually presented to the board or the audit committee so that they may draw their own conclusions about the quality of the financial reporting or the sufficiency of internal control.

When choosing this type of external auditing program, the board or audit committee is responsible for determining whether these procedures meet the external auditing needs of the institution, considering its size and the nature, scope, and complexity of its business activities. For example, if an institution's external auditing program consists solely of confirmations of deposits and loans, the board or committee should consider expanding the scope of the auditing work performed to include additional procedures to test the institution's high-risk areas. Moreover, a financial statement audit, an examination of the effectiveness of the internal control structure over financial reporting, and a balance-sheet audit may be accepted in some states and for national banks in lieu of agreed-upon procedures/state-required examinations.

Other Considerations

Timing. The preferable time to schedule the performance of an external auditing program is as of an institution's fiscal year-end. However, a quarter-end date that coincides with a regulatory report date provides similar benefits. Such an approach allows the institution to incorporate the results of the external auditing program into its regulatory reporting process and, if appropriate, amend the regulatory reports.

External auditing staff. The agencies encourage an institution to engage an independent public accountant to perform its external auditing program. An independent public accountant provides a nationally recognized standard of knowledge and objectivity by performing engagements under GAAS or GASAE. The firm or independent person selected to conduct an external auditing program and the staff carrying out the work should have experience with financial-institution accounting and auditing or similar expertise and should be knowledgeable about relevant laws and regulations.

Special Situations

Holding Company Subsidiaries

When an institution is owned by another entity (such as a holding company), it may be appropriate to address the scope of its external audit program in terms of the institution's relationship to the consolidated group. In such cases, if the group's consolidated financial statements for the same year are audited, the agencies generally would not expect the subsidiary of a holding company to obtain a separate audit of its financial statements. Nevertheless, the board of directors or audit committee of the subsidiary may determine that its activities involve significant risks to the subsidiary that are not within the procedural scope of the audit of the financial statements of the consolidated entity. For example, the risks arising from the subsidiary's

28. When performed by an independent public accountant, "specified procedures" and "agreed-upon procedures" engagements are performed under standards, which are different professional standards than those used for an audit of an institution's financial statements or its balance sheet.

activities may be immaterial to the financial statements of the consolidated entity, but material to the subsidiary. Under such circumstances, the audit committee or board of the subsidiary should consider strengthening the internal audit coverage of those activities or implementing an appropriate alternative external auditing program.

Newly Insured Institutions

Under the FDIC statement of policy on applications for deposit insurance, applicants for deposit insurance coverage are expected to commit the depository institution to obtain annual audits by an independent public accountant once it begins operations as an insured institution and for a limited period thereafter.

Institutions Presenting Supervisory Concerns

As previously noted, an external auditing program complements the agencies' supervisory process and the institution's internal auditing program by identifying or further clarifying issues of potential concern or exposure. An external auditing program also can greatly assist management in taking corrective action, particularly when weaknesses are detected in internal control or management information systems affecting financial reporting.

The agencies may require a financial institution presenting safety-and-soundness concerns to engage an independent public accountant or other independent external auditor to perform external auditing services.[29] Supervisory concerns may include—

- inadequate internal control, including the internal auditing program;
- a board of directors generally uninformed about internal control;
- evidence of insider abuse;
- known or suspected defalcations;
- known or suspected criminal activity;
- probable director liability for losses;
- the need for direct verification of loans or deposits;
- questionable transactions with affiliates; or
- the need for improvements in the external auditing program.

The agencies may also require that the institution provide its appropriate supervisory office with a copy of any reports, including management letters, issued by the independent public accountant or other external auditor. They also may require the institution to notify the supervisory office prior to any meeting with the independent public accountant or other external auditor at which auditing findings are to be presented.

Examiner Guidance

Review of the External Auditing Program

The review of an institution's external auditing program is a normal part of the agencies' examination procedures. An examiner's evaluation of, and any recommendations for improvements in, an institution's external auditing program will consider the institution's size; the nature, scope, and complexity of its business activities; its risk profile; any actions taken or planned by it to minimize or eliminate identified weaknesses; the extent of its internal audit program; and any compensating controls in place. Examiners will exercise judgment and discretion in evaluating the adequacy of an institution's external auditing program.

Specifically, examiners will consider the policies, processes, and personnel surrounding an institution's external auditing program in determining whether—

- the board of directors or its audit committee adequately reviews and approves external auditing program policies at least annually;
- the external auditing program is conducted by an independent public accountant or other independent auditor and is appropriate for the institution;
- the engagement letter covering external auditing activities is adequate;
- the report prepared by the auditor on the results of the external auditing program adequately explains the auditor's findings;
- the external auditor maintains appropriate

29. The Office of Thrift Supervision requires an external audit by an independent public accountant for savings associations with a composite rating of 3, 4, or 5 under the Uniform Financial Institution Rating System, and on a case-by-case basis.

independence regarding relationships with the institution under relevant professional standards;

- the board of directors performs due diligence on the relevant experience and competence of the independent auditor and staff carrying out the work (whether or not an independent public accountant is engaged); and
- the board or audit committee minutes reflect approval and monitoring of the external auditing program and schedule, including board or committee reviews of audit reports with management and timely action on audit findings and recommendations.

Access to Reports

Management should provide the independent public accountant or other auditor with access to all examination reports and written communication between the institution and the agencies or state bank supervisor since the last external auditing activity. Management also should provide the accountant with access to any supervisory memoranda of understanding, written agreements, administrative orders, reports of action initiated or taken by a federal or state banking agency under section 8 of the FDI Act (or a similar state law), and proposed or ordered assessments of civil money penalties against the institution or an institution-related party, as well as any associated correspondence. The auditor must maintain the confidentiality of examination reports and other confidential supervisory information.

In addition, the independent public accountant or other auditor of an institution should agree in the engagement letter to grant examiners access to all the accountant's or auditor's workpapers and other material pertaining to the institution prepared in the course of performing the completed external auditing program.

Institutions should provide reports[30] issued by the independent public accountant or other auditor pertaining to the external auditing program, including any management letters, to the agencies and any state authority in accordance with their appropriate supervisory office's guidance.[31] Significant developments regarding the external auditing program should be communicated promptly to the appropriate supervisory office. Examples of those developments include the hiring of an independent public accountant or other third party to perform external auditing work and a change in, or termination of, an independent public accountant or other external auditor.

Definitions

Agencies. The agencies are the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS).

Appropriate supervisory office. The regional or district office of the institution's primary federal banking agency responsible for supervising the institution or, in the case of an institution that is part of a group of related insured institutions, the regional or district office of the institution's federal banking agency responsible for monitoring the group. If the institution is a subsidiary of a holding company, the term "appropriate supervisory office" also includes the federal banking agency responsible for supervising the holding company. In addition, if the institution is state-chartered, the term "appropriate supervisory office" includes the appropriate state bank or savings association regulatory authority.

Audit. An examination of the financial statements, accounting records, and other supporting evidence of an institution performed by an independent certified or licensed public accountant in accordance with generally accepted

30. The institution's engagement letter is not a "report" and is not expected to be submitted to the appropriate supervisory office unless specifically requested by that office.

31. When an institution's financial information is included in the audited consolidated financial statements of its parent company, the institution should provide a copy of the audited financial statements of the consolidated company and any other reports by the independent public accountant in accordance with their appropriate supervisory office's guidance. If several institutions are owned by one parent company, a single copy of the reports may be supplied in accordance with the guidance of the appropriate supervisory office of each agency supervising one or more of the affiliated institutions and the holding company. A transmittal letter should identify the institutions covered. Any notifications of changes in, or terminations of, a consolidated company's independent public accountant may be similarly supplied to the appropriate supervisory office of each supervising agency.

auditing standards (GAAS) and of sufficient scope to enable the independent public accountant to express an opinion on the institution's financial statements as to their presentation in accordance with generally accepted accounting principles (GAAP).

Audit committee. A committee of the board of directors whose members should, to the extent possible, be knowledgeable about accounting and auditing. The committee should be responsible for reviewing and approving the institution's internal and external auditing programs or recommending adoption of these programs to the full board.

Balance-sheet audit performed by an independent public accountant. An examination of an institution's balance sheet and any accompanying footnotes performed and reported on by an independent public accountant in accordance with GAAS and of sufficient scope to enable the independent public accountant to express an opinion on the fairness of the balance-sheet presentation in accordance with GAAP.

Engagement letter. A letter from an independent public accountant to the board of directors or audit committee of an institution that usually addresses the purpose and scope of the external auditing work to be performed, period of time to be covered by the auditing work, reports expected to be rendered, and any limitations placed on the scope of the auditing work.

Examination of the internal control structure over financial reporting. See "Reporting by an independent public accountant on an institution's internal control structure over financial reporting."

External auditing program. The performance of procedures to test and evaluate high-risk areas of an institution's business by an independent auditor, who may or may not be a public accountant, sufficient for the auditor to be able to express an opinion on the financial statements or to report on the results of the procedures performed.

Financial statement audit by an independent public accountant. See Audit.

Financial statements. The statements of financial position (balance sheet), income, cash flows, and changes in equity together with related notes.

Independent public accountant. An accountant who is independent of the institution and registered or licensed to practice, and holds himself or herself out, as a public accountant, and who is in good standing under the laws of the state or other political subdivision of the United States in which the home office of the institution is located. The independent public accountant should comply with the American Institute of Certified Public Accountants' (AICPA) Code of Professional Conduct and any related guidance adopted by the Independence Standards Board and the agencies. No certified public accountant or public accountant will be recognized as independent who is not independent both in fact and in appearance.

Internal auditing. An independent assessment function established within an institution to examine and evaluate its system of internal control and the efficiency with which the various units of the institution are carrying out their assigned tasks. The objective of internal auditing is to assist the management and directors of the institution in the effective discharge of their responsibilities. To this end, internal auditing furnishes management with analyses, evaluations, recommendations, counsel, and information concerning the activities reviewed.

Outside directors. Members of an institution's board of directors who are not officers, employees, or principal stockholders of the institution, its subsidiaries, or its affiliates, and who do not have any material business dealings with the institution, its subsidiaries, or its affiliates.

Regulatory reports. These reports are the Reports of Condition and Income (call reports) for banks, Thrift Financial Reports (TFRs) for savings associations, Federal Reserve (FR) Y reports for bank holding companies, and the H-(b)11 Annual Report for thrift holding companies.

Reporting by an independent public accountant on an institution's internal control structure over financial reporting. Under this engagement, management evaluates and documents its review of the effectiveness of the institution's internal control over financial reporting in the identified risk areas as of a specific report date. Management prepares a written assertion, which specifies the criteria on which management based its evaluation about the effectiveness of the institution's internal control over financial reporting in the identified risk areas and states management's opinion on the effectiveness of internal control over this specified financial reporting. The independent public accountant is engaged to perform tests on the internal control over the specified financial reporting in order to attest to management's assertion. If the accountant concurs with management's assertion, even if the assertion discloses one or more instances of material internal control weakness, the accountant would provide a report attesting to management's assertion.

Risk areas. Those particular activities of an institution that expose it to greater potential losses if problems exist and go undetected. The areas with the highest financial-reporting risk in most institutions generally are their lending and investment-securities activities.

Specified procedures. Procedures agreed upon by the institution and the auditor to test its activities in certain areas. The auditor reports findings and test results, but does not express an opinion on controls or balances. If performed by an independent public accountant, these procedures should be performed under generally accepted standards for attestation engagements (GASAE).

Issued by the FFIEC on September 28, 1999.

CERTIFIED PUBLIC ACCOUNTANTS

This section discusses the standards for competence and independence of certified public accountants (CPAs) as well as the standards required in connection with their audits.

Standards of Conduct

The Code of Professional Ethics for CPAs who are members of the American Institute of Certified Public Accountants (AICPA) requires that audits be performed according to generally accepted auditing standards (GAAS). GAAS, as distinct from generally accepted accounting principles, or GAAP, are concerned with the auditor's professional qualifications, the judgment the auditor exercises in the performance of an audit, and the quality of the audit procedures.

On the other hand, GAAP represents all of the conventions, rules, and procedures that are necessary to define accepted accounting practices at a particular time. GAAP includes broad guidelines of general application and detailed practices and procedures that have been issued by the Financial Accounting Standards Board (FASB), the AICPA, the SEC, or other authoritative bodies that set accounting standards. Thus, GAAP provides guidance on financial-reporting and disclosure matters.

Generally Accepted Auditing Standards

GAAS are grouped into three categories: general standards, standards of field work, and standards of reporting.

The *general standards* require that the audit be performed by a person or persons having adequate technical training and proficiency; that independence in mental attitude be maintained; and that due professional care be exercised in the performance of the audit and the preparation of the report.

Standards of field work require that the work be adequately planned; assistants, if any, be properly supervised; a proper study and evaluation of existing internal controls be made for determining the audit scope and the audit procedures to be performed during the audit; and sufficient evidence be obtained to formulate an opinion regarding the financial statements under audit.

Standards of reporting require that the CPA state whether the financial statements are presented in accordance with GAAP. The application of GAAP in audited financial statements and reports must achieve the fundamental objectives of financial accounting, which are to provide reliable financial information about the economic resources and obligations of a business enterprise. In addition, the informative disclosures in the financial statements must follow GAAP, or the CPA must state otherwise in the report.

GAAS recognizes that management—not the CPA—has primary responsibility for the preparation of the financial statements and the presentations therein. The auditor's responsibility is to express an opinion on the financial statements. GAAS (or the audit requirements previously set forth) requires that audits cover the following financial statements: balance sheet, income statement, statement of changes in stockholders' equity, and statement of cash flows.

GAAS requires that CPAs plan and perform auditing procedures to obtain reasonable assurance that financial statements are free from material misstatement. Under GAAS, an audit includes examining on a test basis and should include evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

Independence

In the performance of their work, CPAs must be independent of those they serve. Traditionally, independence has been defined as the ability to act with integrity and objectivity. In accordance with the rule on independence included in the SEC's independence rules and the Code of Professional Ethics and related AICPA interpretations, the independence of a CPA is considered to be impaired if, during the period of his or her professional engagement, the CPA or his or her firm had any direct or material indirect financial interest in the enterprise or had any loan to or from the enterprise or any officer, director, or principal stockholder thereof. The latter prohibition does not apply to the following loans from a financial institution when made under normal lending procedures, terms, and requirements:

- automobile loans and leases collateralized by the automobile
- loans in the amount of the cash surrender value of a life insurance policy
- borrowings fully collateralized by cash deposits at the same financial institution (for example, passbook loans)
- credit cards and cash advances under lines of credit associated with checking accounts with aggregate unpaid balances of $5,000 or less

Such loans must, at all times, be kept current by the CPA as to all terms.

Other loans have been grandfathered by the AICPA under recent ethics interpretations. These other loans (mortgage loans, other secured loans, and loans not material to the AICPA member's net worth) must, at all times, be current as to all terms and shall not be renegotiated with the client financial institution after the latest of—

- January 1, 1992;
- the date that the financial institution first becomes a client;
- the date the loans are sold from a nonclient financial institution to the client financial institution; or
- the date of becoming a member in the AICPA.

The examiner may decide under certain circumstances to test the independence of the CPA through reviews of loan listings, contracts, stockholder listings, and other appropriate measures. Concerns about independence should be identified in the report of examination.

The SEC has also released guidance relating to the independence of auditors for public institutions. According to SEC Rule 101, the independence of an auditor would be impaired if financial, employment, or business relationships exist between auditors and audit clients, and if there are relationships between auditors and audit clients in which the auditors provide certain nonaudit services to their audit clients. Much of the language found in the SEC's independence rules is incorporated in the Interagency Policy Statement on the Internal Audit Function and Its Outsourcing.

EXTERNAL AUDIT REPORTS

The external auditor generates various types of reports and other documents. These reports typically include—

- the standard audit report, which is generally a one-page document;
- a "management letter" in which the auditor confidentially presents detailed findings and recommendations to management; and
- an attestation report in which the auditor attests to management's assertion of internal controls and procedures over financial reports (for public companies and institutions subject to section 36 of the FDI Act); and

- other reports from the auditor to regulators during the audit period.

The major types of standard audit reports will never have a heading or other statement in the report that identifies which type it is. Rather, the type of report is identified by certain terminology used in the text of the report. The major types of standard audit reports are described below.

The *unqualified report,* sometimes referred to as a "clean opinion," states that the financial statements are "presented fairly" in conformity with GAAP and that the necessary audit work was done.

The *qualified report* may generally have the same language as the unqualified report but will use the phrase "except for" or some other qualification to indicate that some problem exists. The types of problems include a lack of sufficient evidential matter, restrictions on the scope of audit work, or departures from GAAP in the financial statements. This type of report is not necessarily negative but indicates that the examiner should ask additional questions of management.

An *adverse report* basically concludes that the financial statements are not presented fairly in conformity with GAAP. This type of report is rarely issued because auditors and management usually work out their differences in advance.

A *disclaimer* expresses no opinion on the financial statements. CPAs may issue a disclaimer when they have concluded that substantial doubt exists about the ability of the institution to continue as a going concern for a reasonable period of time. This disclaimer is intended to indicate that the CPA is not assuming any responsibility for these statements.

REVIEW OF THE EXTERNAL AUDITOR'S INDEPENDENCE AND AUDIT

Because of the professional and ethical standards of the public accounting profession, the Federal Reserve has concluded that the examiner should conduct an in-depth review of the competence and independence of the CPA only in unusual situations. One such situation would be a recent change in CPAs by a bank, particularly if the change was made after an audit had commenced.

Ordinarily, specific tests to determine independence are not necessary. However, there may be occasions when the examiner has sufficient reason to question the independence of a CPA or the quality of his or her work. For example, the examiner may discover that during the period of a CPA's professional engagement, which includes the period covered by the financial statements on which the CPA has expressed an opinion, the CPA or a member of his or her firm—

- had a direct financial interest in the bank;
- was connected with the bank in a capacity equivalent to that of a member of management or was a director of the bank;
- maintained, completely or in part, the books and records of the bank and did not perform audit tests with respect to such books and records; or
- had a prohibited loan from the bank (as discussed earlier).

In these and similar instances, the CPA would not have complied with professional standards.

The examiner should determine the scope of the CPA's examination by reviewing the most recent report issued by the CPA. If the audit is in progress or is planned to commence in the near future, the examiner should review any engagement letter to the bank from the CPA. The examiner also should obtain and review any adjusting journal entries suggested by the CPA at the conclusion of the examination. This should be done to determine whether such entries were the result of breakdowns in the internal control structure and procedures for financial reporting.

Under certain circumstances, a CPA may issue a qualified or adverse opinion or may disclaim an opinion on a bank's financial statements. In such circumstances, the examiner should first determine the reasons for the particular type of opinion issued. If the matters involved affect specific areas of the bank's operations, a review of the work performed by the CPA may help the examiner understand the problem that gave rise to this opinion. The examination procedures section describes the steps the examiner should follow when conducting a review of the work performed by the CPA. (See the FFIEC interagency Policy Statement on the External Auditing Programs of Banks and

Savings Associations (effective January 1, 2000) (SR-99-33)).

LIMITATIONS OF AUDITS AND AUDITED FINANCIAL STATEMENTS

Although auditing standards are designed to require the use of due care and objectivity, a properly designed and executed audit does not necessarily guarantee that all misstatements of amounts or omissions of disclosure in the financial statements have been detected. Moreover, a properly designed and executed audit does not guarantee that the auditor addressed FRB safety-and-soundness considerations. Examination personnel should be cognizant of the limitations inherent in an audit. The following examples illustrate some common limitations of audits:

- The auditor is not responsible for deciding whether an institution operates wisely. An unqualified audit report means that the transactions and balances are reported in accordance with GAAP. It does not mean that the transactions made business sense, that the associated risks are managed in a safe and sound manner, or that the balances can be recovered upon disposition or liquidation.
- The auditor's report concerning financial statements does not signify that underwriting standards, operating strategies, loan-monitoring systems, and workout procedures are adequate to mitigate losses if the environment changes. The auditor's report that financial statements present fairly the bank's financial position is based on the prevailing evidence and current environment, and it indicates that reported assets can be recovered in the normal course of business. In determining that reported assets can be recovered in the normal course of business, the auditor attempts to understand financial-reporting internal controls and can substitute other audit procedures when these controls are weak or nonexistent.
- The quality of management and how it manages risk are not considered in determining historical cost and its recoverability. Although certain assets and instruments are marked to market (for example, trading accounts), GAAP generally uses historical cost as the basis of presentation. Historical cost assumes that the entity is a going concern. The going-concern concept allows certain mark-to-market losses to be deferred because management believes the cost basis can be recovered during the remaining life of the asset.
- GAAP financial statements offer only limited disclosures of risks, uncertainties, and the other safety-and-soundness factors on which the institution's viability depends.
- Under GAAP, loan-loss reserves are provided for "probable losses" currently "inherent" (that is, anticipated future charge-offs are based on current repayment characteristics) in the portfolio. GAAP defines probable as the likelihood that a future event will occur, confirming the fact of the loss. Additionally, the amount of the loss must be reasonably estimable.

COMMUNICATION WITH EXTERNAL AUDITORS

GAAS requires that the external auditor can consider regulatory authorities as a source of competent evidential matter when conducting an audit of the financial statements of a banking organization. Accordingly, the external auditor may review communications from, and make inquiries of, the regulatory authorities.

Generally, the Federal Reserve encourages auditors to attend examination exit conferences upon completion of the examiner's field work or to attend other meetings concerning examination findings between supervisory examiners and an institution's management or board of directors (or a committee thereof). Banks should ensure that their external auditors are informed in a timely manner of scheduled exit conferences and other relevant meetings with examiners and of the FRB's policies regarding auditor attendance at such meetings.

When other conferences between examiners and management are scheduled (those that do not involve examination findings that are relevant to the scope of the external auditor's work), the institution should first obtain the approval of the appropriate Federal Reserve Bank personnel for the auditor to attend the meetings. The interagency policy statement of July 23, 1992, does not preclude the Federal Reserve from holding meetings with the management of banks without auditor attendance or from requiring that the auditor attend only certain portions of the meetings. (See SR-92-28.)

The 1992 interagency policy statement was issued to improve coordination and communication between external auditors and examiners. Examination personnel should provide banking organizations with advance notice of the starting date of the examination when appropriate, so management can inform external auditors in advance and facilitate the planning and scheduling of their audit work.

Some institutions prefer that audit work be completed at different times than examination work to reduce demands on their staff members and facilities. Other institutions prefer to have audit work and examination work performed during similar periods so the institution's operations are affected only at certain times during the year. By knowing when examinations are planned, institutions have the flexibility to schedule external audit work concurrent with, or separate from, examinations.

Meetings and Discussions Between External Auditors and Examiners

An external auditor may request a meeting with the FRB regulatory authorities involved in the supervision of the institution or its holding company during or after completion of examinations to inquire about supervisory matters relevant to the institution under audit. External auditors should provide an agenda in advance. The FRB regulatory authorities will generally request that management of the institution under audit be represented at the meeting. In this regard, examiners generally will only discuss with an auditor examination findings that have been presented to bank management.

In certain cases, external auditors may wish to discuss with examiners matters relevant to the institution without bank management representation. External auditors may request such confidential meetings with the FRB regulatory authorities, who may also request such meetings with the external auditor.

Information Required to Be Made Available to External Auditors

Section 931 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) and section 112 of FDICIA (12 USC 1811) pertain to depository institutions insured by the FDIC that have engaged the services of an external auditor to audit the banking organization within the past two years. FIRREA and FDICIA require banks to provide the auditor with copies of the most recent Report of Condition (call report), report of examination, and pertinent correspondence or reports received from its regulator. This information is to be provided to the external auditor by the bank under audit, not by the FRB. In addition, banking organizations must provide the independent auditor with—

- a copy of any supervisory memorandum of understanding or written agreement between a federal or state banking agency and the bank put into effect during the period covered by the audit, and
- a report of any formal action taken by a federal or state banking agency during such period, or any civil money penalty assessed with respect to the bank or any banking organization–affiliated party.

Regulatory personnel should ascertain if the banking organization is in compliance with the requirements of section 931 of FIRREA (12 USC 1817(a)) and section 112 of FDICIA and should report instances of noncompliance in the report of examination.

Confidentiality of Supervisory Information

While the policies of the FRB regulatory authorities permit external auditors to have access to the information described above, institutions and their auditors are reminded that information contained in examination reports, inspection reports, and supervisory discussions—including any summaries or quotations—is confidential supervisory information and must not be disclosed to any party without the written permission of the FRB. Unauthorized disclosure of confidential supervisory information may lead to civil and criminal actions and fines and other penalties.

1. To determine whether internal and external audit functions exist.
2. To determine with reasonable assurance that the bank has an adequate internal audit function that ensures efficient and effective operations, including the safeguarding of assets, reliable financial reporting, and compliance with applicable laws and regulations.
3. To ascertain, through the examination process, that the bank's internal audit function monitors, reviews, and ensures the continued existence and maintenance of sound and adequate internal controls over the bank's management process—the control environment, risk assessment, control activities, information and communication, and monitoring activities.
4. To review and evaluate internal audit outsourcing arrangements and the actions of the outsourcing vendor under the standards established by the Interagency Policy Statement on the Internal Audit Function and Its Outsourcing.
5. To evaluate the independence of those who provide the internal and external audit functions.
6. To evaluate the competence of those who provide the internal and external audit functions.
7. To determine the adequacy of the procedures performed by the internal and external auditors.
8. To determine, based on the criteria above, if the work performed by internal and external auditors is reliable.

This examination program must be used in conjunction with the audit function and audit outsourcing questionnaire section to review the bank's internal and external audits and the audit procedures they encompass. The audit guidelines are general and all sections or questions may not be applicable to every bank.

Before reviewing any specific audit procedures, the examiner should first determine the independence and competence of the auditors. If the examiner believes the auditors to be both competent and independent, he or she should then determine the acceptability of their work. Based on the answers to the audit function questions and on the auditor's work, the examiner must then determine the scope of the examination. The program and related supporting documentation should be completed in an organized manner and should be retained as part of the examination workpapers.

Upon completion of the program, the examiner should be able to formulate a conclusion on the adequacy of audit coverage. Conclusions of weaknesses in the internal audit work being performed at the bank should be summarized for inclusion in the report of examination. Significant recommendations should be discussed with bank management and noted in the questionnaire and the report of examination. If recommendations are made orally, a memorandum of the discussion should be prepared and included in the workpapers.

INTERNAL AUDITORS

1. *Organizational structure of the audit department.* Review the bylaws and the organization chart of the bank and the minutes of the board's audit or examining committee to determine how effectively the board of directors is discharging its responsibility.
2. *Independence of the audit function.* Interview the auditor and observe the operation of the audit department to determine its functional responsibilities.
3. *Auditors' qualifications.* Review biographical data and interview the auditor to determine his or her ability to manage the auditor's responsibility in the bank.
4. *Audit staff qualifications.* Review the biographical data and interview the management staff of the audit department to determine their qualifications for their delegated responsibilities.
5. *Content and use of the audit frequency and scope schedule.* Review the organization charts and the bank's chart of accounts to determine the adequacy of the audit program.
6. *Audit department participation in systems design projects.* Determine, through interviews with the auditor and appropriate staff members and through the documentation review, the department's role in automated and/or manual systems design.
7. *Audit manual.* Review the audit manuals and associated internal control questionnaires to determine the sufficiency of the prescribed procedures for the accomplishment of the objectives.
8. *Maintenance of audit records.* Review a sample of the audit reports and associated workpapers to determine compliance with prescribed procedures and proper documentation.
9. *Audit department's formal reporting procedures.* Review all auditor's reports to the board of directors (audit or examining committee) and a representative sample of the departmental or functional reports, consider their distribution and follow-up procedures, and determine how effectively the audit department responsibility is discharged.
10. *Use and effectiveness of audit computer programs.* Interview the auditor and/or the appropriate staff members regarding the use of the computer and access to the files for audit purposes.

INTERNAL AUDIT FUNCTION ADEQUACY

1. Adjust the scope of the examination if the bank's internal audit function does not sufficiently meet the bank's internal audit needs (whether or not the audit function is outsourced), does not satisfy the Interagency Guidelines Establishing Standards for Safety and Soundness, or is otherwise inadequate.

2. Discuss supervisory concerns and outstanding internal-external audit report comments with the internal audit manager or other person responsible for reviewing the system of internal control. If these discussions do not resolve the examiner's comments and concerns, bring these matters to the attention of senior management and the board of directors or the audit committee.
3. If material weaknesses in the internal audit function or the internal control system exist, discuss them with appropriate Federal Reserve Bank supervisory staff to determine the appropriate actions (including formal and informal enforcement actions) that should be taken to ensure that the bank corrects the deficiencies.
4. Incorporate conclusions about the bank's internal audit function into the bank's management and composite supervisory ratings.
5. Include in the report of examination comments concerning the adequacy of the internal audit function, significant issues or concerns, and recommended corrective actions.

INDEPENDENCE OF THE OUTSOURCING VENDOR

1. If the initial review of an internal audit outsourcing arrangement, including the actions of the outsourcing vendor, raises questions about the bank's and its vendor's adherence to the independence standards discussed in parts I and II (and also in part III, if the vendor provides both external and internal audit services to the bank) of the Interagency Policy Statement on the Internal Audit Function and Its Outsourcing—
    a. ask the bank and the outsourcing vendor how the audit committee determined that the vendor was independent;
    b. if the vendor is an accounting firm, ask the audit committee how it assessed that the arrangement has not compromised applicable SEC, PCAOB, AICPA, or other regulatory standards concerning auditor independence;
    c. if the answers to the above supervisory concerns are not adequately addressed, discuss the matter with appropriate Reserve Bank supervisory staff; and
    d. if the Reserve Bank supervisory staff concurs that the independence of the external auditor or other vendor appears to be compromised, discuss the examination findings and the supervisory actions that may be taken with the bank's senior management, board of directors (or audit committee), and the external auditor or other vendor.

EXTERNAL AUDITORS

1. When certified public accountants or consulting firms have been engaged by the bank for statement certification, operational reviews, or appraisal of the audit function, review the most recent reports and management letters.

REGULATORY EXAMINATIONS

1. Review the most recent examination report and interview the auditor to determine his or her responsibilities in this area.

Review the documentation as instructed in the examination procedures section to answer the following audit function and audit outsourcing questions. Where appropriate, supporting documentation and pertinent information should be retained or noted under comments.

ORGANIZATIONAL STRUCTURE AND INTERNAL CONTROL ENVIRONMENT OF THE AUDIT DEPARTMENT

1. Has the board of directors delegated responsibility for the audit function? If so, to whom?
2. Has the board of directors established an audit committee? Is it composed solely of outside directors?
3. Are the members of the audit committee qualified for their particular responsibilities?
4. Does the audit committee promote the internal audit manager's impartiality and independence by having him or her directly report audit findings to it? How often does the audit committee meet with and review reports issued by the auditor?
5. Are the audit committee meetings with the auditor closed to bank personnel?
6. Do the minutes of the audit committee indicate an appropriate interest in the activities and findings?
7. Does the auditor report to the board of directors, the audit committee, or an executive officer who is sufficiently high in the bank's hierarchy? If so, which one? If not, to whom does the auditor report?
8. Are the internal audit function's control risk assessment, audit plans, and audit programs appropriate for the bank's activities?
9. Are internal audit activities consistent with the long-range goals and strategic direction of the bank, and are they responsive to its internal control needs?
10. Do management and the board of directors use reasonable standards, such as the IIA's *Standards for the Professional Practice of Internal Auditing,* when assessing the performance of internal audit?
11. Does the audit function provide high-quality advice and counsel to management and the board of directors on current developments in risk management, internal control, and regulatory compliance?

INDEPENDENCE AND MANAGEMENT OF THE AUDIT FUNCTION

1. Is the audit department functionally segregated from operations in the organizational structure?
2. Does the audit committee review or approve the budget and salary of the auditor? If not, who does?
3. Are the reporting procedures of the auditor independent of the influence of any operating personnel?
4. Is the internal audit function adequately managed to ensure that audit plans are accomplished and the audit results are promptly communicated to the audit committee, senior management, and the board of directors?
5. Has the audit staff been relieved of responsibility for conducting continuous audits?
6. Has the audit department been relieved of responsibility for maintaining duplicate records?
7. Do the responsibilities of the audit staff exclude any duties to be performed in lieu of operating personnel, such as preparation or approval of general ledger entries, official checks, daily reconcilements, dual control, etc.?

AUDITOR'S QUALIFICATIONS

1. Are the auditor's academic credentials comparable to other bank officers who have major responsibilities within the organization?
2. Is the auditor certified (or in the process of becoming certified) as a chartered bank auditor, certified internal auditor, or certified public accountant? If yes, which one (or ones)?
3. Is the auditor's experience in both auditing and banking comparable both in quality and

in duration to that required of the officers assigned major responsibilities?
4. Does the auditor communicate and relate well with all levels of personnel?
5. Does the auditor demonstrate a commitment to continuing education and a current knowledge of the latest developments in banking and auditing technology?
6. Is the auditor dedicated to the standards and ethics of his or her profession (such as those published by the Bank Administration Institute, the Institute of Internal Auditors, and the American Institute of Certified Public Accountants)?

AUDIT STAFF QUALIFICATIONS

1. Is the audit staff sufficient in number to perform its tasks adequately?
2. Is the staff adequately experienced in auditing and banking?
3. Are members of the staff experienced in specialized areas, such as EDP, foreign-exchange trading, trust, and subsidiary activities of the bank?
4. Is there a formal audit training program in effect?
5. Is the number of unfilled vacancies on the audit staff considered reasonable?
6. Is the turnover of audit personnel acceptable?
7. Does management have plans to improve its audit capability, if needed?

CONTENT AND USE OF THE AUDIT FREQUENCY AND SCOPE SCHEDULE

1. Is the audit program formalized and therefore on record as a commitment that can be analyzed and reviewed?
2. Are all important bank functions and services identified as subjects of the audits?
3. Does the audit program include procedures necessary to ensure compliance with the Federal Election Campaign Act and the Foreign Corrupt Practices Act?
4. Does the internal audit department have access to all reports, records, and minutes?
5. Are internal audit activities adjusted for significant changes in the bank's environment, structure, activities, risk exposures, or systems?
6. Does the frequency and scope schedule require approval by the audit committee, the board of directors, regulatory authorities, or others? If so, by whom, and has such approval been obtained?
7. Does the frequency and scope schedule comply with state statutory requirements, if any, for internal audits, including minimum audit standards?
8. Does the auditor periodically report his or her progress in completing the frequency and scope schedule to the board's audit committee?
   a. If not to the board's audit committee, to whom?
   b. Does the committee approve significant deviations, if any, in the original program?
9. Does the auditor prepare a time budget? Are budgeted versus actual time analyses used as a guide in forward planning?
10. Does the depth of coverage appear to be sufficient?
11. Are different entry dates and time periods between reviews scheduled so as to frustrate reliable anticipation of entry dates by auditees?
12. Is the bank's possession of all assets owned or managed in fiduciary capacities subjected to verification?
13. Are controls on opening and closing general ledger and subsidiary accounts adequate and is the auditor formally advised of any changes?
14. If the bank has automated systems, does the program call for the application of independently prepared computer programs that employ the computer as an audit tool?
15. Will the audit staff examine the documentation of all bank systems and produce their own documentation?
16. Are all service-related activities not specifically manifested in general ledger accounts subject to adequate periodic review (for example, supervisory regulations, security, vacation policy, purchases, traveler's checks, and safekeeping)?
17. Will appraisals of administrative control be made for each function, yielding audit comments and suggestions for improvements of operational efficiency?

AUDIT DEPARTMENT PARTICIPATION IN SYSTEMS DESIGN PROJECTS

1. Is there a formal or informal procedure for notifying the auditor of contemplated new systems or systems modifications in the early planning stages?
2. Is the auditor a member of an executive systems planning or steering committee? If not, does the auditor have access to and review the minutes of such committees?
3. Does an audit representative review the activities of systems design teams for audit and internal control requirements? Is the specialized training and experience of the audit staff sufficient to support effective reviews?
4. Does the audit department avoid over-participation in systems design, modification, and conversion?
5. Is the auditor's "sign-off" on new or modified systems restricted to control and audit trail features?

AUDIT MANUAL

1. Has responsibility for the establishment and maintenance of the audit manual been clearly assigned?
2. Does the audit manual require approval by the board of directors, the audit committee, or others? If so, has such approval been obtained?
3. Is the content of the audit manual independent from adverse influence by other interests, such as operating management or independent CPAs?
4. Is the audit manual current, and are procedures for keeping the manual current adequate?
5. Does the audit manual contain the scope and objective of each audit?
6. Does the manual provide for valid deviations from audit procedures to be officially approved by audit management?
7. Do audit procedures provide for the follow-up of exceptions noted in previous audits?
8. Does the manual prescribe that each audit procedure be cross-referenced to the appropriate audit workpapers?
9. Must an auditor initial each program step as testimony of his or her performance?
10. Does the manual prescribe that full control be established at the time of entry over the records selected for audit?
11. Is proof of subsidiary to control records required?
12. Are subsidiary direct verification programs covering all forms of customer deposit, loan, safekeeping, collateral, collection, and trust accounts included?
13. Are flow charts called for as evidence of thorough analytical auditing?
14. Do the procedures employ scientific sampling techniques that have acceptable reliability and precision?
15. Does the audit manual provide for the resolution of exceptions and deficiencies?
16. Does the audit manual contain provisions for report format and content and an expression of the opinion of the auditor regarding the adequacy, effectiveness, and efficiency of internal controls?
17. For each audit, do audit procedures provide for a documented method of assuring audit management that a proper study and evaluation of existing internal controls has been made, such as an internal control questionnaire or memorandum?
18. Does the audit manual contain a provision for a review and update of the procedures for each audit, where required, upon the audit's completion?
19. Does the audit manual provide for the maintenance of a permanent file for audits conducted?
20. Does the audit manual contain provisions for the formal, standardized preparation and maintenance of workpapers?
21. Are applicable statutory and regulatory requirements included in the audit procedures?

MAINTENANCE OF AUDIT RECORDS

1. Are workpapers arranged and maintained for filing and reference in—
   a. the current file?
   b. the permanent file?
2. Is a reasonable record-retention schedule and departmental index maintained for audit records?
3. Are audit procedures being complied with during each audit?

4. Do the workpapers contain evidence that all significant deviations from standard audit procedures are documented and have received the approval of audit management?
5. Are procedures for preparing and maintaining workpapers being adhered to?
6. Do workpapers adequately document the internal audit work performed and support the audit reports?
7. Do workpapers contain a copy of the audit report, an adequate index, an internal control questionnaire, audit procedures, and other appropriate material?
8. Are workpapers numbered, indexed, and cross-referenced to audit procedures and the workpapers index?
9. Is each workpaper dated and initialed by the preparer?
   a. Are sources of data clearly shown?
   b. Are tick marks explained?
10. From the workpapers, can it be determined how various sample sizes were determined (by judgment or statistical sampling), including the range and confidence level?
11. Do workpapers contain evidence that supervisory personnel of the audit department have reviewed the workpapers and resultant findings?
12. Are all significant or unresolved exceptions noted in workpapers required to be included in the report?
13. Are applicable statutory and regulatory requirements being complied with?

AUDIT DEPARTMENT'S FORMAL REPORTING PROCEDURES

1. Does the auditor submit formal reports? If so, to whom?
2. Do the reports convey to the reader the auditor's general observation of the condition of the operation of the department or function?
   a. Do they adequately reflect the scope of the audit?
   b. Do they contain an opinion of the auditor regarding the adequacy, effectiveness, and efficiency of internal controls?
   c. Do they call for a prompt response, where appropriate?
3. With regard to audit exceptions and recommendations, is the method of resolving differences of opinion between audit and operating management effective?
4. Does the auditor maintain a formal record of all audit reports that contain unresolved recommendations and exceptions?
5. Does the bank promply respond to significant identified internal control weaknesses? Are exceptions and recommendations generally resolved within 90 days?
6. Are audit reports submitted promptly?
7. Are responses received promptly?

USE AND EFFECTIVENESS OF AUDIT COMPUTER PROGRAMS

1. What audit computer programs are used and what are their purposes?
2. Is there a member of the audit staff qualified to write and appraise the quality of audit computer programs?
3. Is the auditor satisfied that he or she has sufficient "free access" to the computer files?
4. Are audit programs run on request?
5. Do direct verification programs allow the auditor flexibility in selecting the criteria to be used in determining the sample?
6. Have procedures been established for the development and maintenance of documentation for audit computer programs? Are they adhered to?
7. Are changes to audit programs controlled?

INTERNAL AUDIT OUTSOURCING ARRANGEMENTS

1. If the bank outsources its internal audit function, does it have a written contract or an engagement letter with the vendor?
2. Does the written contract or engagement letter include provisions that—
   a. define the expectations and responsibilities under the contract for both parties?
   b. set the scope and frequency of, and the fees to be paid for, the work to be performed by the vendor?
   c. set the responsibilities for providing and receiving information, such as the type and frequency of reporting to senior management and directors about the status of contract work?
   d. establish the process for changing the

terms of the service contract, especially for expansion of audit work if significant issues are found, and contain stipulations for default and termination of the contract?

e. state that internal audit reports are the property of the institution, that the institution will be provided with any copies of the related workpapers it deems necessary, and that employees authorized by the institution will have reasonable and timely access to the workpapers prepared by the outsourcing vendor?

f. specify the locations of internal audit reports and the related workpapers?

g. specify the period of time (for example, seven years) that vendors must maintain the workpapers?[1]

h. state that outsourced internal audit services provided by the vendor are subject to regulatory review and that examiners will be granted full and timely access to the internal audit reports and related workpapers prepared by the outsourcing vendor?

i. prescribe a process (arbitration, mediation, or other means) for resolving disputes and for determining who bears the cost of consequential damages arising from errors, omissions, and negligence?

j. state that the outsourcing vendor will not perform management functions, make management decisions, or act or appear to act in a capacity equivalent to that of a member of management or an employee and, if applicable, will comply with AICPA, SEC, Public Company Accounting Oversight Board (PCAOB), or regulatory independence guidance?

3. Does the outsourced internal audit arrangement maintain or improve the quality of the internal audit function and the bank's internal control?
4. Do key employees of the bank and the outsourcing vendor clearly understand the lines of communication and how any internal control problems or other matters noted by the outsourcing vendor are to be addressed?

1. If the workpapers are in electronic format, contracts often call for the vendor to maintain proprietary software that enables the bank and examiners to access the electronic workpapers for a specified time period.

5. Is the scope of the outsourced work revised appropriately when the bank's environment, structure, activities, risk exposures, or systems change significantly?
6. Have the directors ensured that the outsourced internal audit activities are effectively managed by the bank?
7. Does the arrangement with the outsourcing vendor satisfy the independence standards described in the Policy Statement on the Internal Audit Function and Its Outsourcing and thereby preserve the independence of the internal audit function, whether or not the vendor is also the bank's independent public accountant?
8. Has the bank performed sufficient due diligence to satisfy itself of the vendor's competence before entering into the outsourcing arrangement, and are there adequate procedures for ensuring that the vendor maintains sufficient expertise to perform effectively throughout the arrangement?
9. Does the bank have a contingency plan to ensure continuity in audit coverage, especially for high-risk areas?

EXTERNAL AUDIT ACTIVITIES

1. When state, federal, or supervisory regulations or stock exchange listing require an independent CPA audit, did the bank comply?
   a. If so, was the opinion rendered by the accounting firm unqualified?
   b. If not, has the auditor taken appropriate action to resolve any deficiencies?
2. Does the bank policy prohibit loans to its external auditor or the engagement of an external auditor who is a stockholder? If not, has the board considered the materiality of any existing transactions regarding the auditor's independence?
3. Has an external auditor been engaged to perform special reviews of specific departments or areas of the bank since the previous examination? If deficiencies were cited, have they been corrected?
4. Has the same public accounting firm been engaged for the prior two years? If not, obtain a reason for change.
5. Have management letters from the external auditors or other reports from consultants

been presented to management since the last examination?

6. Do deficiencies in management letters receive appropriate attention?
7. Are the notes pertaining to the financial statements reviewed for any information that may allude to significant accounting or control problems?
8. Does the report of examination or the management letter submitted by the public accounting firm comprehensively define the scope of the examination conducted?

REGULATORY EXAMINATION ACTIVITIES

1. Does the internal audit department have access to the examination reports?
2. Does the internal audit department investigate the reasons for adverse comments and recommendations in the examination reports?
3. Does the internal audit department monitor the progress in dealing with these comments and recommendations?

To supplement on-site examinations, the Federal Reserve System routinely monitors the financial condition and performance of state member by banks using automated screening systems. These surveillance systems rely on call reports and other financial regulatory reports, as well as examination data, to identify institutions exhibiting financial deterioration or increased risk profiles. This surveillance process ensures that these banks receive timely supervisory attention and that examination resources can be directed to weak and potentially troubled banks.

System surveillance screens focus on many areas evaluated in the supervisory process, including capitalization, asset growth, loan quality, loan concentrations, interest-rate risk, and liquidity. In addition, they flag banks engaging in new or complex activities. The surveillance information helps identify weak or deteriorating banks and those with changing risk profiles.

Examiners also use the surveillance results in pre-examination planning. For example, before an on-site review, the examiner will determine whether a bank is on the System Bank Watch List (the watch list) and if the bank has failed any surveillance monitoring screens. This information is useful in determining the type of examination scope (full, limited, or targeted) and staff resources that will be needed. It can also be used to identify bank activities that may warrant a higher degree of review or focus during an on-site examination. Thus, the surveillance information helps examination and supervision staff plan and schedule more forward-looking risk-focused examinations.

The surveillance program activities generally consist of the following three supervisory components:

1. *A set of System monitoring screens of financial data.* The process, referred to as ''screening,'' involves a routine monitoring of the financial condition, performance, and risk of banks.
2. *Analysis based on the watch list and other reports.* Staff uses the watch list and other data derived from the surveillance process to flag outlier institutions using measures that correspond to areas of supervisory concern. The monitoring screens and watch list are designed and used to spot trends and changes in the institution's financial condition and performance to determine if identified companies require further review.
3. *Corrective action and follow-up.* Reserve Bank follow-up action is performed for the extreme outlier earmarked institutions. The nature and extent of follow-up depend on current conditions at the bank. Actions range from completing a written analysis of the factors contributing to the outlier status to conducting an on-site examination. These efforts ensure that identified problems are monitored until they can be corrected or resolved.

SYSTEM BANK WATCH LIST PROGRAM

The System Bank Watch List Program, detailed in SR-00-7, is the Federal Reserve's primary means for monitoring state member bank performance and condition between on-site examinations. The watch list is a record of banks that failed selected monitoring screens or ratings criteria. The watch list helps the Reserve Banks track and address troubled or potentially weak banks and identify common supervisory issues in the banks meeting watch list criteria. The program consists of five phases: (1) generating, reviewing, and modifying a watch list of banks meeting certain inclusion criteria; (2) analyzing the financial condition and risk profile of each bank on the final watch list and specifying the factors responsible for the bank's appearance on the watch list; (3) determining whether the safety-and-soundness examination schedule should be accelerated for those banks listed on the watch list; (4) preparing or updating a risk assessment for each bank listed on the watch list; and (5) developing a suitable supervisory response, including possible corrective action, that addresses identified problems.

Watch List Coverage and Criteria

The System Bank Watch List Program applies to all state member banks. Federal Reserve Board staff initiates the watch list process each quarter by subjecting banks to System screens. State member banks placed on the watch list require a significant degree of supervisory attention because of either their financial condition (as reflected in quarterly call report data) or recent examination findings. State member banks are included on the watch list when they meet one or more of the following criteria:

- SEER risk rank greater than or equal to 2 percent (the SEER models are described below)[1]
- SEER rating worse than or equal to 3
- CAMELS composite, CAMELS management component, or CAMELS risk-management rating worse than or equal to 3
- composite rating of 4 or 5 in any one of the specialty examination ratings covering consumer compliance, information technology, and trust
- CRA rating of "needs to improve" or "substantial noncompliance"

Banks rated 4 and 5 are included on the list since they have been identified as problem institutions subject to increased examination frequency, monitoring, and supervision. Reserve Bank and Board staff may also add state member banks to the watch list for reasons other than those listed above. For example, they may elect to include selected de novo banks, banks reporting rapid asset or loan growth or significant changes in business mix, and other institutions with financial characteristics that suggest the need for greater supervisory attention. This surveillance program and approach gives the Reserve Banks discretion to determine the scope of follow-up activities, and it permits examiners to balance subjective knowledge about the institution's management and risk-management systems with objective, quantitative measures derived from automated screening tools.

SEER

SEER, the System to Estimate Examination Ratings, is an off-site, early-warning system for monitoring the financial condition of banks during periods between on-site examinations. The system consists of two econometric models that generate complementary surveillance scores: the SEER rating model and the SEER risk-rank model.

1. Historically, less than 5 percent of commercial banks have had SEER risk ranks greater than 2 percent each quarter. Annual SEER model validation studies have shown that, in general, banks with risk ranks exceeding 2 percent exhibit problem characteristics similar to those with less than satisfactory CAMELS ratings.

SEER Rating Model

Using the two previous quarters' call report and examination data, the SEER rating model provides a statistical relationship between composite CAMELS ratings assigned and a selection of financial ratios and examination data. This statistical relationship is then used to estimate a CAMELS rating for each bank based on the most recent call report data and prior examination ratings. The estimated CAMELS rating, called the SEER rating, helps to identify banks whose financial conditions have changed between on-site examinations.

SEER Risk-Rank Model

The SEER risk-rank model estimates the probability, ranging from 0 to 100 percent, that a bank will fail within the next two years. The model uses data from banks that failed during the period from 1985 to 1991 to provide a statistical relationship between bank failures and financial data. This relationship is used to estimate a quarterly SEER risk rank for each bank using current data from the call report.

Review of Bank Watch List and Reserve Bank Analysis

After bank call report data are finalized, Federal Reserve Board staff send (electronically and in hard copy) the watch list results and the results of a set of monitoring screens to each Reserve Bank. The monitoring screens assist Reserve Bank staff in analyzing the watch list banks and in identifying other banks that may require increased supervisory attention. These screens address areas of supervisory interest, focusing on aspects of bank performance and condition considered by the CAMELS rating system. Upon receipt of this material, Reserve Bank staff perform the procedures outlined below.

- *Review and modification of the watch list.* The staff at each Reserve Bank review the preliminary watch list and add any state member banks from its district that pose significant supervisory concerns. For each bank added, the Reserve Bank submits, by e-mail, the name, ID RSSD number, location, asset size, and the reasons for the bank's inclusion to the manager of the Surveillance and Risk Assessment Section at the Federal Reserve Board. Reserve Bank staff also may recommend removing banks from the watch list that no longer appear to require watch list status (stating the reasons for removal). Board supervision and surveillance staff will review the reasons for removal and determine whether any banks should be removed from the list. On the tenth business day after distribution of the preliminary watch list, the watch list is considered final. The 60-day time frame for completing all follow-up work commences at this point.
- *An assessment of the financial condition and risk profile of each final watch list bank.* Each bank in a Reserve Bank's final watch list is reviewed to assess its financial condition and risk profile. The review should establish the root cause for the bank's inclusion on the list and determine whether its risk profile has improved or deteriorated. Supervisory information to be considered includes recent examination findings regarding both the bank and its affiliates, relevant information included in correspondence between the bank and the Reserve Bank, and other outside sources of information. All appropriate surveillance tools are to be used in evaluating each bank, including the Uniform Bank Performance Report, results of the System Bank Monitoring Screens, SEER Schedule 1A and Risk Profile Analysis (RPA) reports,[2] the Uniform Bank Holding Company Performance Report, and the System BHC Monitoring Screen results. Local Reserve Bank surveillance information also should be reviewed.
- *A determination on whether the safety-and-soundness examination schedule should be accelerated for any bank included on the watch list.* When substantial deterioration in a bank's financial condition is evident or when a bank's risk profile has increased significantly, the Reserve Bank will commence an on-site review of the bank within 60 days after the release of the final watch list. Reserve Banks should commence the on-site reviews under the circumstances detailed in table 1 unless either (1) the findings of the SEER models are not indicative of the bank's financial condition, or (2) the bank's most recent examination (within the last six months) thoroughly reviewed the factors responsible for the deteriorating surveillance results and demonstrated that the factors are not a cause for supervisory concern or have been adequately addressed by existing or proposed corrective actions.

Table 1—Factors Warranting an Expedited Examination

Current CAMELS Rating	*SEER Rating*	*or SEER Risk Rank*
1	3+	10%+
2	3+	10%+
3	4+	10%+

The scope of on-site reviews conducted for watch list banks may vary, depending on the risk factors present and Reserve Bank knowledge about the bank and its management. In some cases, discussing these issues with management may suffice. In others, a full-scope examination may be necessary. When a bank appears on the watch list as a result of an assigned risk-management rating of 3 or worse, the Reserve Bank should pay particular attention to documenting the bank's progress in addressing management deficiencies. When significant progress is not evident within six months of a bank's initial appearance on the list with management weaknesses, a Reserve Bank should assess whether the bank's current CAMELS rating should be downgraded. This assessment may require completion of an on-site review.
- *Preparation of a risk assessment for each watch list bank.* Within 30 days after receiving the quarter's final watch list, Reserve Banks are to document their conclusions on the banks included in the watch list. The form of the documentation necessary to provide a clear assessment of an institution's risk profile

2. These reports facilitate analysis of SEER results by explaining the factors contributing to a bank's SEER measures.

may vary. In all cases, Reserve Banks must address the underlying reasons for a bank's inclusion on the watch list and whether the scheduling of an examination should be accelerated. The documentation must also note whether a bank's current CAMELS rating accurately reflects its condition and the Federal Reserve's supervisory concerns. The documentation should address any adverse SEER results, referencing information contained in the SEER Schedule 1A and Risk Profile Analysis reports. Further, the documentation should include bank management's response to supervisory concerns.

Federal Reserve System Bank Watch List and Surveillance Programs

Examination Objectives

Effective date November 2000

Section 1020.2

1. To identify major changes in the financial condition of the bank between examinations.
2. To assist in determining the scope of the examination and the priority of work to be performed.
3. To check the validity of the data being reported by the bank.
4. To investigate areas where an in-depth review is indicated.

Federal Reserve System Bank Watch List and Surveillance Programs

Examination Procedures

Effective date November 2000

Section 1020.3

1. Obtain any surveillance screening reports, such as the watch list and Federal Reserve System monitoring screens, or other analysis reports prepared by the Reserve Bank or Board that have been generated for the bank.
2. Review the reports obtained in step 1 and discuss with surveillance staff, if necessary, for clarification or for further background information.
3. If a pre-examination analysis has not been prepared, create one from information contained in the bank performance report, current call report, and previous examination report. This analysis should be considered when determining the scope of the examination, and when making staffing decisions.
4. Follow up on unusual aspects revealed in the surveillance screening reports, in analysis reports, or on newly obtained data significantly different from prior information.
5. Perform validity checks necessary to ensure the quality of reported data. This would include such normal examination procedures as validating call report information and confirming the accuracy and soundness of past-due and accrual accounting practices.

INTRODUCTION

Workpapers are the written documentation of the procedures followed and the conclusions reached during the examination of a bank. Accordingly, they include, but are not necessarily limited to, examination procedures and verifications, memoranda, schedules, questionnaires, checklists, abstracts of bank documents and analyses prepared or obtained by examiners.

The definition of workpapers, their purpose, and their quality and organization are important because the workpapers as a whole should support the information and conclusions contained in the related report of examination. The primary purposes of workpapers are to—

- organize the material assembled during an examination to facilitate review and future reference.
- aid the examiner in efficiently conducting the examination.
- document the policies, practices, procedures and internal controls of the bank.
- provide written support of the examination and audit procedures performed during the examination.
- document the results of testing and formalize the examiner's conclusions.
- substantiate the assertions of fact or opinion contained in the report of examination.

They also are useful as—

- a tool for the examiner-in-charge to use in planning, directing, and coordinating the work of the assistants.
- a means of evaluating the quality of the work performed.
- a guide in estimating future personnel and time requirements.
- a record of the procedures used by the bank to assemble data for reports to the Board of Governors of the Federal Reserve System.
- a guide to assist in the direction of subsequent examinations, inquiries and studies.

The initial step in preparing workpapers is to review, where available, the applicable sections of supporting data prepared during the prior examination. When reviewing prior workpapers, the examiner should consider the data prepared in each area for—

- information that is of a continuing or permanent nature.
- guidance in preparation of workpapers for the current examination.
- an indication of changes or inconsistencies in accounting procedures or methods of their application since the last examination.

Accumulation of relevant documentation consistent with prior examinations, however, is often insufficient. Workpapers should be prepared in a manner designed to facilitate an objective review, should be organized to support an examiner's current findings and should document the scope of the current examination. Minimum content necessary for each section of workpapers includes:

Source of Information—This is important, not only in identifying the bank, but also in identifying the preparer. In subsequent examinations, the preparer should be able to readily determine the bank personnel from whom the information was obtained during the previous examination as well as the examiner who prepared the workpapers. Accordingly, each workpaper should include—

- bank name and subdivision thereof, either functional or financial.
- statement of title or purpose of the specific analysis or schedule.
- specific identification of dates, examination date and work performance date.
- initials of preparer and initials indicating review by the examiner designated to perform that function. Although appropriate use may be made of initials, the full names and initials of all examiners should appear on a time and planning summary or on an attachment to the file to facilitate future identification.
- name and title of person, or description of records, that provided the information needed to complete the workpaper.
- an index number identifying the workpaper and facilitating organization of the workpaper files.

Scope of Work—This includes an indication of the nature, timing and extent of testing in application of examination and audit procedures. It also includes the examiner's evaluation of and reliance on internal and external audit procedures and compliance testing of internal controls. To the extent that this information is contained in other workpapers, such as an examination procedure or a questionnaire, a reference to the appropriate workpaper will be sufficient.

Conclusions—The examiner should develop conclusions, in accordance with the examination objectives, with respect to the information obtained, documentation provided and the results of the examination and audit procedures performed. Such conclusions provide the basis for information contained in the report of examination.

To develop workpapers that have the qualities of clarity, completeness and conciseness, adequate planning and organization of content are essential. Therefore, before the workpaper is prepared, the examiner should determine the following:

- What examination objective will be satisfied by preparing the analysis or workpaper?
- Can preparation of the analysis be avoided by testing the bank's records and indicating the nature and extent of testing in an examination or an audit procedure or by comment on a related schedule or another supporting document?
- Is the analysis necessary to support the information in the report of examination?

Subsequent to the determination that an analysis is required, but before initiating preparation, the examiner should decide if—

- previous examination analyses can be adapted and carried forward to the current examination.
- the analysis can be prepared by an internal auditor or other bank personnel.
- the format of the analysis may be designed in a manner to facilitate its use in future examinations.

Once it has been determined that preparation of an analysis is required, the examiner should consider the following techniques that promote clarity of workpaper preparation:

- Restrict writing to only one side of the paper.
- Use a standard size sheet of paper large enough to avoid overcrowding.
- Condense information for simplicity.

Frequently, time can be saved by carrying forward workpapers from one examination to the next. Thus, when laying out an analysis that might be repeated in future examinations, the examiner should arrange it in a manner to facilitate future use. For example, extra columns may be left blank within an account analysis displaying little activity for insertion of transaction information during future examinations. In such a situation, appropriate space (boxes and column headings) should be provided for the signature or initials of the preparer and reviewer during each examination. When a workpaper is removed from one examination file and carried forward, a notation should be made in the file from which the paper is extracted. This is important in the event workpapers applicable to a particular examination are needed several years after the completion of the examination.

INITIAL PREPARATION BY OTHERS

Although all items included in the report of examination should be supported by workpapers, their preparation may not always require original work by the examiner. Frequently, arrangements can be made for bank personnel, including internal auditors, to prepare workpapers for examination use or to make available papers prepared by them as part of their regular duties. Examples include outstanding checklists, lists of outstanding certificates of deposit, schedules of employee borrowings, and debt maturity schedules. The extent to which examiners can utilize analyses and data prepared by bank personnel increases the efficiency with which examination procedures are completed.

As part of the initial examination planning process, arrangements should be made with appropriate bank management for the timely completion of bank-prepared data and information. The coordinating bank officer(s) must understand what information is being requested and why it is being requested, in order to avoid confusion and unnecessary regulatory burden. Arrangements, however, may have to be made for the bank to supply supporting details or other schedules or items to comply with the requests.

Upon receipt of bank-prepared analyses, an examiner should review the documents for overall completeness and note the date of receipt. This facilitates future planning and provides a ready reference as to which analyses have been received from the bank at any given point during the examination. Also, all bank-prepared workpapers should be tested and the nature and extent of testing performed by the examiner should be indicated on the papers.

INITIAL APPROACH IN WORKPAPER PREPARATION

The initial approach in preparing workpapers that support balances in the statement of condition is quantitative. In using this approach, the examiner obtains an analysis of the composition of the account balance as of the examination date. This inventory of the composition may be represented by a trial balance of loans, a listing of outstanding official checks, a listing of individual deposit accounts, or other similar items. Only after determining the composition and insuring that the total agrees with the bank's records is the examiner in a position to perform examination procedures and to arrive at a conclusion about the overall quality of the items comprising the balance.

For certain analyses, however, it is preferable to include account activity (transactions) in the workpapers. Typical examples of such analyses are those of bank premises and equipment and of reserve for possible loan losses. The format for reserve for possible loan losses should include beginning balances (prior examination ending balances), provisions for loan losses, collections, charge-offs, other transactions (transfers to/from undivided profits) and ending balances as of the examination date.

CONTROL AND REVIEW

All examiners assigned to an examination should insure that workpapers are controlled at all times while the examination is in progress. For example, when in the bank's offices, the workpapers should be secured at night and safeguarded during the lunch hour or at other times when no examining personnel are present in the immediate vicinity. It is essential to completely control confidential information provided by the bank. In addition, information relating to the extent of tests and similar details of examination procedures should not be made available to bank employees.

In cases where customary examination practices are not practical, alternative procedures and the extent to which they are applied should be documented. The need for completeness requires that there be no open items, unfinished operations or unanswered questions in the workpapers at the conclusion of the examination.

The clarity of workpapers should be such that an examiner or Federal Reserve official unfamiliar with the work could readily understand it. Handwritten commentaries should be legible, concise and should support the examiner's conclusions. Descriptions of work done, notations of conferences with bankers, conclusions reached and explanations of symbols used should be free from ambiguity or obscurity. Excessive use of symbols usually can be avoided by expanding a comment to include the nature and extent of work performed instead of using separate symbols for each portion of the work performed. In addition, instructions to assisting personnel concerning standards or workpaper content are necessary to ensure that they will meet the quality standards of the Federal Reserve. When workpapers have the necessary qualities of completeness, clarity, conciseness and neatness, a qualified reviewer may easily determine their relative value in support of conclusions and objectives reached. Incomplete, unclear or vague workpapers should, and usually will, lead a reviewer to the conclusion that the examination has not been adequately performed.

REVIEW PROCEDURES

Experienced personnel must review all workpapers prepared during an examination. Usually that review is performed by the examiner-in-charge, although in some cases, the examiner-in-charge may designate other experienced personnel to perform an initial review. An overall review is then performed by the examiner-in-charge. The two primary purposes of a review of workpapers by senior personnel are to determine that the work is adequate given the circumstances, and to ensure that the record is sufficient to support the conclusions reached in the report of examination. The timely review of workpapers and subsequent discussion of them with the individual who prepared them also is one of the more effective procedures for on-the-job training.

Normally, the review should be performed as soon as practicable after the completion of each work area. This review ideally occurs at the bank's office so that if the need for obtaining additional information arises or additional work is required the matter can be promptly attended to with minimum loss of efficiency.

When the review of workpapers is completed, the reviewer should sign or initial the applicable documents. Although all workpapers should be reviewed, the depth and degree of detail depends on factors such as:

- The nature of the work and its relative importance to the overall examination objectives.
- The extent to which the reviewer has been associated with the area during the examination.
- The experience of the examiners who have carried out the various operations.

Professional judgment must be exercised throughout the review process.

ORGANIZATION OF WORKPAPER FILES

Administration of an examination includes—

- organizing the workpaper files.
- delegating authority for completion of all applicable workpaper sections.
- reviewing and assembling the completed workpapers.

To ensure efficiency in locating information contained in the workpapers and completion of all necessary procedures, workpapers should be filed and indexed in a standard manner.

FILES

The file provides the organizational vehicle to assemble workpapers applicable to specific areas of the examination. Files might include detailed workpapers related to—

- management appraisal.
- overall conclusions about the condition of the bank.
- cash accounts.
- investments.
- loans.
- reserve for possible loan losses.
- bank premises and equipment.
- other assets.
- deposits.
- other liabilities.
- capital accounts and dividends.

Each individual file would normally include—

- related examination and audit procedures.
- detailed information and other documentation necessary to indicate the specific procedures performed, the extent of such procedures and the examiner's conclusions for the specific area.
- a summary, in comparative form, of the supporting general ledger balances with appropriate cross-references.

Judgment is required as to what the file should include on any specific examination. Lengthy documents should be summarized or highlighted (underlined) so that the examiner who is performing the work in the related area can readily locate the important provisions, without having to read the entire document. It also may be desirable to have a complete copy of the document in the file to support the summaries or answer questions of a specific legal nature.

Examples of documents that might be contained in the files are—

- a brief history and organization of the bank.
- organization charts of applicable departments within the bank.
- copies of, or excerpts from, the charter and bylaws.
- copies of capital stock certificates, debentures agreements and lease agreements.
- excerpts from minutes or contracts that are of interest beyond the current year.
- a chart of accounts and an accounting manual, if available, supplemented by descriptions of unique accounts and unusual accounting methods.
- lists of names and titles of the board of directors, important committees and relevant departmental personnel.

Indexing and Cross-Referencing

To promote efficiency and help ensure that all applicable areas of an examination have been considered and documented, the use of an indexing system aids in the organization of workpaper files. A general outline or index including all examination areas provides a basis for organization to which a numbering or other sequential system can be assigned and applied to each workpaper file.

When all workpapers pertinent to a specific area of the examination have been completed, a cover sheet listing the contents of each file should be attached to the front to provide a permanent record for reference. This permits not only efficient location of a set of workpapers pertinent to a specific area of the examination (for example, cash or commercial loans), but also facilitates the location of a specific analysis (or other document) within the set.

Amounts or other pertinent information appearing in more than one place in the workpapers should be cross-referenced between the analyses. A notation on the index, including appropriate cross-referencing of those items removed or filed elsewhere, facilitates location of specific data and records and also helps to prevent inadvertent loss of documents. An example is the cross-referencing of net charge-offs obtained in the review of the reserve for possible loan losses to the amount approved in the board of director's minutes. Proper cross-referencing is important because it—

- serves as a means of locating work performed for a particular account or group of accounts.
- identifies the source of supporting amounts in a particular analysis.
- facilitates the review of the workpapers.
- helps in following the workpapers during the succeeding examination.

WORKPAPER RETENTION

Examiners should retain on a readily available basis those workpapers from—

- the most recent full-scope Federal Reserve examination.
- the most recent general EDP examination.
- examinations of banks requiring or recommended for more than normal or special supervisory attention (composite rating of 3, 4 or 5; consumer compliance rating of 3, 4 or 5; EDP departments rated 4 or 5; or those subject to administrative action such as civil money penalties) until such banks are no longer the subject of such scrutiny.
- examinations disclosing conditions that may lead eventually to more than normal or special supervisory attention, as described above, until the supporting workpapers are no longer appropriate.
- examinations disclosing conditions that lead, or may eventually lead, to a criminal referral or criminal investigation.

These guidelines are the minimum required retention period for workpapers; longer retention periods may be set by individual Reserve Banks.

Cash accounts include U.S. and foreign coin and currency on hand and in transit, clearings, and cash items.

CASH

Every bank maintains a certain amount of U.S. currency and some may have foreign currency on hand. To avoid having excess nonearning assets and to minimize exposure to misappropriation and robbery, each bank should establish a policy to maintain cash balances at the minimum levels necessary to serve its customers. The amount will vary from bank to bank depending on anticipated needs of customers and the availability of replenishment monies, with a reasonable allowance made for unusual demands.

Foreign currency may not be included in cash positions for management purposes when the amounts are not significant. However, the coin and currency of other countries are foreign-currency assets, as are loans or nostro accounts, and should be included in the foreign-currency positions.

CLEARINGS

Clearings are checks, drafts, notes, and other items that a bank has cashed or received for deposit that are drawn on other local banks and cleared directly with them. These items can usually be exchanged more efficiently among local banks than through correspondent banks or the Federal Reserve System. Many communities with two or more banks have formally organized clearinghouse associations, which have adopted rules governing members in the exchange of checks. Clearinghouse associations often extend their check-exchange arrangements to other nearby cities and towns. In most banks, clearings will be found in the department responsible for processing checks.

Proof and transit were once two separate functions in a bank: the proving of work (proof) and the sending of out-of-town cash items (transit) for collection. Most banks have now combined these two functions. Proof and transit may be performed by any combination of tellers or proof clerks, a separate proof and transit department, a check-processing department, an out-clearing department, or some other department that is characteristic of the area of the country where the bank operates. The functions may be centralized or decentralized, manual or automated, depending on the size of the bank and the volume of transactions. The volume of clearings may be so great that the bank's proof operations are conducted after time deadlines for transaction posting or courier delivery. In these cases, daily clearings customarily are determined as of a specific cutoff time. Checks processed to that time are carried in one day's totals, and checks processed after that time are carried in the following day's totals. However, no matter who performs the function or how large the bank, the objectives of a proof and transit system are the same:

- to forward items for collection so that funds are available as soon as possible
- to distribute all incoming checks and deposits to their destinations
- to establish whether deposit totals balance with the totals shown on deposit tickets
- to prove the totals of general ledger entries and other transactions
- to collect data for computing the individual customer's service charges and determining the availability of the customer's funds
- to accomplish the assigned functions at the lowest possible cost

CASH ITEMS

Cash items are checks or other items in the process of collection that are payable in cash upon presentation. A separate control of all cash items is usually maintained on the bank's general ledger and, if applicable, on the international division general ledger. The ledger is supported by a subsidiary record of individual amounts and other pertinent data. Cash items and the related records are usually in the custody of one employee at each banking office.

In their normal daily operations, banks have an internal charge, on the general ledger, to total demand deposits not charged to individual accounts because of insufficient funds, computer misreads, or other problems. Commonly known as return items or rejected or unposted debits, these items may consist of checks received in the ordinary course of business, loan-payment debits, and other debit memos. In some banks, return items are separated by the bookkeepers and an entry is made reclassifying them to a separate asset account entitled ‘‘bookkeepers' return items.’’ Other banks do not use a separate asset account; instead, the bookkeepers include the items in a subsidiary control account in the individual demand deposit ledgers. In that case, the account would have a debit balance and would be credited when the bank processes items for posting or returns the checks to their source.

Since bookkeepers' return items are usually processed and posted to an individual account or returned to their source on the next business day, the balance of the bookkeepers' return items account should represent the total of only one day's returned items.

When data processing systems are used, the common practice is to post all properly encoded debit items, regardless of whether an overdraft is created. The resulting preliminary overdraft list, together with the items charged, is subsequently reviewed by bank employees, and unapproved items are reversed and separated as bookkeepers' return items. The total of the resulting final overdraft list becomes the final overdraft figure shown on the general ledger. The examination of overdrafts is discussed in ‘‘Deposit Accounts,’’ section 3000.1. The examination of international overdrafts is discussed in ‘‘Due from Banks,’’ ‘‘Borrowed Funds,’’ and ‘‘International—Foreign Exchange,’’ sections 2010.1, 3010.1, and 7100.1, respectively.

Several types of cash items should be considered ‘‘cash items not in the process of collection’’ and shown in an appropriate ‘‘other assets’’ account. Some examples are (1) items that are payable upon presentation but which the bank has elected to accumulate and periodically forward to the payor, such as Series EE bonds or food stamps; (2) items that are not immediately payable in cash upon presentation; and (3) items that were not paid when presented and require further collection effort.

In addition to those items carried in the separate ‘‘cash items’’ account on the general ledger, most banks will have several sources of internal float in which irregular cash items can be concealed. Such items include any memoranda slips; checks drawn on the bank; checks returned by other banks; checks of directors, officers, employees, and their interests; checks of affiliates; debits purporting to represent currency or coin shipments; notes, usually past due; and all aged and unusual items of any nature that might involve fictitious entries, manipulations, or uncollectible accounts.

CURRENCY TRANSACTIONS

The Financial Recordkeeping and Reporting of Currency and Foreign Transactions regulation, 31 CFR 103, requires financial institutions to maintain records that might be useful in criminal, tax, or regulatory investigations. The regulation also seeks to identify persons who attempt to avoid payment of taxes through transfers of cash to or from foreign accounts. The examination procedures for determining compliance with the regulation require the examiner to ascertain the quality of the bank's auditing procedures and operating standards relating to financial recordkeeping.[1] Examiners also determine the adequacy of written policies and bank training programs. The Financial Recordkeeping and Reporting of Currency and Foreign Transactions checklist (see the *Bank Secrecy Act Examination Manual*) is to be used in checking compliance and for reporting apparent violations. Any violations noted should be listed with appropriate comments in the report of examination. Inadequate compliance could result in a cease-and-desist order to effect prompt compliance with the statute.

1. Section 208.63 of Regulation H establishes procedures to ensure that state member banks establish and maintain procedures reasonably designed to ensure and monitor compliance with the regulation.

1. To determine if the policies, practices, procedures, and internal controls regarding ''cash accounts'' are adequate.
2. To determine if bank officers and employees are operating in conformance with the established guidelines.
3. To determine the scope and adequacy of the audit function.
4. To determine compliance with laws and regulations.
5. To initiate corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws or regulations have been noted.

1. If selected for implementation, complete or update the cash accounts section of the internal control questionnaire.
2. Based on the evaluation of internal controls and the work performed by internal or external auditors, determine the scope of the examination.
3. Test for compliance with policies, practices, procedures and internal controls in conjunction with performing the remaining examination procedures. Also obtain a listing of any deficiencies noted in the latest review done by internal or external auditors from the examiner assigned to that area of examination, and determine if appropriate corrections have been made.
4. Scan the general ledger cash accounts for any unusual items or abnormal fluctuations. Investigate any such items and document any apparent noncompliance with policies, practices and procedures for later review with appropriate management personnel.
5. Obtain teller settlement sheet recap or similar document as of the examination date and agree to the general ledger. Scan for reasonableness and conformity to bank policy.
6. Obtain detailed listings of cash items, including any bank items which are carried in the general ledger under ‘‘other assets,’’ agree listings to general ledger balances and scan for propriety and conformity to bank policy.
7. Test compliance with Regulation H (12 CFR 208) by—
   a. selecting teller and banking office cash-balance sheets and determining that balances are within currency limits established;
   b. selecting bait money and agreeing serial numbers to applicable records;
   c. reviewing documentation showing training sessions held since the preceding examination;
   d. performing any visual inspections deemed appropriate;
   e. analyzing the bank’s system of security and protection against external crimes (Guidance for this analysis is provided in the internal control questionnaire in this section of the manual.); and
   f. determining, through discreet corroborative inquiry of responsible bank officials and review of documentation, whether a security program that equals or exceeds the standards prescribed by Regulation H (12 CFR 208.61(c)) is in effect and that the annual compliance report and any other reports requested by the Federal Reserve System have been filed.
8. Review compliance with the Financial Recordkeeping and Reporting of Currency and Foreign Transactions Act, 31 CFR 103.
9. Review tellers’ over and short accounts for recurring patterns and any large or unusual items and follow up as considered necessary. Investigate differences centered in any one teller or banking office. Determine whether corrective action has been taken, if required.
10. Determine, by discreet corroborative inquiry of responsible bank officials and review of documentation, whether defalcations and/or mysterious disappearances of cash since the preceding examination have been properly reported pursuant to current requirements of the Board of Governors.
11. Review foreign-currency control ledgers and dollar book value equivalents for the following:
    a. accuracy of calculations and booking procedures
    b. unusual fluctuations
    c. concentrations
    d. unusual items
12. Review international division revaluation calculations and procedures.
13. Review the following items with appropriate management personnel (or prepare a memo to other examining personnel for their use in reviewing with management):
    a. internal-control exceptions and deficiencies in, or noncompliance with, written policies, practices and procedures
    b. uncorrected audit deficiencies
    c. violations of law
    d. inaccurate booking of U.S. dollar book value equivalents for foreign currencies
    e. inaccurate revaluation calculations and procedures performed by cash-account operations staff
14. Prepare comments on deficiencies or

violations of law noted above for inclusion in the examination report.

15. Update the workpapers with any information that will facilitate future examinations.

Review the bank's internal-control policies, practices, and procedures for cash accounts. The bank's system should be documented completely and concisely and should include, where appropriate, narrative descriptions, flow charts, copies of forms used, and other pertinent information. Items marked with an asterisk require substantiation by observation or testing.

CASH ON HAND

*1. Do all tellers, including relief tellers, have sole access to their own cash supply, and are all spare keys kept under dual control?

*2. Do tellers have their own vault cubicle or controlled cash drawer in which to store their cash supply?

3. When a teller is leaving for vacation or for any other extended period of time, is that teller's total cash supply counted?

4. Is each teller's cash verified periodically on a surprise basis by an officer or other designated official (if so, is a record of such count retained)?

*5. Are cash drawers or teller cages provided with locking devices to protect the cash during periods of the teller's absence?

6. Is a specified limit in effect for each teller's cash?

*7. Is each teller's cash checked daily to an independent control from the proof or accounting control department?

8. Are teller differences cleared daily?

9. Is an individual, cumulative over and short record maintained for all persons handling cash, and is the record reviewed by management?

10. Does the teller prepare and sign a daily proof sheet detailing currency, coin, and cash items?

*11. Are large teller differences required to be reported to a responsible official for clearance?

12. Is there a policy against allowing teller "kitties"?

*13. Are teller transactions identified through use of a teller stamp?

*14. Are teller transfers made by tickets or blotter entries which are verified and initialed by both tellers?

15. Are maximum amounts established for tellers' cashing checks or allowing withdrawal from time deposit accounts without officer approval?

16. Does the currency at each location include a supply of bait money?

17. Are tellers provided with operational guidelines on check-cashing procedures and dollar limits?

18. Is a record maintained showing amounts and denominations of reserve cash?

*19. Is reserve cash under dual custody?

*20. Are currency shipments—
   a. prepared and sent under dual control and
   b. received and counted under dual control?

*21. If the bank uses teller machines—
   a. is the master key controlled by someone independent of the teller function,
   b. is the daily proof performed by someone other than the teller, and
   c. are keys removed by the teller during any absence?

*22. Is dual control maintained over mail deposits?

23. Is the night depository box under a dual lock system?

24. Is the withdrawal of night deposits made under dual control?

25. Regarding night depository transactions—
   a. are written contracts in effect;
   b. are customers provided with lockable bags; and
   c. are the following procedures completed with two employees present:
      • opening of the bags
      • initial recording of bag numbers, envelope numbers, and depositors' names in the register
      • counting and verification of the contents

*26. Regarding vault control—
   a. is a register maintained which is signed by the individuals opening and closing the vault;
   b. are time-clock settings checked by a second officer;
   c. is the vault under dual control; and
   d. are combinations changed periodically and every time there is a change in custodianship?

27. Are tellers prohibited from processing their own checks?
*28. Are tellers required to clear all checks from their funds daily?
*29. Are tellers prevented from having access to accounting department records?
*30. Are teller duties restricted to teller operations?

CASH-DISPENSING MACHINES

*31. Is daily access to the automated teller machine (ATM) made under dual control?
*32. When maintenance is being performed on a machine, with or without cash in it, is a representative of the bank required to be in attendance?
*33. Are combinations and keys to the machines controlled (if so, indicate controls)?
34. Do the machines and the related system have built-in controls that—
    a. limit the amount of cash and number of times dispensed during a specified period (if so, indicate detail) and
    b. capture the card if the wrong PIN (personal identification number) is consecutively used?
35. Does the machine automatically shut down after it experiences recurring errors?
36. Is lighting around the machine provided?
37. Does the machine capture cards of other banks or invalid cards?
38. If the machine is operated ''off line,'' does it have negative-file capability for present and future needs, which includes lists of lost, stolen, or other undesirable cards which should be captured?
39. Is use of an ATM by an individual customer in excess of that customer's past history indicated on a ''suspicious-activity'' report to be checked out by bank management (for example, three uses during past three days as compared with a history of one use per month)?
40. Have safeguards been implemented at the ATM to prevent, during use, the disclosure of a customer's PIN by others observing the PIN pad?
41. Are ''fish-proof'' receptacles provided for customers to dispose of printed receipts, rather than insecure trash cans, etc.?
42. Does a communication interruption between an ATM and the central processing unit trigger the alarm system?
43. Are alarm devices connected to all automated teller machines?
44. For on-line operations, are all messages to and from the central processing unit and the ATM protected from tapping, message insertion, modification of message or surveillance by message encryption (scrambling techniques)? (One recognized encryption formula is the National Bureau of Standards Algorithm.)
*45. Are PINs mailed separately from cards?
*46. Are bank personnel who have custody of cards prohibited from also having custody of PINs at any stage (issuance, verification, or reissuance)?
47. Are magnetic stripe cards encrypted (scrambled) using an adequate algorithm (formula) including a total message control?
48. Are encryption keys, i.e., scramble plugs, under dual control of personnel not associated with operations or card issuance?
*49. Are captured cards under dual control of persons not associated with bank operation card issuance or PIN issuance?
*50. Are blank plastics and magnetic stripe readers under dual control?
51. Are all cards issued with set expiration dates?
52. Are transaction journals provided that enable management to determine every transaction or attempted transaction at the ATM?

CASH ITEMS

*53. Are returned items handled by someone other than the teller who originated the transaction?
54. Does an officer or other designated individual review the disposition of all cash items over a specified dollar limit?
55. Is a daily report made of all cash items, and is it reviewed and initialed by the bank's operations officer or other designated individual?
56. Is there a policy requiring that all cash items uncollected for a period of 30 days be charged off?

57. Do the bank's present procedures forbid the holding of overdraft checks in the cash-item account?
58. Are all cash items reviewed at least monthly at an appropriate level of management?
*59. Are cash items recommended for charge-off reviewed and approved by the board of directors, a designated committee thereof, or an officer with no operational responsibilities?

PROOF AND TRANSIT

60. Are individuals working in the proof and transit department precluded from working in other departments of the bank?
61. Is the handling of cash letters such that—
    a. they are prepared and sent on a daily basis;
    b. they are photographed before they leave the bank;
    c. copy of proof or hand-run tape is properly identified and retained;
    d. records of cash letters sent to correspondent banks are maintained with identification of the subject bank, date, and amount; and
    e. remittances for cash letters are received by employees independent of those who send out the cash letters?
62. Are all entries to the general ledger either originated or approved by the proof department?
63. Are all entries prepared by the general ledger and/or customer accounts department reviewed by responsible supervisory personnel other than the person preparing the entry?
64. Are errors detected by the proof operator in proving deposits corrected by another employee or designated officer?
65. Are all postings to the general ledger and subsidiary ledgers supported by source documents?
66. Are returned items—
    *a. handled by an independent section of the department or delivered unopened to personnel not responsible for preparing cash letters or handling cash,
    b. reviewed periodically by responsible supervisory personnel to determine that items are being handled correctly by this section and are clearing on a timely basis,
    *c. scrutinized for employee items, and
    d. reviewed for large or repeat items?
67. Are holdover items—
    a. appropriately identified in the general ledger,
    *b. handled by an independent section of the department, and
    c. reviewed periodically by responsible supervisory personnel to determine that items are clearing on a timely basis?
68. Does the proof and transit department maintain a procedures manual describing the key operating procedures and functions within the department?
*69. Are items reported missing from cash letter promptly traced and a copy sent for credit?
*70. Is there a formal system to ensure that work distributed to proof machine operators is formally rotated?
71. Are proof machine operators prohibited from—
    a. filing checks or deposit slips or
    b. preparing deposit account statements?
72. Are proof machine operators instructed to report unusually large deposits or withdrawals to a responsible officer (if so, over what dollar amount $__________)?

REGULATION H (12 CFR 208)—COMPLIANCE QUESTIONNAIRE

73. Has a security officer been designated by the board of directors in accordance with Regulation H (12 CFR 208.61(b))?
74. Has a security program been developed and implemented in accordance with Regulation H (12 CFR 208.61(c))?
75. Does the bank have security devices that give a general level of protection and that are at least equivalent to the minimum requirements of Regulation H?
76. Has the installation, maintenance, and operation of security devices considered the operating environment of each office and the requirements of Regulation H (12 CFR 206.61(c))?
77. Does the security officer report at least annually to the bank's board of directors on the administration and effectiveness of

the security program in accordance with Regulation H (12 CFR 206.61(d))?

31 CFR 103—COMPLIANCE QUESTIONNAIRE

78. Is the bank in compliance with the financial recordkeeping and reporting regulations?

INTERNATIONAL DIVISION

*79. Are foreign-currency control ledgers and dollar-book-value equivalents posted accurately?
*80. Is each foreign currency revalued at least monthly, and are profit and loss entries passed on to the appropriate income accounts?
*81. Are revaluation calculations, including the rates used, periodically reviewed for accuracy by someone other than the foreign-currency tellers?
*82. Does the internal auditor periodically review for accuracy revaluation calculations, including the verification of rates used and the resulting general ledger entries?

CONCLUSION

83. Is the foregoing information considered an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
84. Based on a composite evaluation as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate). A separate evaluation should be made for each area, i.e., cash on hand, cash items, etc.

Banks maintain deposits in other banks to facilitate the transfer of funds. Those bank assets, known as ''due from bank deposits'' or ''correspondent bank balances''[1] are a part of the primary, uninvested funds of every bank. A transfer of funds between banks may result from the collection of cash items and cash letters, the transfer and settlement of securities transactions, the transfer of participating loan funds, the purchase or sale of federal funds, and many other causes.

In addition to deposits kept at the Federal Reserve Bank and with correspondent banks, a bank may maintain interest-bearing time deposits with international banks. Those deposits are a form of investment, and relevant examination considerations are included in ''Investment Securities and End-User Activities,'' section 2020.1, and ''International—Due from Banks—Time,'' section 7070.1.

Banks also use other banks to provide certain services that can be performed more economically or efficiently by another facility because of its size or geographic location. These services include processing of cash letters, packaging loan agreements, performing EDP services, collecting out-of-area items, providing safekeeping for bank and customer securities, exchanging foreign currency, and providing financial advice in specialized loan areas. When the service is one way, the receiving bank usually maintains a minimum balance at the providing bank to compensate in full or in part for the services received.

DEPOSITS WITH OTHER DEPOSITORY INSTITUTIONS

Section 206.3 of Regulation F (12 CFR 206) requires FDIC-insured depository institutions to adopt written policies and procedures to address the risk arising from exposure to a correspondent, and to prevent excessive exposure to any individual correspondent. These policies and procedures should take into account the financial condition of a correspondent and the size, form, and maturity of the exposure. Section 206.4(a) of Regulation F stipulates that any FDIC-insured depository institution must limit its interday credit exposure to an individual correspondent that is not ''adequately capitalized''[2] to 25 percent of the institution's total capital.[3] For a more detailed discussion of Regulation F, refer to SR-93-36 (''Examiner Guidelines for Regulation F—Interbank Liabilities,'' June 18, 1993).

BALANCES WITH FEDERAL RESERVE BANKS

All state member banks are required by Regulation D (12 CFR 204) to keep reserves equal to specified percentages of the deposits on their books. These reserves are maintained in the form of vault cash or deposits with the Federal Reserve Bank. The Federal Reserve Bank monitors the deposits of each bank to determine that reserves are kept at required levels. The reserves provide the Federal Reserve System with a means of controlling the nation's money supply. Changes in the level of required reserves affect the availability and cost of credit in the economy. The examiner must determine that the information supplied to the Federal Reserve Bank for computing reserves is accurate.

The Monetary Control Act of 1980 enables a nonmember financial institution to borrow from the Reserve Bank's discount window on the same terms and conditions as member banks. For member banks, loan transactions are usually effected through their reserve account. For nonmember banks, the Reserve Bank typically requires the institution to open a special account called a clearing account. The loan transactions are then processed through the clearing account. However, in some instances, the Reserve Bank may allow a nonmember institution to process discount loan transactions through the account of a member bank. In most of these isolated

1. Balances due from such institutions include all interest-bearing and non-interest-bearing balances, whether in the form of demand, savings, or time balances, including certificates of deposit, but excluding certificates of deposit held in trading accounts.

2. See section 206.5(a) of Regulation F for the capital ratios necessary for a correspondent bank to be considered adequately capitalized.

3. The Board may waive this requirement if the primary federal supervisor of the insured institution advises the Board that the institution is not reasonably able to obtain necessary services, including payment-related services and placement of funds, without incurring exposure to a correspondent in excess of the otherwise applicable limit.

cases, a transaction of a nonmember institution is being processed through the account of the bank with which the nonmember institution has a correspondent relationship.

Under the reserve account charge agreements used by most Federal Reserve Banks, the member bank's reserve account may be charged if the nonmember bank defaults on the loan processed through the member bank's account. Since member banks may not act as the guarantor of the debts of another, member banks may only legally enter into revocable reserve account charge agreements. Revocable agreements allow the member bank, at its option, to revoke the charge and thus avoid liability for the debt of the nonmember correspondent. In contrast, irrevocable charge agreements constitute a binding guarantee of the nonmember correspondent's debt and generally cannot be entered into by a member bank. Banks that enter into revocable charge agreements should establish written procedures to ensure their ability to make prudent, timely decisions.

DEPOSIT BROKERS

On the asset side of the balance sheet, examiners should review the activities of banks that place deposits through money brokers. These banks should have sufficient documentation to, among other things, verify the amounts and terms of individual deposits and the names of depository institutions in which the deposits are placed. Banks should also be able to demonstrate that they have exercised appropriate credit judgment with respect to each depository institution in which they have placed funds. Deficiencies in this area could constitute an unsafe or unsound banking practice. A more detailed discussion of brokered deposits is included in ''Deposit Accounts,'' section 3000.1 of this manual.

DUE FROM FOREIGN BANKS

Due from foreign banks demand or nostro accounts are handled in the same manner as due from domestic bank accounts, except that the balances due are generally denominated in foreign currency.

A bank must be prepared to make and receive payments in foreign currencies to meet the needs of its international customers. This can be accomplished by maintaining accounts (nostro balances) with banks in foreign countries in whose currencies receipts and payments are made.

Nostro balances may be compared with an inventory of goods and must be supervised in the same manner. For example, payment to import goods manufactured in France to the United States can be made through a U.S. bank's French franc account with another bank in France. Upon payment in France, the U.S. bank will credit its nostro account with the French bank and charge its U.S. customer's dollar account for the appropriate amount in dollars. Conversely, exporting U.S. goods to France results in a debit to the U.S. bank's French correspondent account. The first transaction results in an outflow of the U.S. bank's ''inventory'' of French francs, while the second transaction results in an inflow of French francs. The U.S. bank must maintain adequate balances in its nostro accounts to meet unexpected needs and to avoid overdrawing those accounts for which interest must be paid. However, the bank should not maintain excessive idle nostro balances that do not earn interest, causing a loss of income.

The U.S. bank also runs risks by being either long or short in a particular foreign currency or by maintaining undue gaps. Losses could result if that currency appreciates or depreciates significantly or if the bank must purchase or borrow the currency at a higher rate.

Excessive nostro overages and shortages can be avoided by entering into spot and forward exchange contracts to buy or sell such nostro inventories. Those contracts are discussed in ''International—Foreign Exchange,'' section 7100.1. However, all foreign-currency transactions, except over-the-counter cash trades, are settled through nostro accounts. Therefore, the volume of activity in those accounts may be substantial and the accounts must be properly controlled.

In addition, an account service known as a payable-through account is being marketed by U.S. banks, Edge corporations, and the U.S. branches and agencies of foreign banks to foreign banks that otherwise would not have the ability to offer their customers access to the U.S. banking system. This account service, referred to by other names such as pass-through accounts and pass-by accounts, involves a U.S. banking entity's opening of a deposit account for the foreign bank. Policies and procedures should be developed to guard against the possible improper or illegal use of payable-through account facilities by foreign banks and their customers. Examination procedures relating to this area are part of the *Bank Secrecy Act Examination Manual*.

1. To determine if the policies, practices, procedures, and internal controls regarding due from banks are adequate.
2. To determine if bank officers and employees are operating in conformance with the established guidelines.
3. To determine that all due from accounts are reasonably stated and represent funds on deposit with other banks.
4. To evaluate the credit quality of banks with whom demand accounts are maintained.
5. To determine the scope and adequacy of the audit coverage.
6. To determine compliance with laws, rulings, and regulations.
7. To initiate corrective action when policies, practices, procedures, or internal controls are deficient or when violations of law, rulings, or regulations have been noted.

1. If selected for implementation, complete or update the Due From Banks Internal Control Questionnaire.
2. Determine the scope of the examination, based on the evaluation of internal controls and the work performed by internal/external auditors.
3. Test for compliance with policies, practices, procedures and internal controls in conjunction with performing the remaining examination procedures. Also, obtain a listing of any deficiencies noted in the latest review done by internal/external auditors from the examiner assigned ''Internal Control,'' and determine if corrections have been accomplished.
4. Scan the most recent bank-prepared reconcilements for any unusual items and determine that closing balances listed on reconcilements agree with the general ledger and with the balance shown on the cut-off statement if one has been obtained.
5. If the bank's policy for charge-off of old open items provides for exceptions in extenuating circumstances, review excepted items and determine if charge-off is appropriate.
6. If the bank has no policy for charge-off of old open items, review any items which are large or unusual or which have been outstanding for over two months, along with related correspondence, and determine if charge-off is appropriate.
7. Test the bank's calculation of its Federal Reserve requirement and determine that reports are accurate and complete by:
   a. Performing a limited review of a sample of line items if the bank has effective operating procedures and has an audit program covering the required reports.
   b. Performing a detailed review of all line items if the bank has not established operating procedures or does not have an audit program covering the required reports.
8. Confer with the examiner assigned to check for compliance with the laws and regulations relating to insider loans at correspondent banks and loans to insiders of correspondent banks (subpart B of Regulation O and title VIII of FIRA) and either provide a list, or verify a bank supplied list, of correspondent banks. (This effort should be coordinated with the examiner assigned to ''Deposit Accounts'' to avoid duplication of work.)
9. Review the maximum deposit balance established for each due from bank account and determine if the maximum balance:
   a. Is established after consideration of compensating balance requirements resulting from commitments or credit lines made available to the bank or its holding company. Coordinate this effort with examiner assigned ''Bank-Related Organizations.''
   b. Appears to be related to loans of executive officers or directors or to loans which have been used to acquire stock control of the bank under examination.
      • If such due from accounts are detected, provide full details of the account to the examiner assigned to check for compliance with the law relating to loans to insiders of correspondent banks (title VIII of FIRA).
10. Determine the existence of any concentrations of assets with other banks. Include correspondent accounts, time deposits and any federal funds sold in computation. For concentrations exceeding 25 percent of the bank's capital structure, forward the information to examiners assigned ''Concentrations of Credit'' for possible inclusion in the report of examination.

Note: Procedures 11 through 21 apply to due from foreign banks—demand (nostro accounts).

11. Obtain or prepare a trial balance (including local currency book values) of due from foreign banks—demand by bank customer and:
    a. Agree or reconcile balances to department controls and the general ledger.
    b. Review reconciling items for reasonableness.
12. Using the appropriate sampling technique, select demand account banks for examination.
13. Prepare credit line sheets to include:
    a. Customer's aggregate due from banks—

demand liability in foreign currency amount and local currency equivalent.
b. Amount of customer's line designated by the bank.
c. Frequency of recent overdrawn nostro accounts.

(Overdrawn nostro accounts as they relate to foreign exchange activities are discussed in the International—Foreign Exchange section. Also, the examiner assigned ''Borrowed Funds'' must obtain (or prepare) a listing of overdrawn nostro accounts for inclusion in the borrowing section of the report of examination.)

d. Past compliance with customer's line limitation as determined from review of liability ledger records.

14. Obtain from the examiner assigned ''International—Loan Portfolio Management,'' schedules on the following, if they are applicable to the due from foreign banks—demand:
    a. Delinquencies.
    b. Miscellaneous loan debit and credit suspense accounts.
    c. Criticized shared national credits.
    d. Interagency Country Exposure Review Committee credits.
    e. Loans criticized during the previous examination.
    f. Information on directors, officers and their interests, as contained in statements required under Regulation O.
    g. Specific guidelines in the bank policy relating to due from banks—demand.
    h. Current listing of due from foreign banks—demand approved customer lines.
    i. Any useful information resulting from the review of the minutes of the loan and discount committee or any similar committee.
    j. Reports furnished to the board of directors.
15. Review the information received and perform the following for:
    a. Miscellaneous loan debit and credit suspense accounts:
        - Discuss with management any large or old items.
        - Perform additional procedures as deemed appropriate.
    b. Interagency Country Exposure Review Committee Credits:
        - Compare the schedule to the trial balance to determine which due from foreign banks—demand deposits are portions of Interagency Country Exposure Review Committee credits.
        - For each due from foreign bank—demand deposit so identified, transcribe appropriate information to line sheets and forward the information to the examiner assigned ''International—Loan Portfolio Management.''
    c. Loans criticized during the previous examination (due from foreign banks—demand portion):
        - Determine the disposition of the due from foreign banks—demand so criticized by transcribing:
            — Current balance and payment status, or
            — Date the deposit was paid and the source of repayment.
16. Transcribe or compare information from the above schedules to credit line sheets, where appropriate, and indicate any cancelled bank lines.
17. Prepare credit line cards for any due from foreign banks—demand not in the sample which, based on information derived from the above schedules, requires in-depth review.
18. Obtain liability and other information on common borrowers from examiners assigned to cash items, overdrafts and loan areas and together decide who will review the borrowing relationship. Pass or retain completed credit line cards.
19. Obtain credit files for all due from foreign banks—demand for whom credit line cards were prepared and complete credit line cards where appropriate. To analyze the loans, perform the procedures set forth in step 14 of the International—Due From Banks–Time section.
20. By reviewing appropriate bank records, determine that:
    a. Profit or losses resulting from revaluation adjustment on net open positions spot are passed properly to the respective due from foreign bank—demand (nostro) account (usually monthly).
    b. At the delivery of the ''swap'' forward contract, proper entries are made to the respective due from foreign bank—demand (nostro) and swap adjustment accounts.

21. Determine compliance with laws, regulations and rulings pertaining to due from foreign banks—demand activities by performing the following for:
    a. Reporting of Foreign Exchange Activities:
       - Determine that Foreign Currency Forms FC-1, FC-2, FC-1a and FC-2a, as required, are submitted to the Department of the Treasury under the provisions of 31 CFR 128.
       - Check that copies of those forms are forwarded by each state member bank to the Federal Reserve at each filing time specified in 31 CFR 128.

    Note: Due from foreign banks—demand (nostro) deposits will be reviewed, discussed with appropriate bank officers, and prepared in suitable report form by the examiner assigned ''International—Due From Banks–Time'', if the bank maintains international due from banks—time and/or call money deposits.

22. Forward list of due from banks accounts to the examiner assigned to ''Investment Securities'' and to ''Loan Portfolio Management.''
23. Consult with the examiner assigned ''Asset/Liability Management'' and provide the following, if requested:
    a. A listing, by maturity and amount, of due from banks—time deposits.
    b. The amounts of due from banks—demand deposits that exceed the required reserve balance at the Federal Reserve Bank and that exceed the working balances at correspondent banks.
24. Discuss with appropriate officer(s) and prepare in suitable report form of:
    a. Cancelled due from foreign banks—demand deposit lines that are unpaid.
    b. Violations of laws, regulations and rulings.
    c. Internal control exceptions and deficiencies, or noncompliance with written policies, practices and procedures.
    d. Any items to be considered for charge-off.
    e. Uncorrected audit deficiencies.
    f. Due from foreign banks—demand deposits not supported by current and complete financial information.
    g. Due from foreign banks—demand deposits on which documentation is deficient.
    h. Concentrations.
    i. Criticized loans (portions applicable to due from foreign banks—demand deposits).
    j. Due from foreign banks—demand deposits which for any other reason are questionable as to quality and ultimate collection.
    k. Other matters regarding condition of the department.
25. Update the workpapers with any information that will facilitate future examinations.

Review the bank's internal controls, policies, practices and procedures for due from bank accounts. The bank's system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used and other pertinent information. Items marked with an asterisk require substantiation by observation or testing.

POLICIES FOR DUE FROM BANK DOMESTIC AND FOREIGN—DEMAND ACCOUNTS

1. Has the board of directors, consistent with its duties and responsibilities, adopted written policies for due from bank accounts that:
   a. Provide for periodic review and approval of balances maintained in each such account?
   b. Indicate person(s) responsible for monitoring balances and the application of approved procedures?
   c. Establish levels of check-signing authority?
   d. Indicate officers responsible for approval of transfers between correspondent banks and procedures for documenting such approval?
   e. Indicate the supervisor responsible for regular review of reconciliations and reconciling items?
   f. Indicate that all entries to the accounts are to be approved by an officer or appropriate supervisor and that such approval will be documented?
   g. Establish time guidelines for charge-off of old open items?
2. Are the policies for due from bank accounts reviewed at least annually by the board or the board's designee to determine their adequacy in light of changing conditions?

BANK RECONCILEMENTS

3. Are bank reconcilements prepared promptly upon receipt of the statements?

*4. Are bank statements examined for any sign of alteration and are payments or paid drafts compared with such statements by the persons who prepare bank reconcilements (if so, skip question 5)?

*5. If the answer to question 4 is no, are bank statements and paid drafts or payments handled before reconcilement only by persons who do not also:
   a. Issue drafts or official checks and prepare, add or post the general or subsidiary ledgers?
   b. Handle cash and prepare, add or post the general ledger or subsidiary ledgers?

*6. Are bank reconcilements prepared by persons who do not also:
   a. Issue drafts or official checks?
   b. Handle cash?
   c. Prepare general ledger entries?

7. Concerning bank reconcilements:
   a. Are amounts of paid drafts or repayments compared or tested to entries on the ledgers?
   b. Are entries or paid drafts examined or reviewed for any unusual features?
   c. Whenever a delay occurs in the clearance of deposits in transit, outstanding drafts and other reconciling items, are such delays investigated?
   d. Is a record maintained after an item has cleared regarding the follow-up and reason for any delay?
   e. Are follow-up and necessary adjusting entries directed to the department originating or responsible for the entry for correction with subsequent review of the resulting entries by the person responsible for reconcilement?
   f. Is a permanent record of the account reconcilement maintained?
   g. Are records of the account reconcilements safeguarded against alteration?
   h. Are all reconciling items clearly described and dated?
   i. Are details of account reconcilement reviewed and approved by an officer or supervisory employee?
   j. Does the person performing reconcilements sign and date them?
   k. Are reconcilement duties for foreign

demand accounts rotated on a formal basis?

DRAFTS

8. Are procedures in effect for the handling of drafts so that:
   *a. All unissued drafts are maintained under dual control?
   b. All drafts are prenumbered?
   c. A printer's certificate is received with each supply of new prenumbered drafts?
   d. A separate series of drafts is used for each bank?
   e. Drafts are never issued payable to cash?
   f. Voided drafts are adequately cancelled to prevent possible reuse?
   *g. A record of issued and voided drafts is maintained?
   *h. Drafts outstanding for an unreasonable period of time (perhaps six months or more) are placed under special controls?
   i. All drafts are signed by an authorized employee?
   *j. The employees authorized to sign drafts are prohibited from doing so before a draft is completely filled out?
   *k. If a check-signing machine is used, controls are maintained to prevent its unauthorized use?

FOREIGN CASH LETTERS

9. Is the handling of foreign cash letters such that:
   a. They are prepared and sent on a daily basis?
   b. They are copied or photographed prior to leaving the bank?
   c. A copy of proof or hand run tape is properly identified and retained?
   d. Records of foreign cash letters sent to correspondent banks are maintained, identifying the subject bank, date and amount?

FOREIGN RETURN ITEMS

10. Are there procedures for the handling of return items so that:
   *a. They are delivered unopened and reviewed by someone who is not responsible for preparation of cash letters?
   b. All large unusual items or items on which an employee is listed as maker, payee or endorser are reported to an officer?
   c. Items reported missing from cash letters are promptly traced and a copy sent for credit?

FOREIGN EXCHANGE ACTIVITIES

*11. Are persons handling and reconciling due from foreign bank—demand accounts excluded from performing foreign exchange and position clerk functions?

*12. Is there a daily report of settlements made and other receipts and payments of foreign currency affecting the due from foreign bank—demand accounts?

*13. Is each due from foreign bank—-demand foreign currency ledger revalued monthly and are appropriate profit or loss entries passed to applicable subsidiary ledgers and the general ledger?

*14. Does an officer not preparing the calculations review revaluations of due from foreign bank—demand ledgers, including the verification of rates used and the resulting general ledger entries?

OTHER—FOREIGN

*15. Are separate dual currency general ledger or individual subsidiary accounts maintained for each due from foreign bank—demand account, indicating the foreign currency balance and a U.S. dollar (or local currency) equivalent balance?

16. Do the above ledger or individual subsidiary accounts clearly reflect entry and value dates?

17. Are the above ledger or individual subsidiary accounts balanced to the general ledger on a daily basis?

18. Does international division management receive a daily trial balance of due from foreign bank—demand customer balances by foreign currency and U.S. dollar (or local currency) equivalents?

OTHER

19. Is a separate general ledger account or individual subsidiary account maintained for each due from bank account?
20. Are overdrafts of domestic and foreign due from bank accounts properly recorded on the bank's records and promptly reported to the responsible officer?
21. Are procedures for handling the Federal Reserve account established so that:
    a. The account is reconciled on a daily basis?
    b. Responsibility is assigned for assuring that the required reserve is maintained?
    c. Figures supplied to the Federal Reserve for use in computing the reserve requirement are reviewed to ensure they do not include asset items ineligible for meeting the reserve requirement, and that all liability items are properly classified as required by Regulation D and its interpretations?
22. Does the foregoing information constitute an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly and indicate any additional examination procedures deemed necessary.
23. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

This section provides guidance on the management of a depository institution's investment and end-user activities. The guidance applies to (1) all securities in held-to-maturity and available-for-sale accounts as defined in the Statement of Financial Accounting Standards No. 115 (FAS 115), (2) all certificates of deposit held for investment purposes, and (3) all derivative contracts not held in trading accounts (end-user derivative contracts).[1] The guidance also covers all securities used for investment purposes, including money market instruments, fixed- and floating-rate notes and bonds, structured notes, mortgage pass-through and other asset-backed securities, and mortgage-derivative products. All end-user derivative instruments used for non-trading purposes, such as swaps, futures, and options, are also discussed.

Institutions must ensure that their investment and end-user activities are permissible and appropriate within established limitations and restrictions on bank holdings of these instruments. Institutions should also employ sound risk-management practices consistently across these varying product categories, regardless of their legal characteristics or nomenclature. This section provides examiners with guidance on—

- the permissibility and appropriateness of securities holdings by state member banks;
- sound risk-management practices and internal controls used by banking institutions in their investment and end-user activities;
- the review of securities and derivatives acquired by the bank's international division and overseas branches for its own account, as well as the bank's foreign equity investments that are held either directly or through Edge Act corporations;
- banking agency policies on certain high-risk mortgage-derivative products; and
- unsuitable investment practices.

1. In general terms, derivatives are financial contracts whose value derives from the value of one or more underlying assets, interest rates, exchange rates, commodities, or financial or commodity indexes.

LIMITATIONS AND RESTRICTIONS ON SECURITIES HOLDINGS

Many states extend the investment authority that is available to national banks to their chartered banks—often by direct reference. The security investments of national banks are governed in turn by the seventh paragraph of 12 USC 24 (section 5136 of the Revised Statutes) and by the investment securities regulations of the Office of the Comptroller of the Currency (OCC). If state law permits, state member banks are subject to the same limitations and conditions for purchasing, selling, underwriting, and holding investment securities and stocks as national banks are under 12 USC 24 (seventh). To determine whether an obligation qualifies as a permissible investment for state member banks, and to calculate the limits with respect to the purchase of such obligations, a state member bank is advised to see the OCC's investment securities regulation at 12 CFR 1. (See also section 208.21(b) of Regulation H (12 CFR 208.21(b)).)

Under 12 USC 24, an ''investment security'' is defined as a debt obligation that is not predominantly speculative. A security is not predominantly speculative if it is rated investment grade. An ''investment-grade security'' is a security that has been rated in one of the four highest rating categories by two or more nationally recognized statistical rating organizations (one rating may suffice if the security has been rated by only one organization). For example, securities rated AAA, AA, A, and BBB by Standard and Poor's and Aaa, Aa, A or A-1, and Baa-1 or Baa by Moody's are considered investment grade. In the case of split ratings—different ratings from different rating organizations—the lower rating applies. Although the analyses of major rating agencies are basically sound and are updated frequently, bank personnel should keep in mind that ratings are only evaluations of probabilities. To determine appropriate credit limits for a particular counterparty, the bank should supplement bond ratings with its own credit analysis of the issuer. (See table 1 for a summary of rating systems.)

Table 1—Summary of Rating Systems

Standard & Poor's	*Moody's*	*Description*
	Bank-quality investments	
AAA	Aaa	Highest-grade obligations
AA	Aa	High-grade obligations
A	A, A-1	Upper-medium grade
BBB	Baa-1, Baa	Medium-grade, on the borderline between definitely sound obligations and those containing predominantly speculative elements
	Speculative and defaulted issues	
BB	Ba	Lower-medium grade with only minor investment characteristics
B	B	Low-grade, default probable
Ccc, cc, c, D	Caa, Ca, c	Lowest-rated class, defaulted, extremely poor prospects

Bank-Eligible Securities

The OCC's investment securities regulation identifies five basic types of investment securities (types I, II, III, IV, and V) and establishes limitations on a bank's investment in those types of securities based on the percentage of capital and surplus that such holdings represent. For calculating concentration limits, the term ''capital and surplus'' includes the balance of a bank's allowance for loan and lease losses not included in tier 2 capital. Table 2 on the next page summarizes bank-eligible securities and their investment limitations.

Table 2—Summary of New Investment-Type Categories

Type Category	*Characteristics*	*Limitations*
Type I securities	• U.S. government securities • general obligations of a state or political subdivision • municipal bond activities by well-capitalized* banks, other than types II, III, IV, or V securities • obligations backed by the full faith and credit of the U.S. government • FHLB, Fannie Mae, and FHLMC debt or similarly collateralized debt of a state or political subdivision backed by the full faith and credit of the U.S. government	No limitations on banks' investment, dealing, or underwriting abilities. With respect to all municipal securities, a member bank that is well capitalized* may deal in, underwrite, purchase, and sell any municipal bond for its own account without any limit tied to the bank's capital and surplus.
Type II securities	• state obligations for housing, university, or dormitory purposes that would not qualify as a type I municipal security • obligations of international development banks • debt of Tennessee Valley Authority • debt of U.S. Postal Service • obligations that a national bank is authorized to deal in, underwrite, purchase, or sell under 12 USC 24 (seventh), other than type I securities	Banks may deal in, underwrite, or invest subject to the limitation that the aggregate par value of the obligation of any one obligor may not exceed 10 percent of a bank's capital and surplus.
Type III securities	• an investment security that does not qualify as type I, II, IV, or V • municipal revenue bonds, except those that qualify as a type I municipal security • corporate bonds	The aggregate par value of a bank's purchases and sales of the securities of any one obligor may not exceed 10 percent of a bank's capital and surplus.

continued

* subject to the statutory prompt-corrective-action standards (12 USC 1831o)

Type Category	*Characteristics*	*Limitations*
Type IV securities	• small business–related securities that are rated investment-grade or the equivalent and that are fully secured by a loan pool • residential or commercial mortgage–related securities rated AA or Aa or higher	For securities rated AA or Aa or higher, no investment limitations. For lower-rated investment-grade securities, the aggregate par value of a bank's purchases and sales of the securities of any one obligor may not exceed 25 percent of a bank's capital and surplus. For mortgage-related securities, no investment limitations. A bank may deal in type IV securities with limitation.
Type V securities	• asset-backed securities (credit card, auto, home equity, student loan, manufactured housing) that are investment-grade and are marketable • residential and commercial mortgage–related securities rated below AA or Aa, but still investment-grade	The aggregate par value of a bank's purchases and sales of the securities of any one obligor may not exceed 25 percent of a bank's capital and surplus.

Type I securities are those debt instruments that national and state member banks can deal in, underwrite, purchase, and sell for their own accounts without limitation. Type I securities are obligations of the U.S. government or its agencies; general obligations of states and political subdivisions; municipal bonds (including municipal revenue bonds) other than a type II, III, IV, or V security by a bank that is well capitalized; and mortgage-related securities. A bank may purchase type I securities for its own account subject to no limitations, other than the exercise of prudent banking judgment. (See 12 USC 24(7) and 15 USC 78(c)(a)(41).)

Type II securities are those debt instruments that national and state member banks may deal in, underwrite, purchase, and sell for their own account subject to a 10 percent limitation of a bank's capital and surplus for any one obligor. Type II investments include obligations issued by the International Bank for Reconstruction and Development, the Inter-American Development Bank, the Asian Development Bank, the Tennessee Valley Authority, and the U.S. Postal Service, as well as obligations issued by any state or political subdivision for housing, university, or dormitory purposes that do not qualify as a type I security and other issuers specifically identified in 12 USC 24(7).

Type III is a residual securities category consisting of all types of investment securities not specifically designated to another security "type" category and that do not qualify as a type I security. Banks cannot deal in or underwrite type III securities, and their holdings of these instruments are limited to 10 percent of the bank's capital and surplus for any one obligor.

Type IV securities include the following asset-backed securities (ABS) that are fully secured by interests in pools of loans made to numerous obligors:

- investment-grade residential mortgage–related securities that are offered or sold pursuant to section 4(5) of the Securities Act of 1933 (15 USC 77d(5))
- residential mortgage–related securities as described in section 3(a)(41) of the Securities Exchange Act of 1934 (15 USC 78c(a)(41)) that are rated in one of the two highest investment-grade rating categories
- investment-grade commercial mortgage secu-

rities offered or sold pursuant to section 4(5) of the Securities Act of 1933 (15 USC 77d(5))
- commercial mortgage securities as described in section 3(a)(41) of the Securities Exchange Act of 1934 (15 USC 78c(a)(41)) that are rated in one of the two highest investment-grade rating categories
- investment-grade, small-business-loan securities as described in section 3(a)(53)(A) of the Securities Exchange Act of 1934 (15 USC 78c(a)(53)(A))

For all type IV commercial and residential mortgage securities and for type IV small-business-loan securities rated in the top two rating categories, there is no limitation on the amount a bank can purchase or sell for its own account. Type IV investment-grade, small-business-loan securities that are not rated in the top two rating categories are subject to a limit of 25 percent of a bank's capital and surplus for any one issuer. In addition to being able to purchase and sell type IV securities, subject to the above limitation, a bank may deal in those type IV securities that are fully secured by type I securities.

Type V securities consist of all ABS that are not type IV securities. Specifically, they are defined as marketable, investment-grade-rated securities that are not type IV and are ''fully secured by interests in a pool of loans to numerous obligors and in which a national bank could invest directly.'' Type V securities include securities backed by auto loans, credit card loans, home equity loans, and other assets. Also included are residential and commercial mortgage securities as described in section 3(a)(41) of the Securities Exchange Act of 1934 (15 USC 78c(a)(41)) that are not rated in one of the two highest investment-grade rating categories but that are still investment grade. A bank may purchase or sell type V securities for its own account provided the aggregate par value of type V securities issued by any one issuer held by the bank does not exceed 25 percent of the bank's capital and surplus.

As mentioned above, type III securities represent a residual category. The OCC requires a national bank to determine (1) that the type III instrument it plans to purchase is marketable and of sufficiently high investment quality and (2) that the obligor will be able to meet all payments and fulfill all the obligations it has undertaken in connection with the security. For example, junk bonds, which are often issued to finance corporate takeovers, are usually not considered to be of investment quality because they are predominately speculative and have limited marketability.

The purchase of type II and type III securities is limited to 10 percent of equity capital and surplus for each obligor when the purchase is based on adequate evidence of the maker's ability to perform. That limitation is reduced to 5 percent of equity capital and reserves for all obligors in the aggregate when the judgment of the obligor's ability to perform is based predominantly on ''reliable estimates.'' The term ''reliable estimates'' refers to projections of income and debt-service requirements or conditional ratings when factual credit information is not available and when the obligor does not have a record of performance.

OCC regulations specifically provide for *separate* type I, II, III, IV, and V limits. In the extreme, therefore, national banks can lend 15 percent of their capital to a corporate borrower, buy the borrower's corporate bonds amounting to another 10 percent of capital and surplus (type III securities), and purchase the borrower's ABS up to an additional 25 percent of capital (type V securities), for a total exposure of 50 percent of the bank's capital and surplus. This could be expanded even further if the borrower also issued highly rated type IV securities, upon which there is no investment limitation. However, an exposure to any one issuer of 25 percent or more should be considered a credit concentration, and banks are expected to justify why exposures in excess of 25 percent do not entail an undue concentration. (See table 2 for a summary of the new investment-type categories.)

Municipal Revenue Bonds

Upon enactment of the Gramm-Leach-Bliley Act (GLB Act), most state member banks were authorized to deal in, underwrite, purchase, and sell municipal revenue bonds (12 USC 24 (seventh)). Effective March 13, 2000, these activities (involving type I securities) could be conducted by well-capitalized[1a] banks, without limitation as to the level of these activities relative to the bank's capital. Previously, banks were limited to only underwriting, dealing in, or

1a. See the prompt corrective action at 12 USC 1831o and subpart D of the Federal Reserve's Regulation H (12 CFR 208).

investing in, without limitation, general obligation municipal bonds backed by the full faith and credit of an issuer with general powers of taxation. Member banks could purchase for their own account, but not underwrite or deal in, municipal revenue bonds, but the purchases and sales of such investment securities for any obligor were limited to 10 percent of a member bank's capital and surplus. As a result of the GLB Act amendment, municipal revenue bonds are the equivalent of type I securities for well-capitalized state member banks. [1b] (See SR-01-13.)

The expanded municipal revenue bond authority under the GLB Act necessitates heightened awareness by banks, examiners, and supervisory staff of the particular risks of municipal revenue bond underwriting, dealing, and investment activities. Senior management of a state member bank has the responsibility to ensure that the bank conducts municipal securities underwriting, dealing, and investment activities in a safe and sound manner, in compliance with applicable laws and regulations. Sound risk-management practices are critical. State member banks engaged in municipal securities activities should maintain written policies and procedures governing these activities and make them available to examiners upon request.

Prudent municipal securities investment involves considering and adopting risk-management policies, including appropriate limitations, on the interest-rate, liquidity, price, credit, market, and legal risks in light of the bank's appetite and tolerance for risk. Historically, municipal revenue bonds have had higher default rates than municipal general obligation bonds. The risks of certain industrial development revenue bonds have been akin to the risks of corporate bonds. Therefore, when bondholders are relying on a specific project or private-sector obligation for repayment, banks should conduct a credit analysis, using their normal credit standards, to identify and evaluate the source of repayment before purchasing the bonds. Banks must also perform periodic credit analyses of those securities that remain in the bank's investment portfolio. Prudent banking practices require that management adopt appropriate exposure limits for individual credits and on credits that rely on a similar repayment source; these limits help ensure adequate risk diversification. Furthermore, examiners and other supervisory staff should be aware of the extent to which state laws place further restrictions on municipal securities activities but should defer to state banking regulators on questions of legal authority under state laws and regulations.

For underwriting and dealing activities, the nature and extent of due diligence should be commensurate with the degree of risk posed by and the complexity of the proposed activity. Bank dealer activities should be conducted subject to the types of prudential limitations described above but should also be formulated in light of the reputational risk that may accompany underwriting and dealing activities. Senior management and the board of directors should establish credit-quality and position-risk guidelines, including guidelines for concentration risk.

A bank serving as a syndicate manager would be expected to conduct extensive due diligence to mitigate its underwriting risk. Due diligence should include an assessment of the creditworthiness of the issuer and a full analysis of primary and any contingent sources of repayment. Offering documents should be reviewed for their accuracy and completeness, as well as for full disclosure of all of the offering's relevant risks.

Appraisal of Securities in Bank Examinations

On May 7, 1979, the three federal banking agencies issued a joint statement announcing a "Uniform Agreement on the Classification of Assets and Appraisal of Securities Held by Banks." The statement includes definitions of the classification categories and specific information on classifying securities in bank examinations. The classification categories established also apply to classifying nonbank assets. *Although the classification categories for bank and nonbank assets are the same, the classification standards generally are not applied to classifying nonbank assets because of the difference in risk characteristics of the assets.* Despite the differences that may exist between bank and nonbank assets, the standards for classifying investment securities can be applied directly to securities held by a bank. The statement revised bank examination procedures established in 1938 that were revised July 15, 1949.

Investment-quality securities are marketable

1b. The OCC published final amendments to its investment securities regulation (12 CFR 1) on July 2, 2001 (66 *Fed. Reg.* 34784).

obligations in which the investment characteristics are not distinctly or predominantly speculative. This group generally includes investment securities in the four highest rating grades and unrated securities of equivalent quality. Neither market appreciation nor depreciation in these securities will be taken into account in figuring net sound capital of the bank. The 1979 policy is intended to apply to recognized sound investment practices of banks and not to those situations in which the portfolio requires special treatment by a supervisory agency.

Sub-investment-quality securities are those in which the investment characteristics are distinctly or predominantly speculative. This group includes securities in grades below the four highest grades and also unrated securities of equivalent quality, defaulted securities, and sub-investment-quality stocks. As noted in table 3, securities in grades below the four highest grades and unrated securities of equivalent quality will be valued at market price. The market value (fair value) will be classified substandard, and the depreciation will be classified doubtful. Depreciation in defaulted securities and sub-investment-quality stocks will generally be classified loss; market value (fair value) will be classified substandard.

An exception to the above is to be made for municipal general obligations that are backed by the credit and taxing power of the issuer. The entire book value of sub-investment-quality municipal general obligations that are not in default should be classified substandard. In the event of a default of a municipal general obligation, a period of time is usually necessary to permit the market for these defaulted securities to stabilize or for the issuer to put in place budgetary, tax, or other actions that may eliminate the default or otherwise improve the post-default value of the securities. The market for the defaulted securities will be periodically reviewed by the regulatory authorities. Upon a determination that a functioning market has been reestablished, depreciation on defaulted municipal general obligations will be classified as loss. During this interim, the book value of all defaulted municipal general obligation securities will be classified doubtful. (This exception will not apply in those instances when the supervisory authorities determine that there is no likelihood that the municipality will be able to ultimately repay or satisfactorily restructure its obligations.)

Banks are required to maintain adequate credit information in their files to demonstrate that they are exercising prudent judgment in their securities and derivative transactions. Unrated securities must be evaluated by the bank to determine if the instrument is a bank-eligible investment. Examiners must ensure that the bank's methodology for evaluating unrated securities is sound. All credit-related information and analyses should be retained for as long as the security remains in the bank's portfolio.

The transfer of low-quality securities from one depository institution to another may be made to avoid detection and classification during regulatory examinations; this type of transfer may be accomplished through participations, purchases or sales, and asset swaps with other affiliated or nonaffiliated financial institutions. Broadly defined, low-quality securities include depreciated or sub-investment-grade securities of questionable quality. Situations in which an institution appears to be concealing low-quality securities to avoid examination scrutiny and possible classification represent an unsafe and unsound activity. Furthermore, the purchase of low-quality assets by a bank from a bank or nonbank affiliate is a violation of section 23A of the Federal Reserve Act.

Any situations involving the transfer of low-quality or questionable securities should be brought to the attention of Reserve Bank supervisory personnel who, in turn, should notify the local office of the primary federal regulator of the other depository institution involved in the transaction. For example, if an examiner determines that a state member bank or holding company has transferred or intends to transfer low-quality securities to another depository institution, the Reserve Bank should notify the recipient institution's primary federal regulator of the transfer. The same notification requirement holds true if an examiner determines that a state member bank or holding company has acquired or intends to acquire low-quality securities from another depository institution. This procedure applies to transfers involving savings and loan associations and savings banks, as well as commercial banking organizations.

Situations may arise when transfers of securities are undertaken for legitimate reasons. In these cases, the securities should be properly recorded on the books of the acquiring institution at their fair value on the date of transfer. If the transfer was with the parent holding company or a nonbank affiliate, the records of the affiliate should be reviewed as well.

Table 3—1979 Revision to the 1938 Accord

	Security classifications		
Type of security	*Substandard*	*Doubtful*	*Loss*
Investment-quality	XXX	XXX	XXX
Sub-investment-quality, except—	Market value (fair value)	Market depreciation	XXX
Sub-investment-quality, municipal general obligations	Book value	XXX	XXX
Defaulted securities and sub-investment-quality stocks, except—	Market value (fair value)	XXX	Market depreciation
Defaulted municipal general obligations:			
Interim	XXX	Book value	XXX
Final, i.e., when market is reestablished	Market value (fair value)	XXX	Market depreciation

Permissible Stock Holdings

The purchase of securities convertible into stock at the option of the issuer is prohibited (12 CFR 1.6). Other than as specified in table 4, banks are prohibited from investing in stock.

Table 4—Permitted Stock Holdings by Member Banks

Type of Stock	*Authorizing Statute and Limitation*
Federal Reserve Bank	Federal Reserve Act, sections 2 and 9 (12 USC 282 and 321) and Regulation I (12 CFR 209). Subscription must equal 6 percent of the bank's capital and surplus, 3 percent paid in.
Safe deposit corporation	12 USC 24. 15 percent of capital and surplus.
Corporation holding bank premises	Federal Reserve Act, section 24A (12 USC 371(d)). 100 percent of capital stock. Limitation includes total direct and indirect investment in bank premises in any form (such as loans). Maximum limitation may be exceeded with permission of the Federal Reserve Bank for state member banks and the Comptroller of the Currency for national banks.
Small business investment company	Small Business Investment Act of August 21, 1958, section 302(b) (15 USC 682(b)). Banks are prohibited from acquiring shares of such a corporation if, upon making the acquisition, the aggregate amount of shares in small business investment companies then held by the bank would exceed 5 percent of its capital and surplus.
Edge Act and agreement corporations and foreign banks	Federal Reserve Act, sections 25 and 25A (12 USC 601 and 618). The aggregate amount of stock held in all such corporations may not exceed 10 percent of the member bank's capital and surplus. Also, the member bank must possess capital and surplus of $1 million or more before acquiring investments pursuant to section 25.
Bank service company	Bank Service Corporation Act of 1958, section 2 (12 USC 1861 and 1862). (Redesignated as Bank Service Company Act.) 10 percent of paid in and unimpaired capital and surplus. Limitation includes total direct and indirect investment in any form. No insured banks shall invest more than 5 percent of their total assets.
Federal National Mortgage Corporation	National Housing Mortgage Association Act of 1934, section 303(f) (12 USC 1718(f)). No limit.
Bank's own stock	12 USC 83. Shares of the bank's own stock may not be acquired or taken as security for loans, except as necessary to prevent loss from a debt previously contracted in good faith. Stock so acquired must be disposed of within six months of the date of acquisition.
Corporate stock acquired through debt previously contracted (DPC) transaction	Case law has established that stock of any corporation debt may be acquired to prevent loss from a debt previously contracted in good faith. See Oppenheimer v. Harriman National Bank & Trust Co. of the City of New York, 301 US 206 (1937). However, if the stock is not disposed of within a reasonable time period, it loses its status as a DPC transaction and becomes a prohibited holding under 12 USC 24(7).

Type of Stock	*Authorizing Statue and Limitation*
Operations subsidiaries	12 CFR 250.141. Permitted if the subsidiary is to perform, at locations at which the bank is authorized to engage in business, functions that the bank is empowered to perform directly.
State housing corporation incorporated in the state in which the bank is located	12 USC 24. 5 percent of its capital stock, paid in and unimpaired, plus 5 percent of its unimpaired surplus fund when considered together with loans and commitments made to the corporation.
Agricultural credit corporation	12 USC 24. 20 percent of capital and surplus unless the bank owns over 80 percent. No limit if the bank owns 80 percent or more.
Government National Mortgage Association	12 USC 24. No limit.
Student Loan Marketing Association	12 USC 24. No limit.
Bankers' banks	12 USC 24. 10 percent of capital stock and paid-in and unimpaired surplus. Bankers' banks must be insured by the FDIC, owned exclusively by depository institutions, and engaged solely in providing banking services to other depository institutions and their officers, directors, or employees. Ownership shall not result in any bank's acquiring more than 5 percent of any class of voting securities of the bankers' bank.
Mutual funds	12 USC 24(7). Banks may invest in mutual funds as long as the underlying securities are permissible investments for a bank.
Community development corporation	Federal Reserve Act, section 9, paragraph 23 (12 USC 338a). Up to 10 percent of capital stock and surplus[1] subject to 12 CFR 208.22.

1. Section 208.2(d) of Regulation H defines ''capital stock and surplus'' to mean tier 1 and tier 2 capital included in a member bank's risk-based capital and the balance of a member bank's allowance for loan and lease losses *not included in its tier 2 capital for calculation of risk-based capital,* based on the bank's most recent consolidated Report of Condition and Income. Section 9 of the Federal Reserve Act (12 USC 338a) provides that the Board has the authority under this law to approve public-welfare or other such investments, up to the sum of 5 percent of paid-in and unimpaired capital stock and 5 percent of unimpaired surplus, unless the Board determines by order that the higher amount will pose no significant risk to the affected deposit insurance fund, and the bank is adequately capitalized. In no case may the aggregate of such investments exceed 10 percent of the bank's combined capital stock and surplus.

LIMITED EQUITY INVESTMENTS

Investing in the equity of nonfinancial companies and lending to private-equity-financed companies (that is, companies financed by private equity) have emerged as increasingly important sources of earnings and business relationships at a number of banking organizations (BOs). In this guidance, the term ''private equity'' refers to shared-risk investments outside of publicly quoted securities and also covers activities such as venture capital, leveraged buyouts, mezzanine financing, and holdings of publicly quoted securities obtained through these activities. While private equity securities can contribute substantially to earnings, these activities can give rise to increased volatility of both earnings and capital. The supervisory guidance in SR-00-9 on private equity investments and merchant banking activities is concerned with a BO's proper risk-focused management of its private equity investment activities so that these investments do not adversely affect the safety and soundness of the affiliated insured depository institutions.

An institution's board of directors and senior management are responsible for ensuring that the risks associated with private equity activities do not adversely affect the safety and soundness of the banking organization or any other affiliated insured depository institutions. To this end, sound investment and risk-management practices and strong capital positions are critical elements in the prudent conduct of these activities.

Legal and Regulatory Authority

Depository institutions are able to make limited equity investments under the following statutory and regulatory authorities:

- Depository institutions may make equity investments through small business investment corporations (SBICs). Investments made by SBIC subsidiaries are allowed up to a total of 50 percent of a portfolio company's outstanding shares, but can only be made in companies defined as a small business, according to SBIC rules. A bank's aggregate investment in the stock of SBICs is limited to 5 percent of the bank's capital and surplus.
- Under Regulation K, which implements sections 25 and 25A of the Federal Reserve Act (FRA) and section 4(c)(13) of the Bank Holding Company Act of 1956 (BHC Act), a depository institution may make portfolio investments in foreign companies, provided the investments do not in the aggregate exceed 25 percent of the tier 1 capital of the bank holding company. In addition, individual investments must not exceed 19.9 percent of a portfolio company's voting shares or 40 percent of the portfolio company's total equity.[1c]

Equity investments made under the authorities listed above may be in publicly traded securities or privately held equity interests. The investment may be made as a direct investment in a specific portfolio company, or it may be made indirectly through a pooled investment vehicle, such as a private equity fund.[1d] In general, private equity funds are investment companies, typically organized as limited partnerships, that pool capital from third-party investors to invest in shares, assets, and ownership interests in companies for resale or other disposition. Private-equity-fund investments may provide seed or early-stage investment funds to start-up companies or may finance changes in ownership, middle-market business expansions, and mergers and acquisitions.

1c. Shares of a corporation held in trading or dealing accounts or under any other authority are also included in the calculation of a depository institution's investment. Portfolio investments of $25 million or less can be made without prior notice to the Board. See Regulation K for more detailed information.

1d. For additional stock holdings that state member banks are authorized to hold, see table 4.

Oversight by the Board of Directors and Senior Management

Equity investment activities require the active oversight of the board of directors and senior management of the depository institution that is conducting the private equity investment activities. The board should approve portfolio objectives, overall investment strategies, and general investment policies that are consistent with the institution's financial condition, risk profile, and risk tolerance. Portfolio objectives should address the types of investments, expected business returns, desired holding periods, diversification parameters, and other elements of sound investment-management oversight. Board-approved objectives, strategies, policies, and procedures should be documented and clearly communicated to all the personnel involved in their implementation. The board should actively monitor the performance and risk profile of equity investment business lines in light of the established objectives, strategies, and policies.

The board also should ensure that there is an effective management structure for conducting the institution's equity activities, including adequate systems for measuring, monitoring, controlling, and reporting on the risks of equity investments. The board should approve policies that specify lines of authority and responsibility for both acquisitions and sales of investments. The board should also approve (1) limits on aggregate investment and exposure amounts; (2) the types of investments (for example, direct and indirect, mezzanine financing, start-ups, seed financing); and (3) appropriate diversification-related aspects of equity investments such as industry, sector, and geographic concentrations.

For its part, senior management must ensure that there are adequate policies, procedures, and management information systems for managing equity investment activities on a day-to-day and longer-term basis. Management should set clear lines of authority and responsibility for making and monitoring investments and for managing risk. Management should ensure that an institution's equity investment activities are conducted by competent staff whose technical knowledge and experience are consistent with the scope of the institution's activities.

Management of the Investment Process

Depository institutions engaging in equity investment activities should have a sound process for executing all elements of investment management, including initial due diligence, periodic reviews of holdings, investment valuation, and realization of returns. This process requires appropriate policies, procedures, and management information systems, the formality of which should be commensurate with the scope, complexity, and nature of an institution's equity investment activities. The supervisory review should be risk-focused, taking into account the institution's stated tolerance for risk, the ability of senior management to govern these activities effectively, the materiality of activities in comparison to the institution's risk profile, and the capital position of the institution.

Depository institutions engaging in equity investment activities require effective policies that (1) govern the types and amounts of investments that may be made, (2) provide guidelines on appropriate holding periods for different types of investments, and (3) establish parameters for portfolio diversification. Investment strategies and permissible types of investments should be clearly identified. Portfolio-diversification policies should identify factors pertinent to the risk profile of the investments being made, such as industry, sector, geographic, and market factors. Policies establishing expected holding periods should specify the general criteria for liquidation of investments and guidelines for the divestiture of an underperforming investment. Decisions to liquidate underperforming investments are necessarily made on a case-by-case basis considering all relevant factors. Policies and procedures, however, should require more frequent review and analysis for investments that are performing poorly or that have been in a portfolio for a considerable length of time, as compared with the other investments overall.

Policies and Limits

Policies should identify the aggregate exposure that the institution is willing to accept, by type and nature of investment (for example, direct or indirect, industry sectors). The limits should include funded and unfunded commitments. Formal and clearly articulated hedging policies and strategies should identify limits on hedged exposures and permissible hedging instruments.

Procedures

Management and staff compensation play a critical role in providing incentives and controlling risks within a private equity business line. Clear policies should govern compensation arrangements, including co-investment structures and staff sales of portfolio company interests.

Institutions have different procedures for assessing, approving, and reviewing investments based on the size, nature, and risk profile of an investment. The procedures used for direct investments may be different than those used for indirect investments made through private equity funds. For example, different levels of due diligence and senior management approvals may be required. When constructing management infrastructures for conducting these investment activities, management should ensure that operating procedures and internal controls appropriately reflect the diversity of investments.

The potential diversity in investment practice should be recognized when conducting supervisory reviews of the equity investment process. The supervisory focus should be on the appropriateness of the process employed relative to the risk of the investments made and on the materiality of this business line to the overall soundness of the depository institution, as well as the potential impact on affiliated depository institutions. The procedures employed should include the following:

- *Investment analysis and approvals, including well-founded analytical assessments of investment opportunities and formal investment-approval processes.*

  The methods and types of analyses conducted should be appropriately structured to adequately assess the specific risk profile, industry dynamics, management, specific terms and conditions of the investment opportunity, and other relevant factors. All elements of the analytical and approval processes, from initial review through the formal investment decision, should be documented and clearly understood by the staff conducting these activities.

The evaluation of existing and potential investments in private equity funds should involve an assessment of the adequacy of a fund's structure. Consideration should be given to the (1) management fees, (2) carried interest and its computation on an aggregate portfolio basis,[1e] (3) sufficiency of capital commitments that are provided by the general partners in providing management incentives, (4) contingent liabilities of the general partner, (5) distribution policies and wind-down provisions, and (6) performance benchmarks and return-calculation methodologies.

- *Investment-risk ratings.*
  Internal risk ratings should assign each investment a rating based on factors such as the nature of the company, strength of management, industry dynamics, financial condition, operating results, expected exit strategies, market conditions, and other pertinent factors. Different rating factors may be appropriate for indirect investments and direct investments.
- *Periodic and timely investment strategy and performance (best, worst, and probable case assessment) reviews of equity investments, conducted at the individual and portfolio levels.*
  Management should ensure that periodic and timely review of the institution's equity investments takes place at both individual-investment and portfolio levels. Depending on the size, complexity, and risk profile of the investment, reviews should, when appropriate, include factors such as—
  - — the history of the investment, including the total funds approved;
  - — commitment amounts, principal-cash-investment amounts, cost basis, carrying value, major-investment cash flows, and supporting information including valuation rationales and methodologies;
  - — the current actual percentage of ownership in the portfolio company on both a diluted and undiluted basis;
  - — a summary of recent events and current outlook;
  - — the recent financial performance of portfolio companies, including summary compilations of performance and forecasts, historical financial results, current and future plans, key performance metrics, and other relevant items;
  - — internal investment-risk ratings and rating-change triggers;
  - — exit strategies, both primary and contingent, and expected internal rates of return upon exit; and
  - — other pertinent information for assessing the appropriateness, performance, and expected returns of investments.

  Portfolio reviews should include an aggregation of individual investment-risk and performance ratings; an analysis of appropriate industry, sector, geographic, and other pertinent concentrations; and total portfolio valuations. Portfolio reports that contain the cost basis, carrying values, estimated fair values, valuation discounts, and other factors summarizing the status of individual investments are integral tools for conducting effective portfolio reviews. Reports containing the results of all reviews should be available to supervisors for their inspection.

  Given the inherent uncertainties in equity investment activities, institutions should include in their periodic reviews consideration of the best case, worst case, and probable case assessments of investment performance. These reviews should evaluate changes in market conditions and the alternative assumptions used to value investments—including expected and contingent exit strategies. Major assumptions used in valuing investments and forecasting performance should be identified. These assessments need not be confined to quantitative analyses of potential losses, but may also include qualitative analyses. The formality and sophistication of investment reviews should be appropriate for the overall level of risk the depository institution incurs from this business line.
- *Assessment of the equity investment valuation and accounting policies and the procedures used, their impact on earnings, and the extent of their compliance with generally accepted accounting principles (GAAP).*
  Valuation and accounting policies and proce-

1e. The carried interest is the share of a partnership's return that is received by the general partners or investment advisers.

dures can have a significant impact on the earnings of institutions engaged in equity investment activities. Many equity investments are made in privately held companies, for which independent price quotations are either unavailable or not available in sufficient volume to provide meaningful liquidity or a market valuation. Valuations of some equity investments may involve a high degree of judgment on the part of management or the skillful use of peer comparisons. Similar circumstances may exist for publicly traded securities that are thinly traded or subject to resale and holding-period restrictions, or when the institution holds a significant block of a company's shares. It is of paramount importance that an institution's policies and procedures on accounting and valuation methodologies for equity investments be clearly articulated.

Under GAAP, equity investments held by investment companies, held by broker-dealers, or maintained in the trading account are reported at fair value, with any unrealized appreciation or depreciation included in earnings and flowing to tier 1 capital. For some holdings, fair value may reflect adjustments for liquidity and other factors.

Equity investments that are not held in investment companies, by broker-dealers, or in the trading account and that have a readily determinable fair value (quoted market price) are generally reported as available-for-sale (AFS). They are marked to market with unrealized appreciation or depreciation recognized in GAAP-defined "comprehensive income" but not earnings. Appreciation or depreciation flows to equity, but, for regulatory capital purposes only, depreciation is included in tier 1 capital.[1f] Equity investments without readily determinable fair values generally are held at cost, subject to write-downs for impairments to the value of the asset. Impairments of value should be promptly and appropriately recognized and written down.

In determining fair value, the valuation methodology plays a critical role. Formal valuation and accounting policies should be established for investments in public companies; direct private investments; indirect fund investments; and, where appropriate, other types of investments with special characteristics. When establishing valuation policies, institutions should consider market conditions, taking account of lockout provisions, the restrictions of Securities and Exchange Commission Rule 144, liquidity features, the dilutive effects of warrants and options, and industry characteristics and dynamics.

Accounting and valuation of equity investments should be subject to regular periodic review. In all cases, valuation reviews should produce documented audit trails that are available to supervisors and auditors. These reviews should assess the consistency of the methodologies used in estimating fair value.

Accounting and valuation treatments should be assessed in light of their potential for abuse, such as through the inappropriate management or manipulation of reported earnings on equity investments. For example, high valuations may produce overstatements of earnings through gains and losses on investments reported at "fair value." On the other hand, inappropriately understated valuations can provide vehicles for smoothing earnings by recognizing gains on profitable investments when an institution's earnings are otherwise under stress. While reasonable people may disagree on valuations given to illiquid private equity investments, institutions should have rigorous valuation procedures that are applied consistently.

Increasingly, equity investments are contributing to an institution's earnings. The potential impact of these investments on the composition, quality, and sustainability of overall earnings should be appropriately recognized and assessed by both management and supervisors.

- *A review of assumed and actual equity-investment exit strategies and the extent of their impact on the returns and reported earnings.*

  The principal means of exiting an equity investment in a privately held company include initial public stock offerings, sales to other investors, and share repurchases. An institution's assumptions on exit strategies can significantly affect the valuation of the investment. Management should periodically review investment exit strategies, with particular focus on larger or less liquid investments.
- *Policies and procedures governing the sale, exchange, transfer, or other disposition of equity investments.*

1f. Under regulatory capital rules, tier 2 capital may include up to 45 percent of the unrealized appreciation of AFS equity investments with readily determinable fair values.

Policies and procedures to govern the sale, exchange, transfer, or other disposition of the institution's investments should state clearly the levels of management or board approval required for the disposition of investments.

- *Internal methods for allocating capital based on the risk inherent in the equity investment activities, including the methods for identifying all material risks and their potential impact on the safety and soundness of the institution.*

  Consistent with SR-99-18, depository institutions that are conducting material equity investment activities should have internal methods for allocating economic capital. These methods should be based on the risk inherent in the equity investment activities, including the identification of all material risks and their potential impact on the institution. Organizations that are substantially engaged in these investment activities should have strong capital positions supporting their equity investments. The economic capital that organizations allocate to their equity investments should be well in excess of the current regulatory minimums applied to lending activities. The amount of percentage of capital dedicated to the equity investment business line should be appropriate to the size, complexity, and financial condition of the institution. Assessments of capital adequacy should cover not only the institution's compliance with regulatory capital requirements and the quality of regulatory capital, but should also include an institution's methodologies for internally allocating economic capital to this business line.

Internal Controls

An adequate system of internal controls, with appropriate checks and balances and clear audit trails, is critical to conducting equity investment activities effectively. Appropriate internal controls should address all the elements of the investment-management process. The internal controls should focus on the appropriateness of existing policies and procedures; adherence to policies and procedures; and the integrity and adequacy of investment valuations, risk identification, regulatory compliance, and management reporting. Any departures from policies and procedures should be documented and reviewed by senior management, and this documentation should be available for examiner review.

As with other financial activities, the assessments of an organization's compliance with both written and implied policies and procedures should be independent of line decision-making functions to the fullest extent possible. When fully independent reviews are not possible in smaller, less complex institutions, alternative checks and balances should be established. These alternatives may include random internal audits, reviews by senior management who are independent of the function, or the use of outside third parties.

Documentation

Documentation of key elements of the investment process, including initial due diligence, approval reviews, valuations, and dispositions, is an integral part of any private equity investment internal-control system. This documentation should be accessible to supervisors.

Legal Compliance

An institution's internal controls should focus on compliance with all federal laws and regulations that are applicable to the institution's investment activities. Regulatory compliance requirements, in particular, should be incorporated into internal controls so managers outside of the compliance or legal functions understand the parameters of permissible investment activities.

To ensure compliance with federal securities laws, institutions should establish policies, procedures, and other controls addressing insider trading. A "restricted list" of securities for which the institution has inside information is one example of a widely used method for controlling the risk of insider trading. In addition, control procedures should be in place to ensure that appropriate reports are filed with functional regulators.

The limitations in sections 23A and 23B of the FRA, which deal with transactions between a depository institution and its affiliates, are presumed by the Gramm-Leach-Bliley Act (GLB Act) to apply to certain transactions between a depository institution and any portfolio company in which an affiliate of the institution owns at least a 15 percent equity interest. This ownership threshold is lower than the ordinary definition of an affiliate, which is typically 25 percent.

Compensation

Often, key employees in the private equity investment units of banking organizations may co-invest in the direct or fund investments made by the unit. These co-investment arrangements can be an important incentive and risk-control technique, and they can help to attract and retain qualified management. However, ''cherry picking,'' or selecting only certain investments for employee participation while excluding others, should be discouraged.

The employees' co-investment may be funded through loans from the depository institution or its affiliates, which, in turn, would hold a lien against the employees' interests. The administration of the compensation plan should be appropriately governed pursuant to formal agreements, policies, and procedures. Among other matters, policies and procedures should address the terms and conditions of employee loans and the sales of participants' interests before the release of the lien.

Disclosure of Equity Investment Activities

Given the important role that market discipline plays in controlling risk, institutions should ensure that they adequately disclose the information necessary for the markets to assess the institution's risk profile and performance in this business line. Indeed, it is in the institution's interest, as well as that of its creditors and shareholders, to publicly disclose information about earnings and risk profiles. Institutions are encouraged to disclose in public filings information on the type and nature of investments, portfolio concentrations, returns, and their contributions to reported earnings and capital. Supervisors should fully review and use these disclosures, as well as periodic regulatory reports filed by publicly held banking organizations, as part of the information they review routinely. The following topics are relevant for public disclosure, though disclosures on each of these topics may not be appropriate, relevant, or sufficient in every case:

- the size of the portfolio
- the types and nature of investments (for example, direct or indirect, domestic or international, public or private, equity or debt with conversion rights)
- initial cost, carrying value, and fair value of investments and, when applicable, comparisons to publicly quoted share values of portfolio companies
- the accounting techniques and valuation methodologies, including key assumptions and practices affecting valuation and changes in those practices
- the realized gains (or losses) arising from sales and unrealized gains (or losses)
- insights regarding the potential performance of equity investments under alternative market conditions

Lending to or Engaging in Other Transactions with Portfolio Companies

Additional risk-management issues may arise when a depository institution or an affiliate lends to or has other business relationships with (1) a company in which the depository institution or an affiliate has invested (that is, a portfolio company), (2) the general partner or manager of a private equity fund that has also invested in a portfolio company, or (3) a private-equity-financed company in which the banking institution does not hold a direct or indirect ownership interest but which is an investment or portfolio company of a general partner or fund manager with which the banking organization has other investments. Given the potentially higher than normal risk attributes of these lending relationships, institutions should devote special attention to ensuring that the terms and conditions of such relationships are at arm's length and are consistent with the lending policies and procedures of the institution. Similar issues may arise in the context of derivatives transactions with or guaranteed by portfolio companies and general partners. Lending and other business transactions between an insured depository institution and a portfolio company that meet the definition of an affiliate must be negotiated on an arm's-length basis, in accordance with section 23B of the FRA.

When a depository institution lends to a private-equity-financed company in which it has no equity interest but in which the borrowing company is a portfolio investment of private equity fund managers or general partners with which the institution may have other private-equity-related relationships, care must be taken to ensure that the extension of credit is conducted on reasonable terms. In some cases, lenders may wrongly assume that the general partners or another third party implicitly guarantees or stands behind such credits. Reliance on implicit guarantees or comfort letters should not substitute for reliance on a sound borrower that is expected to service its debt with its own resources. As with any type of credit extension, absent a written contractual guarantee, the credit quality of a private equity fund manager, general partner, or other third party should not be used to upgrade the internal credit-risk rating of the borrower company or to prevent the classification or special mention of a loan.

When an institution lends to a portfolio company in which it has a direct or indirect interest, implications arise under sections 23A and 23B of the FRA, which govern credit-related transactions and asset purchases between a depository institution and its affiliates. Section 23A applies to transactions between a depository institution and any company in which the institution's holding company or shareholders own at least 25 percent of the company's voting shares. The GLB Act extends this coverage by establishing a presumption that a portfolio company is an affiliate of a depository institution if the financial holding company (FHC) uses the merchant banking authority of the GLB Act to own or control more than 15 percent of the equity of the company. Institutions should obtain the assistance of counsel in determining whether such issues exist or would exist if loans were extended to a portfolio company, general partner, or manager. Supervisors, including examiners, should ensure that the institution has conducted a proper review of these issues to avoid violations of law or regulations.

EVALUATING RISK MANAGEMENT AND INTERNAL CONTROLS

Examiners are expected to conduct an adequate evaluation of the risk-management process used to acquire and manage the securities and derivative contracts used in nontrading activities. In conducting this analysis, examiners should evaluate the following four key elements of a sound risk-management process:

- active board and senior management oversight
- adequate risk-management policies and limits
- appropriate risk-measurement and reporting systems
- comprehensive internal controls

This section identifies basic factors that examiners should consider in evaluating these elements for investment and end-user activities; it reiterates and supplements existing guidance and directives on the use of these instruments for nontrading purposes as provided in various supervisory letters and examination manuals.[2]

In evaluating an institution's risk-management process, examiners should consider the nature and size of its holdings. Examiner judgment plays a key role in assessing the adequacy of an institution's risk-management process for securities and derivative contracts. Examiners should focus on evaluating an institution's understanding of the risks involved in the instruments it holds. Regardless of any responsibility, legal or otherwise, assumed by a dealer or counterparty for a particular transaction, the acquiring insti-

2. Existing policies and examiner guidance on various supervisory topics applicable to securities and off-balance-sheet instruments can be found in this manual, the *Bank Holding Company Supervision Manual,* and the *Trust Activities Examination Manual,* as well as in various supervision and regulation (SR) letters, including SR-90-16, ''Implementation of Examination Guidelines for the Review of Asset Securitization Activities''; SR-91-4, ''Inspection of Investment-Adviser Subsidiaries of Bank Holding Companies''; SR-92-1, ''Supervisory Policy Statement on Securities Activities''; SR-93-69, ''Risk Management and Internal Controls for Trading Activities''; and SR-95-17, ''Evaluating the Risk Management and Internal Controls of Securities and Derivative Contracts Used in Nontrading Activities.'' Examiners of U.S. branches and agencies of foreign banks should take the principles included in these guidelines into consideration in accordance with the procedures set forth in the *Examination Manual for Branches and Agencies of Foreign Banking Organizations.*

tution is ultimately responsible for understanding and managing the risks of the transactions into which it enters. Failure of an institution to adequately understand, monitor, and evaluate the risks involved in its securities or derivative positions, either through lack of internal expertise or inadequate outside advice, constitutes an unsafe and unsound banking practice.

As with all risk-bearing activities, institutions should fully support the risk exposures of nontrading activities with adequate capital. Banking organizations should ensure that their capital positions are sufficiently strong to support all the risks associated with these activities on a fully consolidated basis and should maintain adequate capital in all affiliated entities engaged in these activities. In evaluating the adequacy of an institution's capital, examiners should consider any unrecognized net depreciation or appreciation in an institution's securities and derivative holdings. Further consideration should also be given to the institution's ability to hold these securities and thereby avoid recognizing losses.

Board of Directors and Senior Management Oversight

Active oversight by the institution's board of directors and relevant senior management is critical to a sound risk-management process. Examiners should ensure that these individuals are aware of their responsibilities and that they adequately perform their appropriate roles in overseeing and managing the risks associated with nontrading activities involving securities and derivative instruments.

Board of Directors

The board of directors has the ultimate responsibility for the level of risk taken by the institution. Accordingly, the board should approve overall business strategies and significant policies that govern risk-taking, including those involving securities and derivative contracts. In particular, the board should approve policies identifying managerial oversight and articulating risk tolerances and exposure limits for securities and derivative activities. The board should also actively monitor the performance and risk profile of the institution and its various securities and derivative portfolios. Directors should periodically review information that is sufficiently detailed and timely to allow them to understand and assess the credit, market, and liquidity risks facing the institution as a whole and its securities and derivative positions in particular. These reviews should be conducted at least quarterly and more frequently when the institution holds significant positions in complex instruments. In addition, the board should periodically reevaluate the institution's business strategies and significant risk-management policies and procedures, placing special emphasis on the institution's financial objectives and risk tolerances. The minutes of board meetings and accompanying reports and presentation materials should clearly demonstrate the board's fulfillment of these basic responsibilities. The section of this guidance on managing specific risks provides guidance on the types of objectives, risk tolerances, limits, and reports that directors should consider.

The board of directors should also conduct and encourage discussions between its members and senior management, as well as between senior management and others in the institution, on the institution's risk-management process and risk exposures. Although it is not essential for board members to have detailed technical knowledge of these activities, if they do not, it is their responsibility to ensure that they have adequate access to independent legal and professional advice on the institution's securities and derivative holdings and strategies. The familiarity, technical knowledge, and awareness of directors and senior management should be commensurate with the level and nature of an institution's securities and derivative positions. Accordingly, the board should be knowledgeable enough or have access to independent advice to evaluate recommendations presented by management or investment advisors.

Senior Management

Senior management is responsible for ensuring that there are adequate policies and procedures for conducting investment and end-user activities on both a long-range and day-to-day basis. Management should maintain clear lines of authority and responsibility for acquiring instruments and managing risk, setting appropriate limits on risk-taking, establishing adequate systems for measuring risk, setting acceptable standards for valuing positions and measuring performance, establishing effective internal controls, and enacting a comprehensive risk-reporting and risk-management review process. To provide adequate oversight, management should fully understand the institution's risk profile, including that of its securities and derivative activities. Examiners should review the reports to senior management and evaluate whether they provide both good summary information and sufficient detail to enable management to assess the sensitivity of securities and derivative holdings to changes in credit quality, market prices and rates, liquidity conditions, and other important risk factors. As part of its oversight responsibilities, senior management should periodically review the organization's risk-management procedures to ensure that they remain appropriate and sound. Senior management should also encourage and participate in active discussions with members of the board and with risk-management staff regarding risk measurement, reporting, and management procedures.

Management should ensure that investment and end-user activities are conducted by competent staff whose technical knowledge and experience is consistent with the nature and scope of the institution's activities. There should be sufficient depth in staff resources to manage these activities if key personnel are not available. Management should also ensure that back-office and financial-control resources are sufficient to manage and control risks effectively.

Independence in Managing Risks

The process of measuring, monitoring, and controlling risks within an institution should be managed as independently as possible from those individuals who have the authority to initiate transactions. Otherwise, conflicts of interest could develop. The nature and extent of this independence should be commensurate with the size and complexity of an institution's securities and derivative activities. Institutions with large and complex balance sheets or with significant holdings of complex instruments would be expected to have risk managers or risk-management functions fully independent of the individuals who have the authority to conduct transactions. Institutions with less complex holdings should ensure that there is some mechanism for independently reviewing both the level of risk exposures created by securities and derivative holdings and the adequacy of the process used in managing those exposures. Depending on the size and nature of the institution, this review function may be carried out by either management or a board committee. Regardless of size and sophistication, institutions should ensure that back-office, settlement, and transaction-reconciliation responsibilities are conducted and managed by personnel who are independent of those initiating risk-taking positions.

Policies, Procedures, and Limits

Institutions should maintain written policies and procedures that clearly outline their approach for managing securities and derivative instruments. These policies should be consistent with the organization's broader business strategies, capital adequacy, technical expertise, and general willingness to take risks. They should identify relevant objectives, constraints, and guidelines for both acquiring instruments and managing portfolios. In doing so, policies should establish a logical framework for limiting the various risks involved in an institution's securities and derivative holdings. Policies should clearly delineate lines of responsibility and authority over securities and derivative activities. They should also provide for the systematic review of products new to the firm. Examiners should evaluate the adequacy of an institution's risk-management policies and procedures in relation to its size, its sophistication, and the scope of its activities.

Specifying Objectives

Institutions can use securities and derivative instruments for several primary and complementary purposes.[3] Banking organizations should articulate these objectives clearly and identify the types of securities and derivative contracts to be used for achieving them. Objectives also should be identified at the appropriate portfolio and institutional levels. These objectives should guide the acquisition of individual instruments

3. Such purposes include, but are not limited to, generating earnings, creating funding opportunities, providing liquidity, hedging risk exposures, taking risk positions, modifying and managing risk profiles, managing tax liabilities, and meeting pledging requirements.

and provide benchmarks for periodically evaluating the performance and effectiveness of an institution's holdings, strategies, and programs. Whenever multiple objectives are involved, management should identify the hierarchy of potentially conflicting objectives.

Identifying Constraints, Guidelines, and Limits

An institution's policies should clearly articulate the organization's risk tolerance by identifying its willingness to take the credit, market, and liquidity risks involved in holding securities and derivative contracts. A statement of authorized instruments and activities is an important vehicle for communicating these risk tolerances. This statement should clearly identify permissible instruments or instrument types and the purposes or objectives for which the institution may use them. The statement also should identify permissible credit quality, market-risk sensitivity, and liquidity characteristics of the instruments and portfolios used in nontrading activities. For example, in the case of market risk, policies should address the permissible degree of price sensitivity and/or effective maturity volatility, taking into account an instrument's or portfolio's option and leverage characteristics. Specifications of permissible risk characteristics should be consistent with the institution's overall credit-, market-, and liquidity-risk limits and constraints, and should help delineate a clear set of institutional limits for use in acquiring specific instruments and managing portfolios. Limits can be specified either as guidelines within the overall policies or in management operating procedures. Further guidance on managing specific risks and on the types of constraints and limits an institution might use in managing the credit, market, and liquidity risk of securities and derivative contracts is provided later in this section.

Limits should be set to guide acquisition and ongoing management decisions, control exposures, and initiate discussion within the organization about apparent opportunities and risks. Although procedures for establishing limits and operating within them may vary among institutions, examiners should determine whether the organization enforces its policies and procedures through a clearly identified system of risk limits. The organization's policies should also include specific guidance on the resolution of limit excesses. Positions that exceed established limits should receive the prompt attention of appropriate management and should be resolved according to approved policies.

Limits should implement the overall risk tolerances and constraints articulated in general policy statements. Depending on the nature of an institution's holdings and its general sophistication, limits can be identified for individual business units, portfolios, instrument types, or specific instruments. The level of detail of risk limits should reflect the characteristics of the institution's holdings, including the types of risk to which the institution is exposed. Regardless of their specific form or level of aggregation, limits should be consistent with the institution's overall approach to managing various types of risks. They should also be integrated to the fullest extent possible with institution-wide limits on the same risks as they arise in other activities of the firm. Later in this section, specific examiner considerations for evaluating the policies and limits used in managing each of the various types of risks involved in nontrading securities and derivative activities are addressed.

New-Product Review

An institution's policies should also provide for effective review of any products being considered that would be new to the firm. An institution should not acquire a meaningful position in a new instrument until senior management and all relevant personnel (including those in internal-control, legal, accounting, and auditing functions) understand the product and can integrate it into the institution's risk-measurement and control systems. An institution's policies should define the terms ''new product'' and ''meaningful position'' consistent with its size, complexity, and sophistication. Institutions should not be hesitant to define an instrument as a new product. Small changes in the payment formulas or other terms of relatively simple and standard products can greatly alter their risk profiles and justify designation as a new product. New-product reviews should analyze all of the relevant risks involved in an instrument and assess how well the product or activity achieves specified objectives. New-product reviews also should include a description of the relevant accounting guidelines and identify the procedures for measuring, monitoring, and controlling the risks involved.

Accounting Guidelines

The accounting systems and procedures used for general-purpose financial statements and regulatory reporting purposes are critically important to enhancing the transparency of an institution's risk profile. Accordingly, an institution's policies should provide clear guidelines on accounting for all securities and derivative holdings. Accounting treatment should be consistent with specified objectives and with the institution's regulatory requirements. Furthermore, institutions should ensure that they designate each cash or derivative contract for accounting purposes consistent with appropriate accounting policies and requirements. Accounting for nontrading securities and OBS derivative contracts should reflect the economic substance of the transactions. When instruments are used for hedging purposes, the hedging rationale and performance criteria should be well documented. Management should reassess these designations periodically to ensure that they remain appropriate.

Risk-Measurement and Reporting Systems

Clear procedures for measuring and monitoring risks are the foundation of a sound risk-management process. Examiners should ensure that an institution sufficiently integrates these functions into its ongoing management process and that relevant personnel recognize their role and understand the instruments held.

Risk Measurement

An institution's system for measuring the credit, market, liquidity, and other risks involved in cash and derivative contracts should be as comprehensive and accurate as practicable. The degree of comprehensiveness should be commensurate with the nature of the institution's holdings and risk exposures. Exposures to each type of risk (that is, credit, market, liquidity) should be aggregated across securities and derivative contracts and integrated with similar exposures arising from lending and other business activities to obtain the institution's overall risk profile.

Examiners should evaluate whether the risk measures and the risk-measurement process are sufficient to accurately reflect the different types of risks facing the institution. Institutions should establish clear risk-measurement standards for both the acquisition and ongoing management of securities and derivative positions. Risk-measurement standards should provide a common framework for limiting and monitoring risks and should be understood by relevant personnel at all levels of the institution—from individual managers to the board of directors.

Acquisition standards. Institutions conducting securities and derivative activities should have the capacity to evaluate the risks of instruments before acquiring them. Before executing any transaction, an institution should evaluate the instrument to ensure that it meets the various objectives, risk tolerances, and guidelines identified by the institution's policies. Evaluations of the credit-, market-, and liquidity-risk exposures should be clearly and adequately documented for each acquisition. Documentation should be appropriate for the nature and type of instrument; relatively simple instruments would probably require less documentation than instruments with significant leverage or option characteristics.

Institutions with significant securities and derivative activities are expected either to conduct in-house preacquisition analyses or use specific third-party analyses that are independent of the seller or counterparty. Analyses provided by the originating dealer or counterparty should be used only when a clearly defined investment advisory relationship exists. Less active institutions with relatively uncomplicated holdings may use risk analyses provided by the dealer only if the analyses are derived using standard industry calculators and market conventions. Such analyses must comprehensively depict the potential risks involved in the acquisition, and they should be accompanied by documentation that sufficiently demonstrates that the acquirer understands fully both the analyses and the nature of the institution's relationship with the provider of these analyses. Notwithstanding information and analyses obtained from outside sources, management is ultimately responsible for understanding the nature and risk profiles of the institution's securities and derivative holdings.

When reviewing an instrument, it is a prudent practice for institutions to obtain and compare price quotes and risk analyses from more than one dealer before acquisition. Institutions should ensure that they clearly understand the responsibilities of any outside parties that provide analyses and price quotes. If analyses and price quotes provided by dealers are used, institutions should assume that each party deals at arm's length for its own account unless a written agreement stating otherwise exists. Institutions should exercise caution when dealers limit the institution's ability to show securities or derivative contract proposals to other dealers to receive comparative price quotes or risk analyses. As a general sound practice, unless the dealer or counterparty is also acting under a specific investment advisory relationship, an investor or end-user should not acquire an instrument or enter into a transaction if its fair value or the analyses required to assess its risk cannot be determined through a means that is independent of the originating dealer or counterparty.

Portfolio-management standards. Institutions should periodically review the performance and effectiveness of instruments, portfolios, and institutional programs and strategies. This review should be conducted at least quarterly and should evaluate the extent to which the institution's securities and derivative holdings meet the various objectives, risk tolerances, and guidelines established by the institution's policies.[4] Institutions with large or highly complex holdings should conduct reviews more frequently.

For internal measurements of risk, effective measurement of the credit, market, and liquidity risks of many securities and derivative contracts requires mark-to-market valuations. Accordingly, the periodic revaluation of securities and derivative holdings is an integral part of an effective risk-measurement system. Periodic revaluations should be fully documented. When available, actual market prices should be used. For less liquid or complex instruments, institutions with only limited holdings may use properly documented periodic prices and analyses provided by dealers or counterparties. More active institutions should conduct periodic revaluations and portfolio analyses using either in-house capabilities or outside-party analytical systems that are independent of sellers or counterparties. Institutions should recognize that indicative price quotes and model revaluations may differ from the values at which transactions can be executed.

Stress testing. Analyzing the credit, market, and liquidity risk of individual instruments, portfolios, and the entire institution under a variety of unusual and stressful conditions is an important aspect of the risk-measurement process. Management should seek to identify the types of situations, or the combinations of credit and market events, that could produce substantial losses or liquidity problems. Typically, management considers the institutions's consolidated exposures when managing nontrading securities and derivative contracts; therefore, the effect of stress on these exposures should be reviewed. Stress tests should evaluate changes in market conditions, including alternatives in the underlying assumptions used to value instruments. All major assumptions used in stress tests should be identified.

Stress tests should not be limited to quantitative exercises that compute potential losses or gains, but should include qualitative analyses of the tools available to management to deal with various scenarios. Contingency plans outlining operating procedures and lines of communication, both formal and informal, are important products of such qualitative analyses.

The appropriate extent and sophistication of an institution's stress testing depend heavily on the scope and nature of its securities and derivative holdings and on its ability to limit the effect of adverse events. Institutions holding securities or derivative contracts with complex credit, market, or liquidity risk profiles should have an established regime of stress testing. Examiners should consider the circumstances at each institution when evaluating the adequacy or need for stress-testing procedures.

Risk Reporting

An accurate, informative, and timely management information system is essential. Examiners should evaluate the adequacy of an institution's monitoring and reporting of the risks, returns,

4. For example, the performance of instruments and portfolios used to meet objectives for tax-advantaged earnings should be evaluated to ensure that they meet the necessary credit-rating, market-sensitivity, and liquidity characteristics established for this objective.

and overall performance of security and derivative activities to senior management and the board of directors. Management reports should be frequent enough to provide the responsible individuals with adequate information to judge the changing nature of the institution's risk profile and to evaluate compliance with stated policy objectives and constraints.

Management reports should translate measured risks from technical and quantitative formats to formats that can be easily read and understood by senior managers and directors, who may not have specialized and technical knowledge of all financial instruments used by the institution. Institutions should ensure that they use a common conceptual framework for measuring and limiting risks in reports to senior managers and directors. These reports should include the periodic assessment of the performance of appropriate instruments or portfolios in meeting their stated objective, subject to the relevant constraints and risk tolerances.

Management Evaluation and Review

Management should regularly review the institution's approach and process for managing risks. This includes regularly assessing the methodologies, models, and assumptions used to measure risks and limit exposures. Proper documentation of the elements used in measuring risks is essential for conducting meaningful reviews. Limits should be compared with actual exposures. Reviews should also consider whether existing measures of exposure and limits are appropriate in view of the institution's holdings, past performance, and current capital position.

The frequency of the reviews should reflect the nature of an institution's holdings and the pace of market innovations in measuring and managing risks. At a minimum, institutions with significant activities in complex cash or derivative contracts should review the underlying methodologies of the models they use at least annually—and more often as market conditions dictate—to ensure that they are appropriate and consistent. Reviews by external auditors or other qualified outside parties, such as consultants with expertise in highly technical models and risk-management techniques, may often supplement these internal evaluations. Institutions depending on outside parties to provide various risk-measurement capabilities should ensure that the outside institution has personnel with the necessary expertise to identify and evaluate the important assumptions incorporated in the risk-measurement methodologies it uses.

Comprehensive Internal Controls and Audit Procedures

Institutions should have adequate internal controls to ensure the integrity of the management process used in investment and end-user activities. Internal controls consist of procedures, approval processes, reconciliations, reviews, and other mechanisms designed to provide a reasonable assurance that the institution's risk-management objectives for these activities are achieved. Appropriate internal controls should address all of the various elements of the risk-management process, including adherence to polices and procedures, the adequacy of risk identification, and risk measurement and reporting.

An important element of a bank's internal controls for investment and end-user activities is comprehensive evaluation and review by management. Management should ensure that the various components of the bank's risk-management process are regularly reviewed and evaluated by individuals who are independent of the function they are assigned to review. Although procedures for establishing limits and for operating within them may vary among banks, management should conduct periodic reviews to determine whether the organization complies with its investment and end-user risk-management policies and procedures. Positions that exceed established limits should receive the prompt attention of appropriate management and should be resolved according to the process described in approved policies. Periodic reviews of the risk-management process should also address any significant changes in the nature of instruments acquired, limits, and internal controls that have occurred since the last review.

Examiners should also review the internal controls of all key activities involving securities and derivative contracts. For example, for transaction recording and processing, examiners should evaluate and assess adherence to the written policies and procedures for recording transactions. They should also analyze the transaction-processing cycle to ensure the integrity and accuracy of the institution's records and management reports. Examiners should review all significant internal controls associated with the management of the credit, market, liquidity, operational, and legal risks involved in securities and derivative holdings.

The examiner should review the frequency, scope, and findings of any independent internal and external auditors relative to the institution's securities and derivative activities. When applicable, internal auditors should audit and test the risk-management process and internal controls periodically. Internal auditors are expected to have a strong understanding of the specific products and risks faced by the organization. In addition, they should have sufficient expertise to evaluate the risks and controls of the institution. The depth and frequency of internal audits should increase if weaknesses and significant issues exist or if portfolio structures, modeling methodologies, or the overall risk profile of the institution has changed.

In reviewing risk management of nontrading securities and derivative activities, internal auditors should thoroughly evaluate the effectiveness of the internal controls used for measuring, reporting, and limiting risks. Internal auditors should also evaluate compliance with risk limits and the reliability and timeliness of information reported to the institution's senior management and board of directors, as well as the independence and overall effectiveness of the institution's risk-management process. The level of confidence that examiners place in an institution's audit programs, the nature of the audit findings, and management's response to those findings will influence the scope of the current examination of securities and derivative activities.

Examiners should pay special attention to significant changes in the nature of instruments acquired, risk-measurement methodologies, limits, and internal controls that have occurred since the last examination. Significant changes in earnings from securities and derivative contracts, in the size of positions, or in the value-at-risk associated with these activities should also receive attention during the examination.

Evaluating Management of Specific Risks

Specific considerations in evaluating the key elements of sound risk-management systems as they relate to the credit, market, liquidity, operating, and legal risks involved in securities and derivative contracts for nontrading activities are described below.

Credit Risk

Broadly defined, credit risk is the risk that an issuer or counterparty will fail to perform on an obligation to the institution. The policies of an institution should recognize credit risk as a significant risk posed by the institution's securities and derivative activities. Accordingly, policies should identify credit-risk constraints, risk tolerances, and limits at the appropriate instrument, portfolio, and institutional levels. In doing so, institutions should ensure that credit-risk constraints are clearly associated with specified objectives. For example, credit-risk constraints and guidelines should be defined for instruments used to meet pledging requirements, generate tax-advantaged income, hedge positions, generate temporary income, or meet any other specifically defined objective.

As a matter of general policy, an institution should not acquire securities or derivative contracts until it has assessed the creditworthiness of the issuer or counterparty and determined that the risk exposure conforms with its policies. The credit risk arising from these positions should be incorporated into the overall credit-risk profile of the institution to the fullest extent possible. Given the interconnectedness of the various risks facing the institution, organizations should also evaluate the effect of changes in issuer or counterparty credit standing on an instrument's market and liquidity risk. As a matter of policy, the board of directors and responsible senior management should be informed of the institution's total credit-risk exposures at least quarterly.

Selection of securities dealers. In managing their credit risk, institutions also should consider settlement and presettlement credit risk. The selection of dealers, investment bankers, and brokers is particularly important in managing these risks effectively. An institution's policies should identify criteria for selecting these organizations and list all approved firms. The approval process should include a review of each firm's financial statements and an evaluation of its ability to honor its commitments. An inquiry into the general reputation of the dealer is also appropriate. The board of directors or a committee thereof should set limits on the amounts and types of transactions authorized for each firm. They should also periodically review and reconfirm the list of authorized dealers, investment bankers, and brokers.

The management of a depository institution should have sufficient knowledge about the securities firms and personnel with whom they are doing business. A depository institution should not engage in securities transactions with any securities firm that is unwilling to provide complete and timely disclosure of its financial condition. Management should review the securities firm's financial statements and evaluate the firm's ability to honor its commitments both before entering into transactions with the firm and periodically thereafter. An inquiry into the general reputation of the dealer also is necessary. The board of directors or an appropriate committee of the board should periodically review and approve a list of securities firms with whom management is authorized to do business. The board or an appropriate committee thereof should also periodically review and approve limits on the amounts and types of transactions to be executed with each authorized securities firm. Limits to be considered should include dollar amounts of unsettled trades, safekeeping arrangements, repurchase transactions, securities lending and borrowing, other transactions with credit risk, and total credit risk with an individual dealer.

At a minimum, depository institutions should consider the following in selecting and retaining a securities firm:

- the ability of the securities dealer and its subsidiaries or affiliates to fulfill commitments as evidenced by their capital strength, liquidity, and operating results (This evidence should be gathered from current financial data, annual reports, credit reports, and other sources of financial information.)
- the dealer's general reputation or financial stability and its fair and honest dealings with customers (Other depository institutions that have been or are currently customers of the dealer should be contacted.)
- information available from state or federal securities regulators and securities industry self-regulatory organizations, such as the National Association of Securities Dealers, concerning any formal enforcement actions against the dealer, its affiliates, or associated personnel
- in those instances when the institution relies on the advice of a dealer's sales representative, the experience and expertise of the sales representative with whom business will be conducted

In addition, the board of directors (or an appropriate committee of the board) must ensure that the depository institution's management has established appropriate procedures to obtain and maintain possession or control of securities purchased. Purchased securities and repurchase-agreement collateral should only be left in safekeeping with selling dealers when (1) the board of directors or an appropriate committee thereof is completely satisfied as to the creditworthiness of the securities dealer and (2) the aggregate market value of securities held in safekeeping is within credit limitations that have been approved by the board of directors (or an appropriate committee of the board) for unsecured transactions (see the October 1985 FFIEC policy statement "Repurchase Agreements of Depository Institutions with Securities Dealers and Others").

State lending limits generally do not extend to the safekeeping arrangements described above. Notwithstanding this general principle, a bank's board of directors should establish prudent limits for safekeeping arrangements. These prudential limits generally involve a fiduciary relationship, which presents operational rather than credit risks.

To avoid concentrations of assets or other types of risk, banking organizations should, to the extent possible, try to diversify the firms they use for safekeeping arrangements. Further, while certain transactions with securities dealers and safekeeping custodians may entail only operational risks, other transactions with these parties may involve credit risk that could, under some limited circumstances, be subject to statutory lending limits, depending on applicable state laws. If certain transactions are deemed subject to a state's legal lending limit statute because of a particular safekeeping arrangement, the provisions of the state's statutes would, of course, control the extent to which the safekeeping arrangement complies with an individual state's legal lending limit.

Limits. An institution's credit policies should also include guidelines on the quality and quantity of each type of security that may be held. Policies should provide credit-risk diversification and concentration limits, which may define concentrations to a single or related issuer or counterparty, in a geographical area, or in obligations with similar characteristics. Policies should also include procedures, such as increased monitoring and stop-loss limits, for addressing deterioration in credit quality.

Sound credit-risk management requires that credit limits be developed by personnel who are independent of the acquisition function. In authorizing issuer and counterparty credit lines, these personnel should use standards that are consistent with those used for other activities conducted within the institution and with the organization's overall policies and consolidated exposures. To assess the creditworthiness of other organizations, institutions should not rely solely on outside sources, such as standardized ratings provided by independent rating agencies, but should perform their own analysis of a counterparty's or issuer's financial strength. In addition, examiners should review the credit-approval process to ensure that the credit risks of specific products are adequately identified and that credit-approval procedures are followed for all transactions.

For most cash instruments, credit exposure is measured as the current carrying value. In the case of many derivative contracts, especially those traded in OTC markets, credit exposure is measured as the replacement cost of the position, plus an estimate of the institution's potential future exposure to changes in the replacement value of that position in response to market price changes. Replacement costs of derivative contracts should be determined using current market prices or generally accepted approaches for estimating the present value of future payments required under each contract, at current market rates.

The measurement of potential future credit-risk exposure for derivative contracts is more subjective than the measurement of current exposure and is primarily a function of the time remaining to maturity; the number of exchanges of principal; and the expected volatility of the price, rate, or index underlying the contract. Potential future exposure can be measured using an institution's own simulations or, more simply, by using add-ons such as those included in the Federal Reserve's risk-based capital guidelines. Regardless of the method an institution uses, examiners should evaluate the reasonableness of the assumptions underlying the institution's risk measure.

For derivative contracts and certain types of cash transactions, master agreements (including netting agreements) and various credit enhancements (such as collateral or third-party guarantees) can reduce settlement, issuer, and counterparty credit risk. In such cases, an institution's credit exposures should reflect these risk-reducing features only to the extent that the agreements and recourse provisions are legally enforceable in all relevant jurisdictions. This legal enforceability should extend to any insolvency proceedings of the counterparty. Institutions should be prepared to demonstrate sufficient due diligence in evaluating the enforceability of these contracts.

In reviewing credit exposures, examiners should consider the extent to which positions exceed credit limits and whether exceptions are resolved according to the institution's adopted policies and procedures. Examiners should also evaluate whether the institution's reports adequately provide all personnel involved in the acquisition and management of financial instruments with relevant, accurate, and timely information about the credit exposures and approved credit lines.

Market Risk

Market risk is the exposure of an institution's financial condition to adverse movements in the market rates or prices of its holdings before such holdings can be liquidated or expeditiously offset. It is measured by assessing the effect of changing rates or prices on either the earnings or economic value of an individual instrument, a portfolio, or the entire institution. Although many banking institutions focus on carrying values and reported earnings when assessing market risk at the institutional level, other measures focusing on total returns and changes in economic or fair values better reflect the potential market-risk exposure of institutions, portfolios, and individual instruments. Changes in fair values and total returns directly measure the effect of market movements on the economic value of an institution's capital and provide significant insights into their ultimate effects on the institution's long-term earnings. Institutions should manage and control their market risks using both an earnings and an economic-value approach, and at least on an economic or fair-value basis.

When evaluating capital adequacy, examiners should consider the effect of changes in market rates and prices on the economic value of the institution by evaluating any unrealized losses in an institution's securities or derivative positions. This evaluation should assess the ability of the institution to hold its positions and function as a going concern if recognition of unrealized losses would significantly affect the institution's capital ratios. Examiners also should consider the impact that liquidating positions with unrealized losses may have on the institution's prompt-corrective-action capital category.

Market-risk limits should be established for both the acquisition and ongoing management of an institution's securities and derivative holdings and, as appropriate, should address exposures for individual instruments, instrument types, and portfolios. These limits should be integrated fully with limits established for the entire institution. At the institutional level, the board of directors should approve market-risk exposure limits that specify percentage changes in the economic value of capital and, when applicable, in the projected earnings of the institution under various market scenarios. Similar and complementary limits on the volatility of prices or fair value should be established at the appropriate instrument, product-type, and portfolio levels, based on the institution's willingness to accept market risk. Limits on the variability of effective maturities may also be desirable for certain types of instruments or portfolios.

The scenarios an institution specifies for assessing the market risk of its securities and derivative products should be sufficiently rigorous to capture all meaningful effects of any options. For example, in assessing interest-rate risk, scenarios such as 100, 200, and 300 basis point parallel shifts in yield curves should be considered as well as appropriate nonparallel shifts in structure to evaluate potential basis, volatility, and yield curve risks.

Accurately measuring an institution's market risk requires timely information about the current carrying and market values of its securities and derivative holdings. Accordingly, institutions should have market-risk measurement systems commensurate with the size and nature of these holdings. Institutions with significant holdings of highly complex instruments should ensure that they have independent means to value their positions. Institutions using internal models to measure risk should have adequate procedures to validate the models and periodically review all elements of the modeling process, including its assumptions and risk-measurement techniques. Institutions relying on third parties for market-risk measurement systems and analyses should fully understand the assumptions and techniques used by the third party.

Institutions should evaluate the market-risk exposures of their securities and derivative positions and report this information to their boards of directors regularly, not less frequently than each quarter. These evaluations should assess trends in aggregate market-risk exposure and the performance of portfolios relative to their established objectives and risk constraints. They also should identify compliance with board-approved limits and identify any exceptions to established standards. Examiners should ensure that institutions have mechanisms to detect and adequately address exceptions to limits and guidelines. Examiners should also determine that management reporting on market risk appropriately addresses potential exposures to basis risk, yield curve changes, and other factors pertinent to the institution's holdings. In this connection, examiners should assess an institution's compliance with broader guidance for managing interest-rate risk in a consolidated organization.

Complex and illiquid instruments often involve greater market risk than broadly traded, more liquid securities. Often, this higher potential market risk arising from illiquidity is not captured by standardized financial-modeling techniques. This type of risk is particularly acute for instruments that are highly leveraged or that are designed to benefit from specific, narrowly defined market shifts. If market prices or rates do not move as expected, the demand for these instruments can evaporate. When examiners encounter such instruments, they should review how adequately the institution has assessed its potential market risks. If the risks from these instruments are material, the institution should have a well-documented process for stress testing their value and liquidity assumptions under a variety of market scenarios.

Liquidity Risk

Banks face two types of liquidity risk in their securities and derivative activities: risks related to specific products or markets and risks related to the general funding of their activities. The former, market-liquidity risk, is the risk that an institution cannot easily unwind or offset a particular position at or near the previous market price because of inadequate market depth or disruptions in the marketplace. The latter, funding-liquidity risk, is the risk that the bank will be unable to meet its payment obligations on settlement dates. Since neither type of liquidity risk is unique to securities and derivative activities, management should evaluate these risks in the broader context of the institution's overall liquidity.

When specifying permissible securities and derivative instruments to accomplish established objectives, institutions should take into account the size, depth, and liquidity of the markets for specific instruments, and the effect these characteristics may have on achieving an objective. The market liquidity of certain types of instruments may make them entirely inappropriate for achieving certain objectives. Moreover, institutions should consider the effects that market risk can have on the liquidity of different types of instruments. For example, some government-agency securities may have embedded options that make them highly illiquid during periods of market volatility and stress, despite their high credit rating. Accordingly, institutions should clearly articulate the market-liquidity characteristics of instruments to be used in accomplishing institutional objectives.

The funding risk of an institution becomes a more important consideration when its unrealized losses are material; therefore, this risk should be a factor in evaluating capital adequacy. Institutions with weak liquidity positions are more likely to be forced to recognize these losses and suffer declines in their accounting and regulatory capital. In extreme cases, these effects could force supervisors to take prompt corrective actions.

Examiners should assess whether the institution adequately considers the potential liquidity risks associated with the liquidation of securities or the early termination of derivative contracts. Many forms of standardized contracts for derivative transactions allow counterparties to request collateral or terminate their contracts early if the institution experiences an adverse credit event or a deterioration in its financial condition. In addition, under situations of market stress, customers may ask for the early termination of some contracts within the context of the dealer's market-making activities. In these circumstances, an institution that owes money on derivative transactions may be required to deliver collateral or settle a contract early, possibly at a time when the institution may face other funding and liquidity pressures. Early terminations may also open additional, unintended market positions. Management and directors should be aware of these potential liquidity risks and address them in the institution's liquidity plan and in the broader context of the institution's liquidity-management process. In their reviews, examiners should consider the extent to which such potential obligations could present liquidity risks to the institution.

Operating and Legal Risks

Operating risk is the risk that deficiencies in information systems or internal controls will result in unexpected loss. Some specific sources of operating risk include inadequate procedures, human error, system failure, or fraud. Inaccurately assessing or controlling operating risks is one of the more likely sources of problems facing institutions involved in securities and derivative activities.

Adequate internal controls are the first line of defense in controlling the operating risks involved in an institution's securities and derivative activities. Of particular importance are internal controls to ensure that persons executing transactions are separated from those individuals responsible for processing contracts, confirming transactions, controlling various clearing accounts, approving the accounting methodology or entries, and performing revaluations.

Institutions should have approved policies, consistent with legal requirements and internal policies, that specify documentation requirements for transactions and formal procedures for saving and safeguarding important documents. Relevant personnel should fully understand the requirements. Examiners should also consider the extent to which institutions evaluate and control operating risks through internal audits, stress testing, contingency planning, and other managerial and analytical techniques.

An institution's operating policies should establish appropriate procedures to obtain and maintain possession or control of instruments purchased. Institutions should ensure that transactions consummated orally are confirmed as soon as possible. As noted earlier in this section, banking organizations should, to the extent possible, seek to diversify the firms used for their safekeeping arrangements to avoid concentrations of assets or other types of risk.

Legal risk is the risk that contracts are not legally enforceable or documented correctly. This risk should be limited and managed through policies developed by the institution's legal counsel. At a minimum, guidelines and processes should be in place to ensure the enforceability of counterparty agreements. Examiners should determine whether an institution is adequately evaluating the enforceability of its agreements before individual transactions are consummated. Institutions should also ensure that the counterparty has sufficient authority to enter into the transaction and that the terms of the agreement are legally sound. Institutions should further ascertain that their netting agreements are adequately documented, have been executed properly, and are enforceable in all relevant jurisdictions. Institutions should know relevant tax laws and interpretations governing the use of netting instruments.

An institution's policies should also provide conflict-of-interest guidelines for employees who are directly involved in purchasing securities from and selling securities to securities dealers on behalf of their institution. These guidelines should ensure that all directors, officers, and employees act in the best interest of the institution. The board of directors may wish to adopt policies prohibiting these employees from engaging in personal securities transactions with the same securities firms the institution uses without the specific prior approval of the board. The board of directors may also wish to adopt a policy applicable to directors, officers, and employees that restricts or prohibits them from receiving gifts, gratuities, or travel expenses from approved securities dealer firms and their personnel.

INTERNATIONAL DIVISION INVESTMENTS

The same types of instruments exist in international banking as in domestic banking. Securities and derivative contracts may be acquired by a bank's international division and overseas branches for its own account, and foreign equity investments may be held by the bank directly or through Edge Act corporations. The investments held by most international divisions are predominately securities issued by various governmental entities of the countries in which the bank's foreign branches are located. These investments are held for a variety of purposes:

- They are required by various local laws.
- They are used to meet foreign reserve requirements.
- They result in reduced tax liabilities.
- They enable the bank to use new or increased re-discount facilities or benefit from greater deposit or lending authorities.
- They are used by the bank as an expression of "goodwill" toward a country.

The examiner should be familiar with the applicable sections of Regulation K (12 CFR 211) governing a member bank's international investment holdings, as well as other regulations discussed in this section. Because of the mandatory investment requirements of some countries, securities held cannot always be as "liquid" and "readily marketable" as required in domestic banking. However, the amount of a bank's "mandatory" holdings will normally be a relatively small amount of its total investments or capital funds.

A bank's international division may also hold securities strictly for investment purposes; these are expected to provide a reasonable rate of return commensurate with safety considerations. As with domestic investment securities, the bank's safety must take precedence, followed by liquidity and marketability. Securities held by international divisions are considered to be liquid if they are readily convertible into cash at their approximate carrying value. They are marketable if they can be sold in a very short time at a price commensurate with yield and quality. Speculation in marginal foreign securities to generate more favorable yields is an unsound banking practice and should be discouraged.

Banks are generally prohibited from investing in stocks. However, a number of exceptions (detailed earlier in this section) are often applicable to the international division. For example, the bank may, under section 24A of the Federal Reserve Act (12 USC 371d), hold stock in overseas corporations that hold title to foreign bank premises. Both stock and other securities holdings are permissible under certain circumstances and in limited amounts under section 211.4 of Regulation K—Permissible Activities and Investments of Foreign Branches of

Member Banks (12 CFR 211). Other sections of Regulation K permit the bank to make equity investments in Edge Act and agreement corporations and in foreign banks, subject to certain limitations.

Standard & Poor's, Moody's, and other publications from U.S. rating-services rate Canadian and other selected foreign securities that are authorized for U.S. commercial bank investment purposes under 12 USC 24(7). However, in many other countries, securities-rating services are limited or nonexistent. When they do exist, the ratings are only indicative and should be supplemented with additional information on legality, credit soundness, marketability, and foreign-exchange and country-risk factors. The opinions of local attorneys are often the best source of determining whether a particular foreign security has the full faith and credit backing of a country's government.

Sufficient analytical data must be provided to the bank's board of directors and senior management so they can make informed judgments about the effectiveness of the international division's investment policy and procedures. The institution's international securities and derivative contracts should be included on all board and senior management reports detailing domestic securities and derivative contracts received. These reports should be timely and sufficiently detailed to allow the board of directors and senior management to understand and assess the credit, market, and liquidity risks facing the institution and its securities and derivative positions.

MORTGAGE-DERIVATIVE PRODUCTS

Some mortgage-derivative products exhibit considerably more price volatility than mortgages or ordinary mortgage pass-through securities. If not managed in a safe and sound manner, these products can expose investors to significant risk of loss. The price volatility of these products is caused in part by the uncertain cash flows that result from changes in the prepayment rates of the underlying mortgages.

Mortgage-derivative products are complex; a high degree of technical expertise is required to understand how their prices and cash flows may behave in various interest-rate and prepayment scenarios. Moreover, the secondary market for some of these products can be relatively thin, making them difficult to liquidate if the need arises. Finally, new variants of these instruments continue to be introduced, whose price performance under varying market and economic conditions has not been tested.

Under the February 10, 1992, supervisory policy statement of the Federal Financial Institutions Examination Council (FFIEC), the banking agencies call for special management of mortgage-derivative products. A general principle underlying this policy is that mortgage-derivative products possessing average life or price volatility in excess of a benchmark fixed-rate 30-year mortgage-backed pass-through security are high-risk mortgage securities and are not suitable investments. All high-risk mortgage securities (defined later in this section) acquired by depository institutions after February 10, 1992, must be carried in the institution's trading account or as assets available for sale. Mortgage-derivative products that do not meet the definition of a high-risk mortgage security at the time of purchase may be reported as held-to-maturity, available-for-sale, or held-for-trading, as appropriate. Institutions must ascertain at least annually whether such products have become high-risk mortgage securities. Purchases of high-risk mortgage securities before February 10, 1992, generally will be reviewed in accordance with previously existing supervisory policies.

Institutions generally should hold mortgage-derivative products that meet the definition of a high-risk mortgage security only to reduce interest-rate risk, in accordance with safe and sound practices. Before taking a position in any high-risk mortgage security, an institution should conduct an analysis to ensure that the position will reduce its overall interest-rate risk. Furthermore, depository institutions that purchase high-risk mortgage securities must demonstrate that they understand and are effectively managing the risks associated with these instruments. First, a depository institution must determine whether a mortgage-derivative product is high risk before purchasing it. A prospectus supplement or other supporting analysis that fully details the cash flows covering each of the securities held by the institution should be obtained and analyzed before purchase and retained for examiner review. In any event, a prospectus supplement should be obtained as soon as it becomes available. Levels of activity involving high-risk mortgage securities should be reasonably related to an institution's capital, capacity to absorb losses, and level of in-house management sophistication and expertise. Appropriate managerial and financial controls must be in place, and the institution must analyze, monitor, and prudently adjust its holdings of high-risk mortgage securities to correspond with changing price and maturity expectations.

An institution should consider the liquidity and price volatility of high-risk mortgage securities before purchasing them. In certain circumstances, the appropriate federal regulatory authority may deem an institution's purchase or retention of high-risk mortgage securities to be contrary to safe and sound practices for depository institutions, which will result in criticism by examiners. Examiners may require the orderly divestiture of high-risk mortgage securities. Securities and other products with risk characteristics similar to those of high-risk mortgage securities, whether carried on or off the balance sheet (such as CMO swaps, but excluding servicing assets), will be subject to the same supervisory treatment as high-risk mortgage securities.

High-Risk Mortgage Securities

In general, any mortgage-derivative product that exhibits greater price volatility than a benchmark fixed-rate 30-year mortgage-backed pass-through security will be deemed to be high risk. For purposes of the FFIEC policy statement, a high-risk mortgage security is defined as any mortgage-derivative product that at the time of purchase, or at a subsequent testing date, meets any of the following tests. (In general, a mortgage-derivative product that does not meet any of the three tests below will be considered to be a non-high-risk mortgage security.)

- *Average-life test.* The mortgage-derivative product has an expected weighted average life greater than 10.0 years.
- *Average-life sensitivity test.* The expected weighted average life of the mortgage-derivative product—
  - — extends by more than 4.0 years, assuming an immediate and sustained parallel shift in the yield curve of plus 300 basis points or
  - — shortens by more than 6.0 years, assuming an immediate and sustained parallel shift in the yield curve of minus 300 basis points.
- *Price-sensitivity test.* The estimated change in the price of the mortgage-derivative product is more than 17 percent, due to an immediate and sustained parallel shift in the yield curve of plus or minus 300 basis points.

In applying any of the above tests, all of the underlying assumptions (including prepayment assumptions) for the underlying collateral must be reasonable. All of the assumptions underlying the analysis must be available for examiner review. For example, if an institution's prepayment assumptions differ significantly from the median prepayment assumptions of several major dealers as selected by examiners, the examiners may use these median prepayment assumptions to determine if a particular mortgage-derivative product is high risk. The above tests may be adjusted to consider significant movements in market interest rates, to fairly measure the risk characteristics of new mortgage-backed products, and to take appropriate action to prevent circumvention of the definition of a high-risk mortgage security and other such standards.

Generally, a CMO floating-rate debt class will not be subject to the average-life and average-life sensitivity tests described above if it bears a rate that, at the time of purchase or at a subsequent testing date, is below the contractual cap on the instrument. (An institution may purchase interest-rate contracts that effectively uncap the instrument.) For purposes of this guidance, a CMO floating-rate debt class is a debt class whose rate adjusts at least annually on a one-for-one basis with the debt class's index. The index must be a conventional, widely used market-interest-rate index such as the London Interbank Offered Rate (LIBOR). Inverse floating-rate debt classes are not included in the definition of a floating-rate debt class.

Holdings of High-Risk Mortgage Securities

An institution generally may only acquire a high-risk mortgage-derivative product to reduce its overall interest-rate risk. (Institutions meeting the previously discussed guidance on the use of these securities in a trading account may also purchase these securities for trading purposes.) An institution that has acquired high-risk mortgage securities to reduce interest-rate risk needs to frequently assess its interest-rate risk position and the performance of these securities. Since interest-rate positions constantly change, an institution may determine that its high-risk mortgage securities no longer reduce interest-rate risk. Therefore, mortgage-derivative products that are high risk when acquired shall not be reported as held-to-maturity securities at amortized cost.

In appropriate circumstances, examiners may seek the orderly divestiture of high-risk mortgage securities that do not reduce interest-rate risk. Appropriate circumstances are those in which the examiner determines that continued ownership of high-risk mortgage securities represents an undue safety-and-soundness risk to the institution. This risk can arise from (1) the size of a bank's or thrift's holdings of high-risk mortgage securities in relation to its capital and earnings, (2) management's inability to demonstrate an understanding of the nature of the risks inherent in the securities, (3) the absence of internal monitoring systems and other internal controls to appropriately measure the market and cash-flow risks of these securities, (4) management's inability to prudently manage its overall interest-rate risk, or (5) similar factors.

An institution that owns or plans to acquire high-risk mortgage securities must have a monitoring and reporting system in place to evaluate their expected and actual performance. Institutional analysis must show that the proposed acquisition of a high-risk mortgage security will reduce overall interest-rate risk. After purchase, the institution must evaluate at least quarterly whether the high-risk mortgage security has actually reduced interest-rate risk.

Analyses performed before the purchase of high-risk mortgage securities, and subsequent analyses, must be fully documented and will be subject to examiner review. This review will include an analysis of all management assumptions about the interest-rate risk associated with the institution's assets, liabilities, and off-balance-sheet positions. Analyses performed and records constructed to justify purchases on a post-acquisition basis are unacceptable and will be subject to examiner criticism. Reliance on analyses and documentation obtained from a securities dealer or other outside party without internal analyses by the institution are unacceptable, and reliance on these third-party analyses will be subject to examiner criticism.

Management should also maintain documentation demonstrating it took reasonable steps to ensure that the prices paid for high-risk mortgage securities represented fair market value. Generally, price quotes should be obtained from at least two brokers before executing a trade. If price quotes cannot be obtained from more than one broker, management should document those reasons (such as the unique or proprietary nature of the transaction). In addition, a depository institution that owns high-risk mortgage securities must demonstrate that it has established the following:

- a board-approved portfolio policy that addresses the goals and objectives the institution expects to achieve through its securities activities, including objectives for interest-rate risk reduction with respect to high-risk mortgage securities
- limits on the amounts of funds that may be committed to high-risk mortgage securities
- specific financial-officer responsibility for and authority over securities activities involving high-risk mortgage securities
- adequate information systems
- procedures for periodic evaluation of high-risk mortgage securities and their actual performance in reducing interest-rate risk
- appropriate internal controls

The board of directors or an appropriate committee thereof and the institution's senior management should regularly (at least quarterly) review all high-risk mortgage securities to determine whether they are adequately satisfying the objectives for interest-rate risk reduction set forth in the portfolio policy. The depository institution's senior management should be fully knowledgeable about the risks associated with prepayments and their subsequent impact on its high-risk mortgage securities. Failure to comply with this policy will be viewed as an unsafe and unsound practice.

Non-High-Risk Mortgage Securities

Mortgage-derivative products that do not meet the definition of high-risk mortgage securities at the time of purchase should be reported as held-to-maturity, available-for-sale, or held-for-trading, as appropriate. Institutions must ascertain and document before purchase and at least annually thereafter that non-high-risk mortgage securities that are held to maturity remain outside the high-risk category. If an institution is unable to make these determinations through internal analysis, it must use information derived from a source that is independent of the party from whom the product is being purchased. Standard industry calculators used in the mortgage-related securities marketplace are acceptable and considered independent sources. If relying on this type of independent analysis, institutions are responsible for ensuring that the assumptions underlying the analysis and the resulting calculation are reasonable. Documentation verifying this determination will be subject to examiner review.

A mortgage-derivative product that was not a high-risk mortgage security when it was purchased as an investment may later fall into the high-risk category. When this occurs, the depository institution may continue to designate the mortgage-derivative product as held-to-maturity, providing that management intends and is able to hold the security to maturity. Furthermore, examiners should consider any unrecognized net depreciation in held-to-maturity high-risk securities when the adequacy of the depository institution's capital adequacy is evaluated.

Once a mortgage-derivative product has been designated as high risk, it may be redesignated as nonhigh risk only if, at the end of two consecutive quarters, it does not meet the definition of a high-risk mortgage security. Upon redesignation as a non-high-risk security, it does not need to be tested for another year.

UNSUITABLE INVESTMENT PRACTICES

Institutions should categorize each of their security activities as trading, available-for-sale, or held-to-maturity consistent with GAAP (that is, Statement of Financial Accounting Standards No. 115, ‘‘Accounting for Certain Investments in Debt and Equity Securities,’’ as amended) and regulatory reporting standards. Management should reassess the categorizations of its securities periodically to ensure that they remain appropriate.

Securities that are intended to be held principally for the purpose of selling in the near term should be classified as trading assets. Trading activity includes the active and frequent buying and selling of securities for the purpose of generating profits on short-term fluctuations in price. Securities held for trading purposes must be reported at fair value, with unrealized gains and losses recognized in current earnings and regulatory capital. The proper categorization of securities is important to ensure that trading gains and losses are promptly recognized—which will not occur when securities intended to be held for trading purposes are categorized as held-to-maturity or available-for-sale.

It is an unsafe and unsound practice to report securities held for trading purposes as available-for-sale or held-to-maturity securities. A close examination of an institution's actual securities activities will determine whether securities it reported as available-for-sale or held-to-maturity are, in reality, held for trading. When the following securities activities are conducted in available-for-sale or held-to-maturity accounts, they should raise supervisory concerns. The first five practices below are considered trading activities and should not occur in available-for-sale or held-to-maturity securities portfolios, and the sixth practice is wholly unacceptable under all circumstances.

Gains Trading

‘‘Gains trading’’ is the purchase of a security and the subsequent sale of that same security at a profit after a short holding period. However, at the same time, securities acquired for this purpose that cannot be sold at a profit are retained in the available-for-sale or held-to-maturity portfolio; unrealized losses on debt securities in these two categories do not directly affect regulatory capital and are not reported in income until the security is sold. Examiners should note institutions that exhibit a pattern or practice of reporting significant amounts of realized gains on sales of nontrading securities (typically, available-for-sale securities) after short holding periods, while continuing to hold other nontrading securities with significant amounts of unrealized losses. In these situations, examiners may designate some or all of the securities reported outside of the trading category as trading assets.

When-Issued Securities Trading

"When-issued" securities trading is the buying and selling of securities in the period between the announcement of an offering and the issuance and payment date of the securities. A purchaser of a when-issued security acquires all of the risks and rewards of owning a security and may sell this security at a profit before having to take delivery and pay for it.

Pair-Offs

"Pair-offs" are security purchases that are closed out or sold at, or before, settlement date. In a pair-off, an institution commits to purchase a security. Then, before the predetermined settlement date, the institution will pair off the purchase with a sale of the same security. Pair-offs are settled net when one party to the transaction remits the difference between the purchase and sale price to the counterparty. Other pair-off transactions may involve the same sequence of events using swaps, options on swaps, forward commitments, options on forward commitments, or other off-balance-sheet derivative contracts.

Extended Settlements

Regular-way settlement for U.S. government and federal-agency securities (except mortgage-backed securities and derivative contracts) is one business day after the trade date. Regular-way settlement for corporate and municipal securities is three business days after the trade date, and settlement for mortgage-backed securities can be up to 60 days or more after the trade date. The use of a settlement period that exceeds the regular-way settlement periods to facilitate speculation is considered a trading activity.

Short Sales

A short sale is the sale of a security that is not owned. Generally, the purpose of a short sale is to speculate on a fall in the price of the security. Short sales should be conducted in the trading portfolio. A short sale that involves the delivery of the security sold short by borrowing it from the depository institution's available-for-sale or held-to-maturity portfolio should not be reported as a short sale. Instead, it should be reported as a sale of the underlying security with gain or loss recognized. Short sales are not permitted for federal credit unions.

Adjusted Trading

Adjusted trading involves the sale of a security to a broker or dealer at a price above the prevailing market value and the simultaneous purchase and booking of a different security, frequently a lower-grade issue or one with a longer maturity, at a price above its market value. Thus, the dealer is reimbursed for its losses on the purchase from the institution and ensured a profit. Adjusted-trading transactions inappropriately defer the recognition of losses on the security sold and establish an excessive reported value for the newly acquired security. Consequently, these transactions are prohibited and may be in violation of 18 USC sections 1001 (False Statements or Entries) and 1005 (False Entries).

ACCOUNTING FOR SECURITIES AND FINANCIAL CONTRACTS

A single class of a financial instrument that can meet trading, investment, or hedging objectives may have a different accounting treatment applied to it, depending on management's purpose for holding it. Therefore, an examiner reviewing investment or trading activities should be familiar with the different accounting methods to ensure that the particular accounting treatment being used is appropriate for the purpose of holding a financial instrument and the economic substance of the related transaction.

The accounting principles that apply to securities portfolios, including trading accounts, and to off-balance-sheet (OBS) derivative instruments are complex and have evolved over time—both with regard to authoritative standards and related banking practices. The objective of this section is to summarize the major aspects of the accounting principles in this important area to make the accounting guidance for both financial reporting and regulatory reporting purposes understandable and useful to examiners and supervisors. Accordingly, it is not intended to set forth new accounting policies for investment activities. While this section provides a summary of important accounting principles for financial reporting and regulatory reporting purposes in this area, it does not list or explain the detailed line items of financial reports that must be reported for securities portfolios or OBS derivative instruments in financial reports. Examiners should consult the sources of generally accepted accounting principles (GAAP) and regulatory reporting requirements that are referred to in this section for more detailed guidance in these areas.

Examiners should be aware that accounting practices in foreign countries may differ from the accounting principles followed in the United States. Nevertheless, foreign institutions are required to submit regulatory reports prepared in accordance with U.S. banking agency regulatory reporting instructions, which to a large extent incorporate GAAP. This section will focus on reporting requirements of the United States.

The major topics covered in this section are listed below. The discussion of specific types of balance-sheet instruments (for example, securities) and OBS derivative instruments (for example, swaps, futures, forwards, and options) is interwoven with the discussion of these topic areas:

- overview of the broad framework for accounting for securities portfolios, including the general framework for trading activities
- general framework for OBS derivative instruments, including hedges
- summaries of specific accounting principles for OBS derivative instruments

Accounting for Securities Portfolios

Treatment under FASB Statement No. 115

In May 1993, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 115, ''Accounting for Certain Investments in Debt and Equity Securities.''[5] FASB 115 supersedes FASB 12, ''Accounting for Certain Marketable Securities,'' and related interpretations. It also amends other standards, including FASB 65, ''Accounting for Certain Mortgage-Banking Activities,'' to eliminate mortgage-backed securities from that statement's scope. FASB 115 addresses investments in equity securities that have readily determinable fair values and all investments in debt securities.[6] The accounting standard is effective for fiscal years beginning after December 15, 1993, for regulatory reporting and financial reporting purposes. It is to be initially applied as of the beginning of an institution's fiscal year and cannot be applied retroactively to prior years' financial statements. Investments subject to the standard are to be classified in three categories and accounted for as follows:

- *Held-to-maturity account*. Debt securities that the institution has the positive intent and ability to hold to maturity are classified as held-to-maturity securities and reported at amortized cost.
- *Trading account*. Debt and equity securities that are bought and held principally for the purpose of selling them in the near term are classified as trading securities and reported at fair value, with unrealized gains and losses included in earnings. Trading generally reflects active and frequent buying and selling, and trading securities are generally used with the objective of generating profits on short-term differences in price.
- *Available-for-sale account*. Debt and equity securities not classified as either held-to-maturity securities or trading securities areclassified as available-for-sale securities and reported at fair value, with unrealized gains

5. FASB 115 does not apply to investments in equity securities accounted for under the equity method or to investments in consolidated subsidiaries. This statement does not apply to institutions whose specialized accounting practices include accounting for substantially all investments in debt and equity securities at market value or fair value, with changes in value recognized in earnings (income) or in the change in net assets. Examples of those institutions are brokers and dealers in securities, defined-benefit pension plans, and investment companies.

6. FASB 115 states that the fair value of an equity security is readily determinable if sales prices or bid-asked quotations are currently available on a securities exchange registered with the SEC or in the over-the-counter market, provided that those prices or quotations for the over-the-counter market are publicly reported by the National Association of Securities Dealers Automated Quotations systems or by the National Quotation Bureau, Inc. Restricted stock does not meet that definition.

The fair value of an equity security traded only in a foreign market is readily determinable if that foreign market is of a breadth and scope comparable to one of the U.S. markets referred to above. The fair value of an investment in a mutual fund is readily determinable if the fair value per share (unit) is determined and published and is the basis for current transactions.

and losses excluded from earnings and reported as a net amount in a separate component of shareholders' equity.

Under FASB 115, mortgage-backed securities that are held for sale in conjunction with mortgage-banking activities should be reported at fair value in the trading account and not at LOCOM as originally prescribed by FASB 65. The new standard does not apply to loans, including mortgage loans, that have not been securitized.

Upon the acquisition of a debt or equity security, an institution must place the security into one of the above three categories. At each reporting date, the institution must reassess whether the balance-sheet designation continues to be appropriate. Proper classification of securities is a key examination issue.

FASB 115 recognizes that certain changes in circumstances may cause the institution to change its intent to hold a certain security to maturity without calling into question its intent to hold other debt securities to maturity in the future. Thus, the sale or transfer of a held-to-maturity security due to one of the following changes in circumstances will not be viewed as inconsistent with its original balance-sheet classification:

- evidence of a significant deterioration in the issuer's creditworthiness
- a change in tax law that eliminates or reduces the tax-exempt status of interest on the debt security (but not a change in tax law that revises the marginal tax rates applicable to interest income)
- a major business combination or major disposition (such as the sale of a segment) that necessitates the sale or transfer of held-to-maturity securities to maintain the institution's existing interest-rate risk position or credit risk policy
- a change in statutory or regulatory requirements that significantly modifies either what constitutes a permissible investment or the maximum level of investments in certain kinds of securities, thereby causing an institution to dispose of a held-to-maturity security
- a significant increase by the regulator in the industry's capital requirements that causes the institution to downsize by selling held-to-maturity securities
- a significant increase in the risk weights of debt securities used for regulatory risk-based capital purposes

Furthermore, FASB 115 recognizes that other events that are isolated, nonrecurring, and unusual for the reporting institution and could not have been reasonably anticipated may cause the institution to sell or transfer a held-to-maturity security without necessarily calling into question its intent to hold other debt securities to maturity. However, all sales and transfers of held-to-maturity securities must be disclosed in the footnotes to the financial statements.

An institution must not designate a debt security as held-to-maturity if the institution has the intent to hold the security for only an indefinite period. Consequently, a debt security should not, for example, be designated as held-to-maturity if the banking organization or other company anticipates that the security would be available to be sold in response to—

- changes in market interest rates and related changes in the security's prepayment risk,
- needs for liquidity (for example, due to the withdrawal of deposits, increased demand for loans, surrender of insurance policies, or payment of insurance claims),
- changes in the availability of and the yield on alternative investments,
- changes in funding sources and terms, or
- changes in foreign-currency risk.

According to FASB 115, an institution's asset-liability management may take into consideration the maturity and repricing characteristics of all investments in debt securities, including those held to maturity or available for sale, without tainting or casting doubt on the standard's criterion that there be a ''positive intent to hold until maturity.''[7] However, securities should not be designated as held-to-maturity if they may be sold. Further, liquidity can be derived from the held-to-maturity category by

7. In summary, under FASB 115, sales of debt securities that meet either of the following two conditions may be considered as ''maturities'' for purposes of the balance-sheet classification of securities: (i) The sale of a security occurs near enough to its maturity date (or call date if exercise of the call is probable)—for example, within three months—that interest-rate risk has been substantially eliminated as a pricing factor. (ii) The sale of a security occurs after the institution has already collected at least 85 percent of the principal outstanding at acquisition from either prepayments or scheduled payments.

the use of repurchase agreements that are designated as financings, but not sales.

Transfers of a security between investment categories should be accounted for at fair value. FASB 115 requires that at the date of the transfer, the security's unrealized holding gain or loss must be accounted for as follows:

- For a security transferred from the trading category, the unrealized holding gain or loss at the date of the transfer will have already been recognized in earnings and should not be reversed.
- For a security transferred into the trading category, the unrealized holding gain or loss at the date of the transfer should be recognized in earnings immediately.
- For a debt security transferred into the available-for-sale category from the held-to-maturity category, the unrealized holding gain or loss at the date of the transfer should be recognized in a separate component of shareholders' equity.
- For a debt security transferred into the held-to-maturity category from the available-for-sale category, the unrealized holding gain or loss at the date of the transfer should continue to be reported in a separate component of shareholders' equity, but should be amortized over the remaining life of the security as an adjustment of its yield in a manner consistent with the amortization of any premium or discount.

Transfers from the held-to-maturity category should be rare, except for transfers due to the changes in circumstances that were discussed above. Transfers from the held-to-maturity account not meeting the exceptions indicated above may call into question management's intent to hold other securities to maturity. According to the standard, transfers into or from the trading category should also be rare.

FASB 115 requires that institutions determine whether a decline in fair value below the amortized cost for individual securities in the available-for-sale or held-to-maturity accounts is ''other than temporary'' (that is, whether this decline results from permanent impairment). For example, if it is probable that the investor will be unable to collect all amounts due according to the contractual terms of a debt security that was not impaired at acquisition, an other-than-temporary impairment should be considered to have occurred. If the decline in fair value is judged to be other than temporary, the cost basis of the individual security should be written down to its fair value, and the write-down should be accounted in earnings as a realized loss. This new cost basis should not be written up if there are any subsequent recoveries in fair value.

Other Regulatory Reporting Guidance

As mentioned above, FASB 115 has been adopted for regulatory reporting purposes. In January 1992, the Federal Reserve Board issued a policy statement on securities activities which, among other things, provided supervisory accounting guidance for securities portfolios owned by banks. Elements of this policy statement have been incorporated within this section.

Other supervisory accounting guidance on securities portfolios and related matters is presented in—

- the Federal Reserve Board staff's examination guidelines for asset-securitization activities (specifically, volume 2, which addresses related accounting issues), and
- the call report instructions, particularly, the glossary entries on—
  - — coupon stripping, treasury securities, and STRIPS;
  - — trade fails;
  - — foreign debt–exchange transactions;
  - — market value of securities;
  - — nonaccrual status;
  - — premiums and discounts;
  - — short positions;
  - — sales of assets (see also ''participations in pools of residential mortgages'' for mortgage-backed securities);
  - — trading accounts;
  - — trade-date and settlement-date accounting;[8] and
  - — when-issued securities.

These sources should be reviewed for more detailed guidance in the above areas involving securities portfolios and related transactions.

8. As described in this glossary entry, for call report purposes, the preferred method for reporting securities transactions is recognition on the trade date.

General Framework for OBS Derivative Instruments

As discussed in the previous subsection, the general accounting framework for securities portfolios divides them into three categories: held-to-maturity (accounted for at amortized cost), available-for-sale (accounted for at fair value, with changes in fair value recorded in equity), and trading (accounted for at fair value, with changes in fair value recorded in earnings). On the other hand, the traditional accounting framework (that is, trading, investment, and held-for-sale) continues to be relevant for loans and other assets that are not in the legal form of a security.

In contrast, the general accounting framework for OBS derivative instruments under GAAP is set forth below:

- If the instrument meets certain specified hedge-accounting criteria, the gains or losses (income or expense) associated with the OBS derivative instrument can be deferred and realized on a basis consistent with the income or expense of the item that is being hedged.
- Otherwise, gains or losses must be recognized as they occur, and OBS derivative instruments generally must be marked to market. Of course, any OBS derivative instruments that are used for trading purposes should be placed in a well-supervised trading account and marked to market.

As discussed more fully below, this general framework is derived from FASB 52, ‘‘Foreign-Currency Translation,’’ and FASB 80, ‘‘Accounting for Futures Contracts.’’ Each statement presents different hedging criteria and related guidance. Furthermore, reporting requirements for the call report differ from GAAP with regard to domestic futures and forward contracts and written options. However, the call report follows GAAP for foreign-currency OBS derivative instruments and interest-rate swaps.

It is important to note that while GAAP permits hedge accounting for OBS derivative instruments, both GAAP and the call report prohibit the use of hedge-accounting treatment for securities (sometimes called ‘‘cash-market securities’’) or other on-balance-sheet items that may serve as economic hedges of other balance-sheet or OBS items. Thus, even if a security or other balance-sheet instrument would serve the same purpose as an OBS derivative instrument in effectively hedging an institution’s risk exposures, the gains and losses, or income and expense, on that balance-sheet instrument *cannot* be deferred to a future period when the income or expense on the item being hedged is recognized.

The following addresses important GAAP and call report rules for netting of the assets and liabilities arising from OBS derivative instruments.

SPECIFIC ACCOUNTING PRINCIPLES FOR OBS DERIVATIVE INSTRUMENTS

Instruments Covered by Authoritative Accounting Standards

Futures Contracts Not Associated with Foreign-Currency Exposures (‘‘Domestic Futures Contracts’’)

Futures contracts are firm (legally binding) commitments to purchase or sell a particular financial instrument or index, foreign currency, or commodity at a specified future date, quantity, and price or yield. Futures contracts have standardized contractual terms, are traded on organized exchanges, and are typically settled in cash rather than actual delivery.

Under GAAP, all futures contracts, except for foreign-currency futures contracts, should be reported in accordance with FASB 80, ‘‘Accounting for Futures Contracts.’’ Foreign-currency futures contracts should be reported in accordance with the guidance contained in FASB 52, ‘‘Foreign-Currency Translation.’’ These statements should be referred to for more detailed accounting guidance in these areas.

Treatment of open contracts. Contracts are outstanding (open) until they have been terminated by either the acquisition or delivery of the underlying financial instruments, or by offset. ‘‘Offset’’ is the purchase and sale of an opposite position using an equal number of futures contracts on the same delivery month executed through the same broker or dealer and executed on the same exchange.

Transactions in futures contracts generally involve a deposit of cash as margin, which will generally be reported within ‘‘other assets’’ on the balance sheet. As discussed below, changes in the market values of open positions may affect general ledger accounts and related balance-sheet amounts. However, since open positions are executory contracts (firm commitments) for delivery of the underlying financial instrument, the underlying instrument should not be reflected as an asset or liability on the balance sheet.[9] Only when the closing of an open position results in the acquisition or disposition of the underlying financial instrument would an asset be recorded, or removed from, the balance sheet.

As a prudent management measure, all open positions in futures contracts must be reviewed at least monthly (or more often, if material), and their current market values should be determined using published price quotations. These futures positions must be revalued at their current market value on these valuation dates, and any changes in value should be reported in accordance with the guidance presented below for hedge or non-hedge contracts.

Criteria for hedge-accounting treatment. If certain criteria are met, the accounting under GAAP for a futures contract that is used to hedge an asset, liability, commitment, or anticipated transaction (''hedged item'') should be similar to the method of accounting for the hedged item. This means that changes in the market value of the futures contract are recognized in income when the related changes in the price or interest rate of the hedged item are recognized. Where an anticipated transaction is the hedged item, the change in value of the futures contract is included in the measurement of the anticipated transaction. Realized gains or losses from changes in the market value of futures contracts that qualify as a hedge of an existing asset or liability should be recognized as an adjustment of the carrying amount (often called ''book value'') of the hedged item. A change in the market value of a futures contract that is a hedge of a firm commitment should be included in the measurement of the transaction that satisfies the commitment.

Under FASB 80, a futures contract should be accounted for as a hedge when the following conditions are met:

- The institution must have determined that the item to be hedged (that is, an identifiable asset, liability, firm commitment, or anticipated transaction) will expose it to price or interest-rate risk.
- The futures contract must reduce the exposure to risk. This must be demonstrated at the inception of the hedge by an expectation that changes in the prices of both the contract and the hedged item will be highly correlated. Furthermore, ongoing results must show a high degree of correlation, or the hedge will be considered ineffective and consequently marked to market. In other words, the bank must monitor the price movements of both the hedge contract and the hedged item to determine that it is probable (that is, likely to occur) that the results of the futures contract will offset changes in the market value of the hedged item and that these results have done so from inception to the determination date.
- The futures contract must be designated as a hedge by management at the inception of the hedge.

In order for a futures contract to qualify as a hedge of an anticipated transaction, the following two additional criteria must be met:

- Significant characteristics and expected terms of the anticipated transaction must be identified.
- The occurrence of the anticipated transaction must be probable.[10]

If the criteria for applying hedge-accounting methods have been met, the gain or loss on a futures contract, instead of being currently recognized in income, is an adjustment to the cost of the asset or liability being hedged. The adjustment, then, will be recognized in income when gain or loss on the hedged asset or liability is determined. For example, if the item being hedged is an interest-bearing liability that is reported at amortized cost, the changes in the market value of the futures contract would be reflected as adjustments to the carrying amount (or book value) of the liability. The historical cost of the liability and the adjustments brought about by the hedge would then be amortized in

9. Although the underlying instruments or notional amounts of these commitments are not reported in the balance sheet, they are disclosed in footnotes to the financial statement. For regulatory reporting purposes, open positions in futures contracts are to be reported in the call report, Schedule RC-L.

10. It will be particularly difficult to meet this criteria when an anticipated transaction is not expected to take place in the near future.

interest expense over the expected remaining life of the liability.

If the hedged asset or liability is marked to market, the hedge position will also be marked to market. There is no deferral of gains or losses in this situation; likewise, there is no deferral of gains or losses if the futures contract hedges an anticipated transaction if the asset to be acquired or liability incurred will be reported at fair value.

If a futures contract qualifying as a hedge is closed before the date of the related anticipated transaction, the accumulated change in value of the contract should be carried forward (assuming high correlation has occurred) and included in the measurement of the related transaction. When it becomes probable that the quantity of the anticipated transaction will be less than that originally hedged, a pro rata portion of the futures results that would have been included in the measurement of the transaction should be recognized as a gain or loss.

If high correlation between price changes of the hedged item and the futures position is no longer evident, the bank should discontinue accounting for the futures contracts as a hedge. If this were to occur, the portion of the change in the market value of the contract that has not offset the market-value changes of the hedged item should be reflected in income. The contract should thereafter be accounted for as a nonhedge contract with subsequent changes in the contract's market value reflected in current income. When a futures position that has been an effective hedge is terminated before disposition of the hedged item, the gain or loss on the terminated contracts must be deferred and amortized over the remaining life of the hedged item. If the contacts do not qualify as hedges, the gain or loss is recognized currently in income or expense, as appropriate.

Call report treatment. Regulatory reporting standards, as a general rule, do not permit the deferral of gains or losses by banks on domestic futures and forwards, whether or not the contracts are used for hedging purposes. All changes in market value of futures and forward contracts are reported in income in the period they occur. The banking agencies adopted this reporting standard as a supervisory policy before the issuance of FASB 80. As exceptions to the general prohibition, hedge accounting in accordance with FASB 80 is permitted by the three banking agencies only for futures and forward contracts used to hedge mortgage-banking operations, and those foreign-currency futures contracts that are covered by FASB 52.

Foreign-Currency Off-Balance-Sheet Instruments

The primary source of authoritative guidance for accounting for foreign-currency translations and foreign-currency transactions is FASB 52. The standard encompasses futures contracts, forward agreements, and currency swaps as they relate to foreign-currency hedging.

FASB 52 draws a distinction between foreign-exchange translation and transactions. Translation, generally, focuses on the combining of foreign and domestic entities for presentation in the consolidated financial statements and for reporting these financial statements in one currency. Foreign-currency transactions, in contrast, are transactions (such as purchases or sales) by a business operation in currencies other than its functional currency. For U.S. depository institutions, the functional currency will generally be the dollar for its U.S. operations and will typically be the local currency where its foreign operations transact business.[11]

Foreign-currency translation. Translation is the conversion to U.S. dollars of the financial statement of a foreign operation (branch, division, or subsidiary) that is denominated in the operation's functional currency for inclusion in the parent's consolidated financial statements. The foreign operation's balance sheet is translated at the exchange rate in effect on the statement date, and the income statement is translated at an appropriate weighted-average rate for the reporting period. Gains or losses arising from foreign-currency translation are not recognized currently

11. Detailed guidance of determining the functional currency is set forth in appendix 1 of FASB 52:

"An entity's functional currency is the currency of the primary economic environment in which the entity operates; normally, that is the currency of the environment in which an entity primarily generates and expends cash. The functional currency of an entity is, in principle, a matter of fact. In some cases, the facts will clearly identify the functional currency; in other cases they will not."

FASB 52 indicates the salient economic indicators, and possibly other factors, that should be considered both individually and collectively when determining the functional currency. These factors include cashflow, price and market sales indicators, expense indicators, financing indicators, and intercompany transactions and arrangements.

in income; instead, they are treated as adjustments to a separate component of equity. Recognition in income of these cumulative foreign-currency adjustments will take place when the foreign operation is either sold or substantially liquidated.

An institution may engage in hedging transactions to reduce the risk of exchange losses on translating its net equity investments in foreign operations for presentation in its financial statements, thus avoiding the consequent volatility in its capital position. The effect of the special hedging treatment is to include the change in value of the hedging instrument as a part of the same separate component of equity as the translation adjustment.

Foreign-currency transactions. Gains or losses on foreign-currency transactions, in contrast to translation, are recognized in income as they occur, unless they arise from a qualifying hedge. FASB 52 provides the following guidance about the types of foreign-currency transactions for which gain or loss is not currently recognized in earnings.

Gains and losses on the following foreign-currency transactions should not be included in determining net income but should be reported in the same manner as translation adjustments:

- foreign-currency transactions that are designated as, and are effective as, economic hedges of a net investment in a foreign entity, commencing as of the designation date
- intercompany foreign-currency transactions that are of a long-term-investment nature (that is, settlement is not planned or anticipated in the foreseeable future), when the entities to the transaction are consolidated, combined, or accounted for by the equity method in the reporting institution's financial statements

In addition to hedges of the balance sheet, a gain or loss on a forward contract or other foreign-currency transaction that is intended to hedge an identifiable foreign-currency commitment (for example, a firm commitment to sell or purchase equipment) should be deferred and included in the measurement of the related foreign-currency transaction (as an adjustment to the revenue or cost of the equipment in the example). If a foreign-currency hedge is terminated before the transaction date of the related commitment, any deferred gain or loss is to remain deferred until recognition of gain or loss on the items that were hedged occurs. Losses should not be deferred, however, if it is estimated that deferral would lead to recognizing losses in later periods. A foreign-currency transaction should be considered a hedge of an identifiable foreign-currency commitment if both of the following conditions are met:

- The foreign-currency transaction is designated as, and is effective as, a hedge of a foreign-currency commitment.
- The foreign-currency commitment is firm.

Thus, FASB 52 is distinguished from FASB 80 in that hedging the risks from arrangements that have not matured into a firm commitment (that is, an anticipated transaction), such as forecasted foreign sales, do not qualify for hedge treatment. Another dissimilarity between FASB 52 and 80 is that the hedge of a foreign-currency exposure can be considered in isolation; there is no requirement that the overall risk of the institution must be reduced by the hedge as there is under FASB 80. Under the latter accounting standard, an institution is, in effect, required to consider the presence of any natural hedges that may be present in its balance sheet. To illustrate, an institution with foreign-currency-denominated receivables has foreign-exchange risk; however, any accounts payable that are denominated in the same currency as the receivables reduce the overall exposure. Under FASB 52, however, the institution could hedge the gross amount of receivables and qualify for deferring gain or loss recognition. Note, however, that by neutralizing the exposure from the receivables, the institution now has exchange risk equal to its payables position. Thus, gains or losses from a hedge of a foreign-currency risk may be deferred, even though the hedge position may increase the overall foreign-exchange risk of the institution.

To qualify for deferral, a foreign-currency-hedge position is required to be denominated in the same currency as the items it is hedging, unless such a hedge is impracticable. ''Impracticable'' means there are severe impediments to using the currency, such as illiquidity or a limited exchange market in the currency that is to be hedged, not merely that it is uneconomical. Since the foreign-exchange-hedge position is generally denominated in the same currency as the items that are being hedged, there will be perfect correlation (that is, no basis risk) between the hedged items and the hedge position. Therefore, ongoing monitoring of the correlation between the foreign-exchange hedge and the hedged items is required only if a substitute or proxy currency is being used.

Instruments That Are Not Covered by Authoritative Accounting Standards

Forward Contracts

Domestic forward contracts, including forward-rate agreements, are generally accounted for by analogy to the accounting guidance for futures contracts set forth in FASB 80, which is summarized above. As noted above, the accounting for foreign-currency-forward contracts is addressed by FASB 52. Forward-rate agreements denominated in a foreign currency are generally accounted for by analogy to the accounting guidance for forward contracts set forth in FASB 52. Of course, any such instruments that are used for trading purposes should be placed in a well-supervised trading account and marked to market.

Interest-Rate Swaps

Consistent with the general requirement that trading assets or liabilities be marked to market, a dealer or market maker in swap instruments is required to mark its swap trading book to fair value. While the Emerging Issues Task Force (EITF) has provided limited interpretations on interest-rate swaps used as hedges, authoritative standards from the FASB, AICPA, or SEC do not yet exist. In this vacuum, diverse industry practice has resulted. EITF Issue No. 84-7 applies to the early termination of swaps that hedge some financial instrument. According to this issue, gain or loss from early termination is to be deferred and amortized as a yield adjustment to the underlying financial instrument. Issue No. 84-36 applies if there is an underlying debt obligation on the balance sheet of the company entering into a swap. The company should account for the swap like a hedge of the obligation and record interest expense using the revised interest rate. Situations where the swap does not hedge an asset or liability were excluded from the scope of the two issues, other than to note a diversity of accounting treatment. Some accountants view the EITF's discussion of hedging as guidance for accounting for "synthetic instruments" (for example, the transformation of fixed-rate debt into floating-rate debt by use of an interest-rate swap) where there is no risk reduction per se. Interest-rate swaps denominated in a foreign currency, including cross-currency interest-rate swaps, are generally accounted for by analogy to the accounting guidance set forth in FASB 52. Financial institutions engaging in swaps should have written policies that govern the accounting for these instruments, and should be consistently following these policies.

Options

Options involve two parties: the writer (or seller) and the purchaser (or holder). The purchaser of an option has the right, but not the obligation, to purchase or sell the option's underlying instrument according to the terms specified in the option. The option writer, in return for receiving the option premium, is obligated to perform according to the terms of the option.

Purchased Options

When held as a trading asset, a purchased option is to be marked to market under GAAP for presentation in the financial statements. For regulatory reporting purposes, the call report instructions state that purchased options are generally not to be reported at market value. For call report purposes, the only purchased options that have specifically been permitted to be marked to market are those that have been used for trading purposes and have been placed in a well-supervised trading account.

Purchased options can be an effective hedge of anticipated transactions, where they can be exercised if the anticipated transaction matures into a firm commitment or can be allowed to lapse if the anticipated transaction does not occur. Alternatively, options can be used to protect against unfavorable price movements, but allow the institution to benefit from favorable price changes of the hedged items. Virtually no authoritative literature has been issued for the accounting of options. The AICPA released an issues paper in 1986 that proposed certain methods of accounting for options that included criteria for hedging that were similar to FASB 80.

The paper, however, is not authoritative. One recommendation of the report was to account for purchased options used for hedging purposes in two discrete amounts: (a) the intrinsic value (that is the difference, if positive, between the option's exercise price and the market price of the underlying instrument) and (b) the time value of the option. The former would be an adjustment to determining the gain or loss on exercise or expiration; the latter would be amortized over the term of the option. Another recommendation was that if the option qualifies as a hedge of an item carried at historical cost, changes in intrinsic value would be included in a separate component of equity. While parts of the issues paper have become industry practice, some of the approaches advocated, such as these two examples, are rarely seen.

For presentation in the call report, purchased options that are held for hedging purposes generally are to be recorded at cost and amortized over the term of the option. No periodic valuation for balance-sheet presentation of open positions is permitted.

Written options. By their inherent risk profile, written options, whether covered or not, do not generally qualify as a hedge for accounting purposes. The premium received by an option's writer should be deferred until the point at which the option either expires or is exercised. If the option is exercised, the premium is an adjustment to the amount realized on the sale of the underlying obligation. If the option expires out of the money, the premium is considered earned and is reported as other fee income. Options that are in the money (and thus an obligation to the writer) are to be marked to market, according to the SEC.

The call report instructions provide guidance for written ‘‘standby contracts,’’ which are a form of option. Standby contracts are to be valued at the lower of cost or market (since the written option is a liability, the absolute amount reported is the higher of cost (the premium received) or market value). Market value in this context is the loss exposure, which would be based on the difference between the option's strike price and the market price of the underlying instrument.

Purchased options that hedge foreign-exchange exposures related to anticipated transactions. In issuing guidance on foreign-currency hedges that use options (Issue No. 90-17), the EITF noted that FASB 52 did not specifically consider options. The EITF used certain elements from FASB 80 in identifying appropriate criteria for applying hedge-accounting treatment: the requirement that overall risk be reduced, that high correlation between the hedge position and the hedged items be present, and that anticipated transactions could be hedged if they are identifiable and probable. This guidance is narrowly applied to strategies using at-the-money options at the inception of the hedge. When it examined other option-based hedge strategies (Issue No. 91-4), the EITF was unable to reach a consensus because of objections by the SEC about the deferral of gains or losses related to anticipated transactions. The SEC also objected to any deferral of losses from written options, since to write options does not, in the SEC's view, reduce risk.

Netting or Offsetting On- and Off-Balance-Sheet Assets and Liabilities

The FASB issued Interpretation 39 in 1992, which went into effect for 1994 financial statements of banks and other companies. This interpretation applies to the netting of assets and liabilities arising from (i) ‘‘traditional’’ activities, such as loans and deposits, and (ii) OBS derivative instruments. The assets and liabilities from derivatives primarily are their fair value, or estimated market value, and the receivables and payables on these instruments. FIN 39 clarifies the definition of a ‘‘right of setoff’’ that GAAP has long indicated must exist before netting of assets and liabilities can occur in the balance sheet. One of the main purposes of FIN 39 was to clarify that FASB's earlier guidance on netting of assets and liabilities (TB 88-2) applies to amounts recognized for OBS derivative instruments as well.

Balance-sheet items arise from off-balance-sheet interest-rate and foreign-currency instruments primarily in two ways. First, those banking organizations and other companies that trade OBS derivative instruments (for example, interest-rate and currency swaps, forwards, and options) are required by GAAP to mark to market these positions by recording their fair values (estimated market values) on the balance sheet and recording any changes in these fair values (unrealized gains and losses) in earnings. Second, interest-rate and currency swaps have receivables and payables that accrue over time, reflecting expected cash inflows and outflows that must periodically be exchanged under these contracts, and these receivables and payables must be recorded on the balance sheet as assets and liabilities, respectively.[12]

Under FIN 39, setoff, or the netting of assets and liabilities to a particular counterparty, is not permitted unless all of the following four criteria are met:

- Two parties must owe each other determinable amounts.
- The reporting entity must have a right to set off its obligation with the amount due to it.
- The reporting entity must actually intend to set off these amounts.
- The right of setoff must be enforceable at law.

When all four criteria are met, a bank or other company may offset the related asset and liability and report the net amount in its GAAP financial statements. FIN 39 also indicates, without regard to the third criterion (the parties' intent), the netting of fair values of OBS derivative contracts executed with the counterparty under a legally enforceable master netting agreement is permitted. If any one of the other three criteria is not met, the fair value of contracts in a loss position with the counterparty *cannot* be offset against the fair value of contracts in a gain position with that counterparty, and the organization would be required to record gross unrealized gains on such contracts as assets and gross unrealized losses as liabilities.

Call Report Requirements

The call report instructions provide guidance on netting for purposes of reporting risk-based capital information.[13] Furthermore, the FFIEC, on an interim basis, adopted for the call report the provisions of FIN 39 that are applicable to derivative contracts, effective for 1994 call reports. The general instructions to the call report, however, explicitly prohibit the netting of assets and liabilities by banks *unless* specifically required by the instructions. Thus, FIN 39 is not to be applied to traditional balance-sheet assets and liabilities for call report purposes.

DISCLOSURE FOR SECURITIES AND FINANCIAL CONTRACTS

In addition to issuing authoritative guidance on methods of accounting (that is, how a particular transaction is to be reported on the balance sheet or statements of income or cash flow), the FASB (and SEC) also set standards for minimum disclosure of the financial activities, condition, and other issues that should be incorporated in a company's annual report. Information to meet these disclosure requirements is audited by the company's independent accountants and may be presented either as footnotes to the financial statements or incorporated in management's discussion and analysis (MD&A). In MD&A, management reviews in some detail the company's results from operations, its liquid resources and capital position, significant events occurring after the date of the financial statements, and other matters. MD&A is required for reports filed with the SEC, such as the annual 10-K and quarterly 10-Q. Since it is fixed-form, the call report does not have a direct analogue to MD&A. There is, however, considerable overlap as many of the call report's supporting schedules and memoranda state much of the information required under the disclosure standards of GAAP. The following section briefly describes the GAAP requirements for disclosure relating to financial instruments.

As an interim step in a project to improve the accounting for financial instruments, par-

12. In contrast, the notional amounts of off-balance-sheet derivative instruments, or the principal amounts of the underlying asset or assets to which the values of the contracts are indexed, are not recorded on the balance sheet. Note, however, that if the OBS instrument is carried at market value, that value will include any receivable or payable components. Thus, for those OBS instruments that are subject to a master netting agreement, the accrual components in fair value are also netted.

13. The risk-based capital guidelines provide generally that a credit-equivalent amount is calculated for each individual interest-rate and exchange-rate contract. The credit-equivalent amount is determined by summing the positive mark-to-market values of each contract with an estimate of the potential future credit exposure. The credit-equivalent amount is then assigned to the appropriate risk-weight category.

Netting of swaps and similar contracts is recognized for risk-based capital purposes only when accomplished through "netting by novation." This is defined as a written bilateral contract between two counterparties under which any obligation to each other is automatically amalgamated with all other obligations for the same currency and value date, legally substituting one single net amount for the previous gross obligations.

ticularly OBS instruments, the FASB wrote new disclosure standards intended to increase the transparency of contractual terms, risks, and market values of both on- and off-balance-sheet financial instruments. To date, three standards have been written, requiring additional disclosure about instruments having certain risks (including a lack of diversification), the fair market value of financial instruments (including such classes as securities, loans, and deposits), and the discussion of the risk-management strategies when the company uses OBS instruments.

The first standard resulting from the financial instruments project was FASB 105, ‘‘Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk.’’ Under the standard, a company is required to describe the notional amounts and significant contractual terms for financial instruments that have off-balance-sheet risk of accounting loss.[14] Secondly, the company is required to disclose the amount of accounting loss that would occur as a result of credit risk.[15] As a part of the disclosure of credit risk, the company is required to discuss its policies for requiring collateral and a description of the collateral or other security supporting the contracts. Lastly, the company is required to report significant credit concentrations across all classes of financial instruments. This may be done by industry, region, or other economic characteristics. FASB 105 was amended by FASB 119 (see below) to require the disclosure of notional amount and significant contract terms of financial instruments without off-balance-sheet risk of loss (for example, purchased options) in addition to the disclosures described earlier. FASB 105 was required to be followed for annual reports beginning in 1991.

The second standard issued by the FASB was FASB 107, ‘‘Disclosures about Fair Value of Financial Instruments,’’ which was effective for the 1993 annual reports of institutions with assets of $150 million or more and will be effective for the 1996 annual reports of smaller institutions. Under the standard, a company is required to disclose the fair value of virtually all classes of financial instruments. The company should disclose its methods for estimating fair value, such as the use of market quotes or valuation techniques (and disclose the assumptions used if values are estimated) for instruments without active markets. FASB 107 requires that demand deposits be reported at face value and the value of long-term relationships and other intangibles not be taken into account, although these and other nonfinancial assets and liabilities may be separately disclosed. In response to criticisms from industry analysts about the difficulty in following some companies’ disclosures, the FASB amended FASB 107 when it issued FASB 119, ‘‘Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments.’’ FASB 119 requires that the fair-value disclosure separate OBS instruments used as hedges from the instruments on the balance sheet being hedged. FASB 107 was also amended to require fair-value disclosure in a single place rather than scattered throughout the annual report.

In response to calls for further improvement in the disclosure of derivatives activities, FASB 119 requires a firm that issues or holds derivatives to differentiate in its disclosures between derivatives that it uses for trading purposes and derivatives used for risk-management or other end-user reasons.

- *Trading activities*. A dealer is required to report the fair value (both year-end and annual average) of its derivatives positions and to disaggregate derivatives trading profits. This disaggregation may be reported either for derivative instruments alone or broken down by some other method by the firm, such as lines of business, risk exposures (for example, interest-rate or foreign-exchange), or another method as long as trading profits from derivative instruments are disclosed. The FASB encouraged, but did not require, the disclosure of both year-end and average fair values of trading assets and liabilities that are not

14. An off-balance-sheet accounting loss occurs when there is the potential for loss because of market or credit risks that exceed the amount reported on the balance sheet for the OBS instrument. In other words, the loss in the event of a default or adverse market movement could exceed the reported value of the contract. For example, a purchased-put option does not have accounting risk of loss because the most that could be lost by the holder is the amount of the premium paid (of course, the economic loss would be the fair value of the option). The writer of the put, on the other hand, would have an accounting loss to the writer if it must pay cash to settle the contract in excess of the premium it received. Thus the writer has off-balance-sheet risk of loss while the holder does not.

15. For example, an interest-rate swap accounted for using the accrual method that has a market value of $1,000 and an accrued net receivable of $10 has an accounting risk of loss of only $10.

derivatives, whether they are financial instruments or nonfinancial items, to give a more comprehensive picture of the firm's trading pursuits.

- *End-user activities*. For derivatives not used in trading, but instead used for hedging or other risk-management purposes, a firm is now required to describe its objectives for using derivatives and discuss its strategies for achieving those objectives. The firm is also required to describe how it reports derivatives in its financial statements as well as give certain details (such as the amount of gains or losses explicitly deferred) about derivatives used to hedge anticipated transactions. The fair values of end-user derivatives must also be separately disclosed from the fair value of items hedged by the derivatives.

Finally, FASB 119 encourages a firm to disclose quantitative information, consistent with its method for managing risk, that would be useful to financial statement readers in assessing its activities. Suggested approaches include gap analyses, the effect of hypothetical price shocks on reported earnings, and the disclosure of value at risk at the report date and its average during the year. FASB 119 first applied to annual reports for year-end 1994.

1. To determine if policies, practices, procedures, and internal controls regarding investments are adequate.
2. To determine if bank officers are operating in conformance with the established guidelines.
3. To determine the scope and adequacy of the audit function.
4. To determine the overall quality of the investment portfolio and how that quality relates to the soundness of the bank.
5. To determine compliance with laws and regulations.
6. To initiate corrective action when policies, practices, procedures or internal controls are deficient or when violations of laws or regulations have been noted.

1. If selected for implementation, complete or update the ‘‘Investment Securities’’ section of the internal control questionnaire.
2. Based on the evaluation of internal controls and the work performed by internal or external auditors, determine the scope of the examination.
3. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the following examination procedures. Also, obtain a listing of any deficiencies noted in the latest review done by internal or external auditors, and determine if any corrections have been accomplished. Determine the extent and effectiveness of investment-policy supervision by—
   a. reviewing the abstracted minutes of meetings of the board of directors or appropriate committees;
   b. determining that proper authorizations have been made for investment officers or committees;
   c. determining any limitations or restrictions on delegated authorities;
   d. evaluating the sufficiency of analytical data used by the board or investment committee;
   e. reviewing the reporting methods used by department supervisors and internal auditors to ensure compliance with established policy; and
   f. preparing a memo for the examiner who is assigned ‘‘Duties and Responsibilities of Directors’’ and the examiner who is in charge of the international examination, if applicable, stating conclusions on the effectiveness of directors’ supervision of the domestic or international division investment policy. All conclusions should be documented.
4. Obtain the following:
   a. Trial balances of investment-account holdings and money market instruments, such as commercial paper, banker’s acceptances, negotiable certificates of deposit, securities purchased under agreements to resell, and federal funds sold. Identify any depository instruments placed through money brokers.
   b. A list of any assets carried in loans, and a list of discounts on which interest is exempt from federal income taxes and which are carried in the investment account on call reports.
   c. A list of open purchase and sale commitments.
   d. A schedule of all securities, forward placement contracts, futures contracts, contracts on exchange-traded puts and calls, option contracts on futures puts and calls, and standby contracts purchased or sold since the last examination.
   e. A maturity schedule of securities sold under repurchase agreements.
   f. A list of pledged assets and secured liabilities.
   g. A list of the names and addresses of all securities dealers doing business with the bank.
   h. A list of the bank’s personnel authorized to trade with dealers.
   i. A list of all U.S. government–guaranteed loans that are recorded and carried as an investment-account security.
   j. For international division and overseas branches, a list of investments—
      - held to comply with various foreign governmental regulations requiring such investments;
      - used to meet foreign reserve requirements;
      - required as stock exchange guarantees or used to enable the bank to provide securities services;
      - representing investment of surplus funds;
      - used to obtain telephone and telex services;
      - representing club and school memberships;
      - acquired through debts previously contracted;
      - representing minority interests in nonaffiliated companies;
      - representing trading-account securities;
      - representing equity interests in Edge Act and agreement corporations and foreign banks;
      - representing portfolio investments made

pursuant to Regulation K; and
   - held for other purposes.
5. Using updated data available from reports of condition, UBPR printouts, and investment advisor and correspondent bank portfolio-analysis reports, obtain or prepare an analysis of investment and money market holdings that includes—
   a. a month-by-month schedule of par, book, and market values of issues maturing in one year;
   b. schedules of par, book, and market values of holdings in the investment portfolio (schedules should be indexed by maturity date, and individual schedules should be detailed by maturity dates over the following time periods: over one through five years, over five through 10 years, and over 10 years);
   c. book-value totals of holdings by obligor or industry; related obligors or industries; geographic distribution; yield; and special characteristics, such as moral obligations, conversion, or warrant features;
   d. par-value schedules of type I, II, and III investment holdings, by those legally defined types; and
   e. for the international division, a list of international investment holdings (foreign-currency amounts and U.S. dollar equivalents) to include—
      - descriptions of securities held (par, book, and market values),
      - names of issuers,
      - issuers' countries of domicile,
      - interest rates, and
      - pledged securities.
6. Review the reconcilement of investment and money market account (or accounts) trial balances to the general-ledger control account (or accounts).
7. Using either an appropriate sampling technique or the asset-coverage method, select from the trial balance (or balances) the international investments, municipal investments, and money market holdings for examination. If transaction volume permits, include all securities purchased since the last general examination in the population of items to be reviewed.
8. Perform the following procedures for each investment and money market holding selected in step 7:
   a. Check appropriate legal opinions or published data outlining legal status.
   b. If market prices are provided to the bank by an independent party (excluding affiliates and securities dealers selling investments to the bank) or if they are independently tested as a documented part of the bank's audit program, accept those prices. If the independence of the prices cannot be established, test market values by reference to one of the following sources:
      - published quotations, if available
      - appraisals by outside pricing services, if performed
   c. If market prices are provided by the bank and cannot be verified by reference to published quotations or other sources, test those prices by using the ''comparative yield method'' to calculate approximate yield to maturity:

$$\text{approximate yield to maturity} = \frac{\text{annual interest} + \dfrac{\text{par value} - \text{book value}}{\text{number of years to maturity}}}{\tfrac{1}{2}\,(\text{bank-provided market price} + \text{par value})}$$

      - Compare the bank-provided market price and the examiner-calculated approximate yield to maturity with an independent publicly offered yield or market price for a similar type of investment with similar rating, trading volume, and maturity or call characteristics.
      - Compare nonrated issues with fourth-rated (BBB, Baa) bonds.
      - Investigate market-value variances in excess of 5 percent.
   d. For investments and money market obligations in the sample that are rated, compare the ratings provided with the most recent published ratings.

Before continuing, refer to steps 16 through 18. They should be performed in conjunction with steps 9 through 15. International division holdings should be reviewed with domestic holdings to ensure compliance, when combined, with applicable legal requirements.

9. To the extent practical under the circumstances, perform credit analyses of—
   a. the obligors on securities purchased under agreements to resell, when the readily

marketable value of the securities is not sufficient to satisfy the obligation;
b. all international investments, nonrated securities, and money market instruments selected in step 7 or acquired since the last examination;
c. all previously detailed or currently known speculative issues;
d. all defaulted issues; and
e. any issues in the current Interagency Country Exposure Review Committee credit schedule obtained from the international loan portfolio manager by—
   - comparing the schedule with the foreign securities trial balance obtained in step 4 to ascertain which foreign securities are to be included in Interagency Country Exposure Review Committee credits;
   - for each security so identified, transcribing the following appropriate information to a separate examiner's line sheet or a related examiner's credit line sheet:
     — amount (and U.S. dollar equivalent if a foreign currency) to include par, book, and market values
     — how and when acquired
     — maturity date (or dates)
     — default date, if appropriate
     — any pertinent comments; and
   - returning schedule and appropriate examiner's line sheet (or sheets) to the examiner who is assigned "International—Loan Portfolio Management."

10. Review the most recent reports of examination of the bank's Edge Act and agreement corporation affiliates and foreign subsidiaries to determine their overall conditions. Also, compile data on Edge Act and agreement corporations and foreign subsidiaries necessary for the commercial report of examination (that is, asset criticisms, transfer risk, and other material examination findings). Review portfolio investments made by Edge and agreement corporations under Regulation K for compliance with the investment limitations in Regulation K.
11. Classify speculative and defaulted issues according to the following standards (except those securities in the Interagency Country Exposure Review and other securities on which special instructions have been issued):
    a. The entire book value of speculative-grade municipal general obligation securities that are not in default will be classified substandard. Market depreciation on other speculative issues should be classified doubtful. The remaining book value usually is classified substandard.
    b. The entire book value of all defaulted municipal general obligation securities will be classified doubtful. Market depreciation on other defaulted bonds should be classified loss. The remaining book value usually is classified substandard.
    c. Market depreciation on nonexempt stock should be classified loss.
    d. Report comments should include—
       - a description of the issue;
       - how and when each issue was acquired;
       - the default date, if appropriate;
       - the date interest paid to;
       - the rating at time of acquisition; and
       - comments supporting the classification.
12. Review the bank's maturity program.
    a. Review the maturity schedules.
       - Compare book and market values and, after considering the gain or loss on year-to-date sales, determine if the costs of selling intermediate and long-term issues appear prohibitive.
       - Determine if recent acquisitions show a trend toward lengthened or shortened maturities. Discuss such trends with management, particularly with regard to investment objectives approved by the investment committee.
    b. Review the pledged asset and secured liability schedules and isolate pledged securities by maturity segment. Then determine the market value of securities pledged in excess of net secured liabilities.
    c. Review the schedule of securities sold under repurchase agreement and determine—
       - whether financing for securities purchases is provided by repurchase agreement by the securities dealer who originally sold the security to the bank;
       - whether funds acquired through the sale of securities under agreement to repurchase are invested in money market assets, or if short-term repurchase agreements are being used to fund

longer-term, fixed-rate assets;
- the extent of matched asset repo and liability repo maturities and the overall effect on liquidity resulting from unmatched positions;
- whether the interest rate paid on securities sold under agreement to repurchase is appropriate relative to current money market rates; and
- whether the repurchase agreement is at the option of the buying or selling bank.

d. Review the list of open purchase and sale commitments and determine the effect of their completion on maturity scheduling.

e. Submit investment portfolio information regarding the credit quality and practical liquidity of the investment portfolio to the examiner who is assigned ''Asset/Liability Management.''

13. Consult with the examiner responsible for the asset/liability management analysis to determine what information is needed to assess the bank's sensitivity to interest-rate fluctuations and its ability to meet short-term funding requirements. If requested, compile the information using bank records or other appropriate sources. See section 6000.1, ''Instructions for the Report of Examination,'' for factors to be taken into account when compiling this information. Information which may be required to be furnished includes—
    a. the market value of unpledged government and federal-agency securities maturing within one year;
    b. the market value of other unpledged government and federal-agency securities which would be sold without loss;
    c. the market value of unpledged municipal securities maturing within one year;
    d. the book value of money market instruments, such as banker's acceptances, commercial paper, and certificates of deposit (provide amounts for each category); and
    e. commitments to purchase and sell securities, including futures, forward, and standby contracts. (Provide a description of the security contract, the purchase or sales price, and the settlement or expiration date.)

14. Determine whether the bank's investment policies and practices are satisfactorily balancing earnings and risk considerations.
    a. Use UBPR or average call report data to calculate investments as a percentage of total assets, and use average yields on U.S. government and nontaxable investments to—
        - compare results with peer-group statistics,
        - determine the reasons for significant variances from the norm, and
        - determine if trends are apparent and the reasons for such trends.
    b. Calculate current market depreciation as a percentage of gross capital funds.
    c. Review the analysis of municipal and corporate issues by rating classification and—
        - determine the total in each rating class and the total of nonrated issues,
        - determine the total of nonrated investment securities issued by obligors located outside of the bank's service area (exclude U.S. government–guaranteed issues), and
        - review acquisitions since the prior examination and ascertain reasons for trends that may suggest a shift in the rated quality of investment holdings.
    d. Review coupon rates or yields (when available) and compare those recently acquired investments and money market holdings with coupon rates or yields that appear high or low with similarly acquired instruments of analogous types, ratings, and maturity characteristics (Discuss significant rate or yield variances with management.)
    e. Review the schedule of securities, futures, forward, and standby contracts purchased and sold since the last examination, and determine whether the volume of trading is consistent with policy objectives. (If the bank does not have a separate trading account, determine whether such an account should be established, including appropriate recordkeeping and controls.)
    f. If the majority of sales resulted in gains, determine if profit-taking is consistent with stated policy objectives or is motivated by anxiety for short-term income.
    g. Determine whether the bank has discounted or has plans to discount future investment income by selling interest

coupons in advance of interest payment dates.

h. Review the list of commitments to purchase or sell investments or money market investments. (Determine the effect of completion of these contracts on future earnings.).

15. Review the bank's federal income tax position and
    a. determine, by discussion with appropriate officer(s), if the bank is taking advantage of procedures to minimize tax liability in view of other investment objectives;
    b. review or compute actual and budgeted—
        - tax-exempt holdings as a percentage of total assets and
        - applicable income taxes as a percentage of net operating income before taxes; and
    c. discuss with management the tax implications of losses resulting from securities sales.
16. Determine that proper risk diversification exists within the portfolio by—
    a. reviewing totals of holdings by single obligor or industry, related obligors or industries, geographic distribution, yields, and securities that have special characteristics (include individual due from bank accounts from the list received from the bank or from the examiner assigned ‘‘Due from Banks’’ and all money market instruments) and—
        - detail, as concentrations, all holdings equaling 25 percent or more of capital funds and
        - list all holdings equaling at least 10 percent but less than 25 percent of capital funds and submit that information to the examiner assigned ‘‘Loan Portfolio Management’’ (These holdings will be combined with any additional advances in the lending areas.) and
    b. performing a credit analysis of all nonrated holdings determined to be a concentration if not performed in step 9.
17. If the bank is engaged in financial futures, exchange-traded puts and calls, forward placement, or standby contracts, determine if—
    a. the policy is specific enough to outline permissible contract strategies and their relationships to other banking activities;
    b. recordkeeping systems are sufficiently detailed to permit a determination of whether operating personnel have acted in accordance with authorized objectives;
    c. the board of directors or its designee has established specific contract position limits and reviews contract positions at least monthly to ascertain conformance with those limits;
    d. gross and net positions are within authorized positions and limits, and if trades were executed by persons authorized to trade futures; and
    e. the bank maintains general-ledger memorandum accounts or commitment registers which, at a minimum, include—
        - the type and amount of each contract,
        - the maturity date of each contract,
        - the current market price and cost of each contract, and
        - the amount held in margin accounts:
            — All futures contracts and forward and standby and options contracts are revalued on the basis of market or the lower of cost or market at each month-end.
            — Securities acquired as the result of completed contracts are valued at the lower of cost or market upon settlement.
            — Fee income received by the bank on standby contracts is accounted for properly.
            — Financial reports disclose futures, forwards, options, and standby activity.
            — The bank has instituted a system for monitoring credit-risk exposure in forward and standby contract activity.
            — The bank's internal controls, management reports, and audit procedures are adequate to ensure adherence to policy.
18. If the bank is engaged in financial futures, forward placement, options, or standby contracts, determine if the contracts have a reasonable correlation to the bank's business needs (including gap position) and capacity to fulfill its obligations under the contracts by—
    a. comparing the contract commitment and maturity dates to anticipated offset,
    b. reporting significant gaps to the examiner assigned ‘‘Asset/Liability Management’’ (refer to step 13),

c. comparing the amounts of outstanding contracts to the amounts of the anticipated offset,
d. ascertaining the extent of the correlation between expected interest-rate movements on the contracts and the anticipated offset, and
e. determining the effect of the loss recognition on future earnings, and, if significant, reporting it to the examiner assigned ‘‘Analytical Review and Income and Expense.’’

19. On the basis of pricings, ratings, and credit analyses performed above, and using the investments selected in step 7 or from lists previously obtained, test for compliance with applicable laws and regulations by—
    a. determining if the bank holds type II or III investments that are predominantly speculative in nature or securities that are not marketable (12 CFR 1.3(b));
    b. reviewing the recap of investment securities by legal types, as defined by 12 CFR 1, on the basis of the legal restrictions of 12 USC 24 and competent legal opinions, as follows:
       - If a type II or III security is readily marketable, and if the purchaser’s judgment was based on evidence of the obligor’s ability to perform, determine if the par value of such securities issued by a single obligor, which the bank owns or is committed to purchase, exceeds 10 percent of the bank’s capital funds (12 CFR 1.5(a) and 1.7(a)).
       - If the holding of a type II or III security was based on a reliable estimate of the obligor’s ability to perform, determine if the aggregate par value of such issues exceeds 5 percent of the bank’s capital funds (12 CFR 1.5(b) and 1.7(b));
    c. for those investment securities that are convertible into stock or which have stock purchase warrants attached—
       - determining if the book value has been written down to an amount that represents the investment value of the security, independent of the conversion or warrant provision (12 CFR 1.10) and
       - determining if the par values of other securities that have been ruled eligible for purchase are within specified capital limitations;
    d. reviewing pledge agreements and secured liabilities and determining that—
       - proper custodial procedures have been followed,
       - eligible securities are pledged,
       - securities pledged are sufficient to secure the liability that requires securing,
       - Treasury Tax and Loan Remittance Option and Note Option are properly secured, and
       - private deposits are not being secured;

       (Information needed to perform the above steps will be contained in the pledge agreement; Treasury circulars 92 and 176, as amended.)

    e. reviewing accounting procedures to determine that—
       - investment premiums are being extinguished by maturity or call dates (12 CFR 1.11),
       - premium amortization is charged to operating income (12 CFR 1.11),
       - accretion of discount is included in current income for banks required to use accrual accounting for reporting purposes,
       - accretion of bond discount requires a concurrent accrual of deferred income tax payable, and
       - securities gains or losses are reported net of applicable taxes and net gains or losses are reflected in the period in which they are realized;
    f. determining if securities purchased under agreement to resell are in fact securities (not loans), are eligible for investment by the bank, and are within prescribed limits (12 USC 24 and 12 CFR 1). If not, determine whether the transaction is within applicable state legal lending limits;
    g. reviewing securities sold under agreement to repurchase and determining whether they are, in fact, deposits (Regulation D, 12 CFR 204.2(a)(1));
    h. determining that securities and money market investments held by foreign branches comply with section 211.3 of Regulation K—Foreign Branches of Member Banks (12 CFR 211.3) as to—
       - acquiring and holding securities (section 211.3(b)(3)) and

- underwriting, distributing, buying, and selling obligations of the national government of the country in which the branch is located (section 211.3(b)(4)); and

(Further considerations relating to the above are contained in other sections of Regulation K. Also review any applicable sections of Regulation T—Credit by Brokers and Dealers (12 CFR 220), Regulation X—Borrowers of Securities Credit (12 CFR 224), and Board Interpretations 6150 (regarding securities issued or guaranteed by the International Bank for Reconstruction and Development) and 6200 (regarding borrowing by a domestic broker from a foreign broker). Edge Act and agreement corporations are discussed in the Bank-Related Organizations section.

i. determining that the bank's equity investments in foreign banks comply with the provisions of section 25 of the Federal Reserve Act and section 211.5 of Regulation K as to—
   - investment limitations (section 211.5(b)) and
   - investment procedures (section 211.5(c)).

20. Test for compliance with other laws and regulations as follows:
    a. Review lists of affiliate relationships and lists of directors and principal officers and their interests.
       - Determine if the bank is an affiliate of a firm that primarily is engaged in underwriting or selling securities (12 USC 377).
       - Determine if directors or officers are engaged in or employed by firms that are engaged in similar activities (12 USC 78, 377, and 378). (It is an acceptable practice for bank officers to act as directors of securities companies not doing business in the United States, the stock of which is owned by the bank as authorized by the Board of Governors of the Federal Reserve System.)
       - Review the list of federal funds sold, securities purchased under agreements to resell, interest-bearing time deposits, and commercial paper, and determine if the bank is investing in money market instruments of affiliated banks or firms (section 23A, Federal Reserve Act, and 12 USC 371(c)).
       - Determine if transactions involving affiliates, insiders, or their interests have terms that are less favorable to the bank than transactions involving unrelated parties (sections 23A and 22, Federal Reserve Act, and 12 USC 371c, 375, 375a, and 375b).
    b. Determine if Federal Reserve stock equals 3 percent of the subject bank's booked capital and surplus accounts (Regulation I, 12 CFR 209).
    c. Review the nature and duration of federal-funds sales to determine if term federal funds are being sold in an amount exceeding the limit imposed by state legal lending limits.
21. With regard to potential unsafe and unsound investment practices and possible violations of the Securities Exchange Act of 1934, review the list of securities purchased and/or sold since the last examination and—
    a. determine if the bank engages one securities dealer or salesperson for virtually all transactions. If so—
       - evaluate the reasonableness of the relationship on the basis of the dealer's location and reputation and
       - compare purchase and sale prices to independently established market prices as of trade dates, if appropriate;
    b. determine if investment-account securities have been purchased from the bank's own trading department. If so—
       - independently establish the market price as of trade date,
       - review trading-account purchase and sale confirmations and determine if the security was transferred to the investment portfolio at market price, and
       - review controls designed to prevent dumping; and
    c. determine if the volume of trading activity in the investment portfolio appears unwarranted. If so—
       - review investment-account daily ledgers and transaction invoices to determine if sales were matched by a like amount of purchases,
       - determine whether the bank is financing a dealer's inventory,
       - compare purchase and sale prices with independently established market prices

as of trade dates, if appropriate. The carrying value should be determined by the market value of the securities as of the trade date, and
  - cross-reference descriptive details on investment ledgers and purchase confirmations to the actual bonds or safekeeping receipts to determine if the bonds delivered are those purchased.

22. Discuss with appropriate officer(s) and prepare report comments on—
    a. defaulted issues;
    b. speculative issues;
    c. incomplete credit information;
    d. absence of legal opinions;
    e. significant changes in maturity scheduling;
    f. shifts in the rated quality of holdings;
    g. concentrations;
    h. unbalanced earnings and risk considerations;
    i. unsafe and unsound investment practices;
    j. apparent violations of laws, rulings, and regulations and the potential personal liability of the directorate;
    k. significant variances from peer-group statistics;
    l. market-value depreciation, if significant;
    m. weaknesses in supervision;
    n. policy deficiencies; and
    o. material problems being encountered by the bank's Edge Act and agreement corporation affiliates, and other related international concerns, that could affect the condition of the bank.
23. The following guidelines are to be implemented while reviewing securities participations, purchases/sales, swaps, or other transfers. The guidelines are designed to ensure that securities transfers involving state member banks, bank holding companies, and nonbank affiliates are carefully evaluated to determine if they were carried out to avoid classification and to determine the effect of the transfer on the condition of the institution. In addition, the guidelines are designed to ensure that the primary regulator of the other financial institution involved in the transfer is notified.
    a. Investigate any situations in which securities were transferred before the date of examination to determine if any were transferred to avoid possible criticism during the examination.
    b. Determine whether any of the securities transferred were nonperforming at the time of transfer, classified at the previous examination, depreciated or subinvestment-grade, or for any other reason were considered to be of questionable quality.
    c. Review the bank's policies and procedures to determine whether or not securities purchased by the bank are given an independent, complete, and adequate credit evaluation. If the bank is a holding company subsidiary or a member of a chain banking organization, review securities purchases or participations from affiliates or other known members of the chain to determine if the securities purchases are given an *arm's-length* and *independent* credit evaluation by the purchasing bank.
    d. Determine whether or not any bank purchases of securities from an affiliate are in conformance with section 23A, which generally prohibits purchases of low-quality assets from an affiliate.
    e. Determine that any securities purchased by the bank are properly reflected on its books at fair market value (fair market value should at a minimum reflect both the rate of return being earned on such assets and an appropriate risk premium). Determine that appropriate write-offs are taken on any securities sold by the bank at less than book value.
    f. Determine that transactions involving transfers of low-quality securities to the parent holding company or a nonbank affiliate are properly reflected at fair market value on the books of both the bank and the holding company affiliate.
    g. If poor-quality securities were transferred to or from another financial institution for which the Federal Reserve is not the primary regulator, prepare a memorandum to be submitted to the Reserve Bank supervisory personnel. The Reserve Bank will then inform the local office of the primary federal regulator of the other institution involved in the transfer. The memorandum should include the following information, as applicable:
       - name of originating and receiving institutions
       - type of securities involved and type of transfer (i.e., participation, purchase/sale, swap)

- date(s) of transfer
- total number and dollar amount of securities transferred
- status of the securities when transferred (e.g., rating, depreciation, nonperforming, classified, etc.)
- any other information that would be helpful to the other regulator.

24. Reach a conclusion regarding the quality of department management. Communicate your conclusion to the examiner assigned ‘‘Management Assessment’’ and the examiner who is in charge of the international examination, if applicable.
25. Update workpapers with any information that will facilitate future examination. If the bank has overseas branches, indicate those securities requiring review during the next overseas examination and the reasons for the review.

Review the bank's internal controls, policies, practices, and procedures regarding purchases, sales, and servicing of the investment portfolio. The bank's system should be documented in a complete, concise manner and should include, where appropriate, narrative descriptions, flow charts, copies of forms used, and other pertinent information. Items marked with an asterisk require substantiation by observation or testing.

POLICIES

1. Has the board of directors, consistent with its duties and responsibilities, adopted written investment securities policies, including WI securities, futures, and forward placement contracts, that outline—
   a. objectives,
   b. permissible types of investments,
   c. diversification guidelines to prevent undue concentration,
   d. maturity schedules,
   e. limitation on quality ratings,
   f. policies regarding exceptions to standard policy, and
   g. valuation procedures and frequency?
2. Are investment policies reviewed at least annually by the board to determine if they are compatible with changing market conditions?
3. Are securities designated at time of purchase as to whether they are investments for the portfolio or trading account?
4. Have policies been established governing the transfer of securities from the trading account to the investment-securities account?
5. Have limitations been imposed on the investment authority of officers?

*6. Do security transactions require dual authorization?

7. If the bank has due from commercial banks or other depository institutions time, federal funds sold, commercial paper, securities purchased under agreements to resell, or any other money market type of investment—
   a. is purchase or sale authority clearly defined,
   b. are purchases or sales reported to the board of directors or its investment committee,
   c. are maximums established for the amount of each type of asset,
   d. are maximums established for the amount of each type of asset that may be purchased from or sold to any one bank,
   e. do money market investment policies outline acceptable maturities, and
   f. have credit standards and review procedures been established?

CUSTODY OF SECURITIES

*8. Do procedures preclude the custodian of the bank securities from—
   a. having sole physical access to securities;
   b. preparing release documents without the approval of authorized persons;
   c. preparing release documents not subsequently examined or tested by a second custodian; and
   d. performing more than one of the following transactions: (1) execution of trades, (2) receipt or delivery of securities, (3) receipt and disbursement of proceeds?

*9. Are securities physically safeguarded to prevent loss or unauthorized removal or use?

10. Are securities, other than bearer securities, held only in the name or nominee of the bank?
11. When a negotiable certificate of deposit is acquired, is the certificate safeguarded in the same manner as any other negotiable investment instrument?

RECORDS

12. Do subsidiary records of investment securities show all pertinent data describing the security; its location; pledged or unpledged status; premium amortization; discount accretion; and interest earned, collected, and accrued?

*13. Is the preparation and posting of subsidiary records performed or reviewed by persons who do not also have sole custody of securities?

*14. Are subsidiary records reconciled at least monthly to the appropriate general-ledger accounts, and are reconciling items investigated by persons who do not also have sole custody of securities?

15. For international-division investments, are entries for U.S. dollar carrying values of foreign currency–denominated securities rechecked at inception by a second person?

PURCHASES, SALES, AND REDEMPTIONS

*16. Is the preparation and posting of security and open contractual commitments purchase, sale, and redemption records performed or reviewed by persons who do not also have sole custody of securities or authorization to execute trades?

*17. Are supporting documents, such as brokers' confirmations and account statements for recorded purchases and sales checked or reviewed subsequently by persons who do not also have sole custody of securities or authorization to execute trades?

*18. Are purchase confirmations compared to delivered securities or safekeeping receipts to determine if the securities delivered are the securities purchased?

FUTURES CONTRACTS, FORWARD PLACEMENT CONTROLS

19. Do futures and forward contract policies—
    a. outline specific strategies and
    b. relate permissible strategies to other banking activities?
20. Are the formalized procedures used by the trader—
    a. documented in a manual and
    b. approved by the board or an appropriate board committee?
21. Are the bank's futures commission merchant(s) and/or forward brokers—
    a. notified in writing to trade with only those persons authorized as traders and
    b. notified in writing of revocation of trading authority?
22. Has the bank established futures and forward trading limits—
    a. for individual traders,
    b. for total outstanding contracts,
    c. which are endorsed by the board or an appropriate board committee, and
    d. the basis of which is fully explained?
23. Does the bank obtain prior written approval detailing amount of, duration, and reason—
    a. for deviations from individual limits and
    b. for deviations from gross trading limits?
24. Are these exceptions subsequently submitted to the board or an appropriate board committee for ratification?
25. Does the trader prepare a prenumbered trade ticket?
26. Does the trade ticket contain all of the following information:
    a. trade date
    b. purchase or sale
    c. contract description
    d. quantity
    e. price
    f. reason for trade
    g. reference to the position being matched (immediate or future case settlement)
    h. signature of trader
27. Are the accounting records maintained and controlled by persons who cannot initiate trades?
28. Are accounting procedures documented in a procedures manual?
29. Are all incoming trade confirmations—
    a. received by someone independent of the trading and recordkeeping functions and
    b. verified to the trade tickets by this independent party?
30. Does the bank maintain general-ledger control accounts disclosing, at a minimum—
    a. futures or forward contracts memoranda accounts,
    b. deferred gains or losses, and
    c. margin deposits?
31. Are futures and forward contracts activities—
    a. supported by detailed subsidiary records and
    b. agreed daily to general-ledger controls by someone who is not authorized to prepare general-ledger entries?

32. Do periodic statements received from futures commission merchants reflect—
    a. trading activity for the period,
    b. open positions at the end of the period,
    c. market value of open positions,
    d. unrealized gains and losses, and
    e. cash balances in accounts?
33. Are all of these periodic statements—
    a. received by someone independent of both the trading and recordkeeping functions and
    b. reconciled to all of the bank's accounting records?
34. Are the market prices reflected on the statements—
    a. verified with listed prices from a published source and
    b. used to recompute gains and losses?
35. Are daily reports of unusual increases in trading activity reviewed by senior management?
36. Are weekly reports prepared for an appropriate board committee which reflect—
    a. all trading activity for the week,
    b. open positions at the end of the week,
    c. market value of open positions,
    d. unrealized gains and losses,
    e. total trading limits outstanding for the bank, and
    f. total trading limits for each authorized trader?
37. Is the futures and forward contracts portfolio revalued monthly to market value or to the lower of cost or market?
38. Are revaluation prices provided by persons or sources totally independent of the trading function?

OTHER

39. Does the board of directors receive regular reports on domestic and international-division investment securities which include—
    a. valuations,
    b. maturity distributions,
    c. average yield, and
    d. reasons for holding and benefits received (international-division and overseas holdings only)?
40. Are purchases, exchanges, and sales of securities and open contractual commitments ratified by action of the board of directors or its investment committee and thereby made a matter of record in the minutes?

CONCLUSION

41. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly and indicate any additional examination procedures deemed necessary.
42. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

INTRODUCTION

A bank operates as a securities dealer when it underwrites, trades, or deals in securities. These activities may be administered in a separately identifiable trading department or incorporated within the overall treasury department. The organizational structure will generally be a function of the level of activity and the importance of the activity as a product line. If a repetitive pattern of short-term purchases and sales demonstrates that the bank holds itself out to other dealers or investors as a securities dealer, the bank is trading, regardless of what department or section of the bank is engaged in the activity.

The authority under which a bank may engage in securities trading and underwriting is found in section 5136 of the Revised Statutes (12 USC 24 (seventh)). That authority is restricted by limitations on the percentage holding of classes of securities as found in 12 CFR 1.3. This regulation allows banks to deal, underwrite, purchase, and sell (1) type I securities without limit and (2) type II securities subject to a limit of 10 percent of capital and unimpaired surplus per issue. Banks are prohibited from underwriting or dealing in type III securities for their own accounts. See section 2020.1, ‘‘Investment Securities and End-User Activities,’’ for further information on types I, II, and III securities.

Banks are involved in three major types of securities transactions. First, the bank, acting as broker, buys and sells securities on behalf of a customer. These are agency transactions in which the agent (bank) assumes no substantial risk and is compensated by a prearranged commission or fee. A second type of securities transaction banks frequently execute is a ‘‘riskless-principal’’ trade. Upon the order of an investor, the dealer buys (or sells) securities through its own account, with the purchase and sale originating almost simultaneously. Because of the brief amount of time the security is held in the dealer’s own account, exposure to market risks is limited. Profits result from dealer-initiated markup (the difference between the purchase and sale prices). Finally, as a dealer, the bank buys and sells securities for its own account. This is termed a principal transaction because the bank is acting as a principal, buying or selling qualified securities through its own inventory and absorbing whatever market gain or loss is made on the transaction.

The volume of bank dealer activity and the dealer’s capacity in the transaction are critical to an examiner’s assessment regarding the examination scope and the required examiner resources and expertise. Dealers engaging primarily in agency or riskless-principal transactions are merely accommodating customers’ investment needs. Market risk will be nominal, and the key examination concern will be operational risk and efficiency. Active dealers generally carry larger inventory positions and may engage in some degree of proprietary trading. Their market-risk profile may be moderate to high.

Bank dealers’ securities transactions involve customers and other securities dealers. The word ‘‘customer,’’ as used in this section, means an investor. Correspondent banks purchasing securities for an investment account would also be considered a customer. Transactions with other dealers are not considered customer transactions unless the dealer is buying or selling for investment purposes.

The following subsections include general descriptions of significant areas of bank trading and underwriting activities. Foreign exchange is covered in detail in the ‘‘International’’ sections of this manual. Additional bank dealer activities, particularly in derivative products, are extensively covered in the *Trading and Capital-Markets Activities Manual*. In addition, many money-center banks and larger regional banks have transferred dealing activities to separately capitalized holding company subsidiaries (known as underwriting affiliates). The *Bank Holding Company Supervision Manual* contains a separate section on nonbank subsidiaries engaged in underwriting and dealing in bank-ineligible securities.

OVERVIEW OF RISK

For bank dealer activities, risk is generally defined as the potential for loss on an instrument or portfolio. Significant risk can also arise from operational weakness and inadequate controls. Risk management is the process by which managers identify, assess, and control all risks associated with a financial institution’s activities. The increasing complexity of the financial industry and the range of financial instruments banks use have made risk management more difficult to accomplish and evaluate.

The four fundamental elements for evaluating the risk-management process for bank dealer activities are—

- active board and management oversight,
- adequate risk-management policies and limits,
- appropriate risk measurement and management information systems, and
- comprehensive internal controls and audit procedures.

For risk management to be effective, an institution's board and senior management must be active participants in the process. They must ensure that adequate policies and risk-tolerance limits are developed for managing the risk in bank dealer activities, and they must understand, review, and approve these limits across all established product lines. For policies and limits to be effective and meaningful, risk measures, reports, and management information systems must provide management and the board with the information and analysis necessary to make timely and appropriate responses to changing conditions. Risk management must also be supported by comprehensive internal controls and audit procedures that provide appropriate checks and balances to maintain an ongoing process of identifying any emerging weaknesses in an institution's management of risk.[1] At a minimum, the effectiveness of the institution's policies, limits, reporting systems, and internal controls must be reviewed annually.

In assessing the adequacy of the above elements at individual institutions, examiners should consider the nature and volume of a bank's dealer activities and its overall approach toward managing the various types of risks involved. The sophistication or complexity of policies and procedures used to manage risk depends on the bank dealer's chosen products, activities, and lines of business. Accordingly, examiners should expect risk-management activities to differ among institutions.

1. Existing policies and examiner guidance on various topics applicable to the evaluation of risk-management systems can be found in SR-93-69, ''Examining Risk Management and Internal Controls for Trading Activities of Banking Organizations,'' and SR-95-17, ''Evaluating the Risk Management and Internal Controls of Securities and Derivative Contracts Used in Nontrading Activities.'' Many of the managerial and examiner practices contained in these documents are fundamental and are generally accepted as sound practices for both trading and nontrading activities.

As a financial institution's product offerings and geographic scope expand, examiners must review the risk-management process not only by business line, but on a global, consolidated basis. In more sophisticated institutions, the role of risk management is to identify the risks associated with particular business activities and to aggregate summary data into generic components, ultimately allowing exposures to be evaluated on a common basis. This methodology enables institutions to manage risks by portfolio and to consider exposures in relationship to the institution's global strategy and risk tolerance.

A review of the global organization may reveal risk concentrations that are not readily identifiable from a limited, stand-alone evaluation of a branch, agency, Edge Act institution, nonbank subsidiary, or head office. Consolidated risk management also allows the institution to identify, measure, and control its risks, while giving necessary consideration to the breakdown of exposure by legal entity. Sometimes, if applicable rules and laws allow, identified risks at a branch or subsidiary may be offset by exposures at another related institution. However, risk management across separate entities must be done in a way that is consistent with the authorities granted to each entity. Some financial institutions and their subsidiaries may not be permitted to hold, trade, deal, or underwrite certain types of financial instruments unless they have received special regulatory approval. Examiners should ensure that a financial institution only engages in those activities for which it has received regulatory approval. Furthermore, examiners should verify that the activities are conducted in accordance with any Board conditions or commitments attached to the regulatory approval.

Ideally, an institution should be able to identify its relevant generic risks and should have measurement systems in place to quantify and control these risks. While it is recognized that not all institutions have an integrated risk-management system that aggregates all business activities, the ideal management tool would incorporate a common measurement denominator. Risk-management methodologies in the marketplace and an institution's scope of business are continually evolving, making risk management a dynamic process. Nonetheless, an institution's risk-management system should always be able to identify, aggregate, and control all risks posed by underwriting, trading, or dealing in securities that could have a significant impact on capital or equity.

Trading and market-risk limits should be customized to address the nature of the products and any unique risk characteristics. Common types of limits include earnings-at-risk limits, stop-loss limits, limits on notional amounts (both gross and duration-weighted), maturity limits, and maturity-gap limits. The level of sophistication needed within the limit matrix will depend on the type of instrument involved and the relative level of trading activity. Straightforward notional and tenor limits may be adequate for most dealers; however, dealers involved in a wide array of products and more complex transactions will need stronger tools to measure and aggregate risk across products.

In general, risk from trading and dealing activities can be broken down into the following categories:

- Market or price risk is the exposure of an institution's financial condition to adverse movements in the market rates or prices of its holdings before such holdings can be liquidated or expeditiously offset. It is measured by assessing the effect of changing rates or prices on either the earnings or economic value of an individual instrument, a portfolio, or the entire institution.
- Funding-liquidity risk refers to the ability to meet investment and funding requirements arising from cash-flow mismatches.
- Market-liquidity risk refers to the risk of being unable to close out open positions quickly enough and in sufficient quantities at a reasonable price.
- Credit risk is the risk that a counterparty to a transaction will fail to perform according to the terms and conditions of the contract, thus causing the security to suffer a loss in cash-flow or market value. Because securities settlements are typically ''delivery vs. payment'' and settlement periods are relatively short, securities transactions do not involve a significant level of counterparty credit risk. Repurchase transactions, securities lending, and money market transactions, however, involve significantly higher levels of credit risk if not properly controlled. As a result, credit risk is discussed in greater detail in the subsections addressing these products. Credit risk can also arise from positions held in trading inventory. Although U.S. government and agency securities do not generally involve credit risk, other securities (for example, municipal and corporate securities) carried in inventory can decline in price due to a deterioration in credit quality.
- Clearing or settlement risk is (1) the risk that a counterparty who has received a payment or delivery of assets defaults before delivery of the asset or payment or (2) the risk that technical difficulties interrupt delivery or settlement despite the counterparty's ability or willingness to perform.
- Operations and systems risk is the risk of human error or fraud, or the risk that systems will fail to adequately record, monitor, and account for transactions or positions.
- Legal risk is the risk that a transaction cannot be consummated as a result of some legal barrier, such as inadequate documentation, a regulatory prohibition on a specific counterparty, non-enforceability of bilateral and multilateral close-out netting, or collateral arrangements in bankruptcy.

The *Trading and Capital-Markets Activities Manual* contains a comprehensive discussion of these risks, including examination objectives, procedures, and internal control questionnaires by risk category.

GOVERNMENT AND AGENCY SECURITIES

The government securities market is dominated by a number of investment banks, broker-dealers, and commercial banks known as primary dealers in government securities. These dealers make an over-the-counter market in most government and federal-agency securities. Primary dealers are authorized to deal directly with the Open Market Desk of the Federal Reserve Bank of New York. As market makers, primary dealers quote bid/ask prices on a wide range of instruments, and many publish daily quotation sheets or provide live electronic data feeds to larger customers or other dealers.

Government security trading inventories are generally held with the objective of making short-term gains through market appreciation and dealer-initiated markups. Common factors that affect the markup differential include the size of a transaction, the dealer efforts extended, the type of customer (active or inactive), and the nature of the security. Markups on government securities generally range between 1⁄32 and 4⁄32 of a point. Long-maturity issues or derivative products may have higher markups due to the higher risk and potentially larger volatility that may be inherent in these products.

According to industry standards, payments for and deliveries of U.S. government and most agency securities are settled one business day following the trade date, although government dealers and customers can negotiate same-day or delayed settlement for special situations.

When-Issued Trading

A significant potential source of risk to dealers involves ''when-issued'' (WI) trading in government securities. WI trading is the buying and selling of securities in the one- to two-week interim between the announcement of an offering and the security auction and settlement. Although the vast majority of transactions settle on the next business day, WI trading results in a prolonged settlement period. This could increase both the market risk and counterparty credit risk associated with trading these instruments. The prolonged settlement period also provides an opportunity for a dealer to engage in a large volume of off-balance-sheet trading without having to fund the assets or cover the short positions. In essence, WI trading allows the dealers to create securities. If the overall level of WI trading is significant in relation to the size of the issue, the resulting squeeze on the market could increase volatility and risk. Given these potential risk characteristics, WI trading should be subject to separate sublimits to cap the potential exposure.

Short Sales

Another area of U.S. government securities activity involves short-sale transactions. A short sale is the sale of a security that the seller does not own at the time of the sale. Delivery may be accomplished by buying the security or by borrowing the security. When the security delivered is borrowed, the short seller likely will ultimately have to acquire the security in order to satisfy its repayment obligation. The borrowing transaction is collateralized by a security (or securities) of similar value or cash (most likely the proceeds of the short sale). Reverse repurchase transactions are also used to obtain the security needed to make delivery on the security sold short. Carrying charges on borrowed government securities should be deducted from the short sale and purchase spread to determine net profit. Short sales are conducted to (1) accommodate customer orders, (2) obtain funds by leveraging existing assets, (3) hedge the market risk of other assets, or (4) allow a dealer to profit from a possible future decline in market price by purchasing an equivalent security at a later date at a lower price.

Government Securities Clearing

Securities-clearing services for the bulk of U.S. government securities transactions and many federal-agency-securities transactions are provided by the Federal Reserve as part of its electronic securities-transfer system. The various Federal Reserve Banks will wire transfer most government securities between the book-entry safekeeping accounts of the seller and buyer. The Federal Reserve's systems also are used to facilitate security borrowings, loans, and pledges.

Government Securities Act

In response to the failures of a number of unregulated government securities dealers between 1975 and 1985, Congress passed the Government Securities Act of 1986 (GSA). GSA established, for the first time, a federal system for the regulation of the entire government securities market, including previously unregulated brokers and dealers. The primary goal of GSA was to protect investors and ensure the maintenance of a fair, honest, and liquid market.

The GSA granted the Department of the Treasury (Treasury) authority to develop and implement rules for transactions in government and agency securities effected by government securities brokers or dealers (that is, securities firms as well as other financial institutions), and to develop and implement regulations relating to the custody of government securities held by depository institutions. The rules were intended to prevent fraudulent and manipulative acts and practices and to protect the integrity, liquidity, and efficiency of the government securities market. At the same time, the rules were designed to preclude unfair discrimination among brokers, dealers, and customers. Enforcement of the rules for the GSA is generally carried out by an institution's primary regulatory organization.

The rules for the GSA had the most significant effect on those entities that were not previously subject to any form of federal registration and regulation. These entities included not only firms registered as government securities brokers or dealers, but also firms registered as brokers or dealers trading in other securities and financial products. For the first time, the government securities activities of these entities were subject to the discipline of financial responsibility, customer protection, recordkeeping, and advertising requirements. For nonbank dealers, this regulation is enforced by a self-regulatory organization, the National Association of Securities Dealers, which conducts routine examinations under the oversight of the Securities and Exchange Commission (SEC).

The provisions of the GSA that had the most significant effect on government securities brokers and dealers (both bank and nonbank broker-dealers) relate to hold-in-custody repurchase agreement rules. Congress targeted this area because of abuses that had resulted in customer losses. Several requirements to strengthen customer protection were imposed: (1) written repurchase agreements must be in place, (2) the risks of the transactions must be disclosed to the customer, (3) specific repurchase securities must be allocated to and segregated for the customer, and (4) confirmations must be made and provided to the customer by the end of the day on which a transaction is initiated and on any day on which a substitution of securities occurs. For a more detailed description of the rules for the GSA requirements, see the procedures for the examination of government securities activities issued by the Board of Governors of the Federal Reserve System, or 17 CFR 400–450 for the actual text of the regulations.

Registration Exemptions

Most banks acting as government securities brokers or dealers are required to file a form known as a G-FIN. This form details the bank's capacity, the locations where government securities activities are performed, and the persons responsible for supervision. However, certain bank government securities activities are exempt from the filing requirements. Banks handling only U.S. savings bond transactions or submitting tender offers on original issue U.S. Treasury securities are exempt from registration.

Limited government securities brokerage activities are also exempt from registration under certain circumstances. Banks that engage in fewer than 500 government securities transactions annually (excluding savings bond transactions and Treasury tender offers) are exempt. Similarly, banks are exempt if they deal with a registered broker-dealer under a ‘‘networking’’ arrangement, assuming they meet the following conditions: (1) the transacting broker must be clearly identified, (2) bank employees perform only clerical or administrative duties and do not receive transaction-based compensation, and (3) the registered broker-dealer receives and maintains all required information on each customer. Exempt networking arrangements must be fully disclosed to the customer. Finally, banks are exempt from registration requirements if their activities are limited to purchases and sales in a fiduciary capacity or purchases and sales of repurchase or reverse repurchase agreements.

The preceding exemptions provide relief from registration, but exempt banks must comply (if applicable) with regulations addressing custodial holdings for customers (17 CFR 450). Additionally, banks effecting repurchase/reverse repurchase agreements must comply with repurchase-transaction requirements detailed in 17 CFR 403.5(d).

MUNICIPAL SECURITIES

Municipal securities are debt obligations issued by state and local governments and certain agencies and authorities. There are two broad categories of municipal bonds: general obligation bonds and revenue bonds. General obligation bonds (GOs) are backed by the full faith and credit and taxing authority of the government issuer. General obligation bonds are either limited- or unlimited-tax bonds. Limited-tax bonds are issued by government entities whose taxing authority is limited to some extent by law or statute. For instance, a local government may face restrictions on the level of property taxes it can levy on property owners. State and local entities may also issue special tax bonds, which are supported by a specific tax. For instance, a highway project may be financed by a special gasoline tax levied to pay for the bonds. Unlimited-tax bonds are issued by government entities that are not restricted by law or statute in the amount of taxes they can levy; however, there may be some political limitations.

Municipal revenue bonds are backed by a specific project or government authority, and they are serviced by fees and revenues paid by users of the government entity. Revenue bonds are backed by public power authorities, non-profit hospitals, housing authorities, transportation authorities, and other public and quasi-public entities.

Effective March 13, 2000, well-capitalized state member banks were authorized by the Gramm-Leach-Bliley Act (GLB Act) to deal in, underwrite, purchase, and sell municipal revenue bonds without any limitations based on the bank's capital. (See 12 USC 24 (seventh).) Previously, banks were limited to only underwriting, dealing in, or investing in, without limitation, general obligation municipal bonds backed by the full faith and credit of an issuer with general powers of taxation. Member banks could invest in, but not underwrite or deal in, municipal revenue bonds, but the purchases and sales of such investment securities for any obligor were limited to 10 percent of a member bank's capital and surplus. As a result of the GLB Act amendment, municipal revenue bonds are the equivalent of type I securities for well-capitalized state member banks.[2] (See SR-01-13.) Banks that are not well capitalized may engage in more limited municipal securities activities relating to type II and type III securities. For example, banks may also deal in, underwrite, or invest in revenue bonds that are backed by housing, university, or dormitory projects.

In addition to municipal bonds, state and local governments issue obligations to meet short-term funding needs. These obligations are normally issued in anticipation of some specific revenue. The types of debt issued include tax-anticipation notes (TANs), revenue-anticipation notes (TRANs), grants-anticipation notes (GANs), bond-anticipation notes (BANs), commercial paper, and others.

2. The Office of the Comptroller of the Currency published final amendments to its investment securities regulation (12 CFR 1) on July 2, 2001. (See 66 *Fed. Reg.* 34784.)

Because of the large number and diverse funding needs of state and local governments (over 50,000 state and local governments have issued debt in the United States), there is a wide variety of municipal securities. Some municipal security issues have complex structures that require an increased level of technical expertise to evaluate. As with all areas of banking, dealers who invest in complex instruments are expected to understand the characteristics of the instruments and how these instruments might affect their overall risk profile. While there are some large issuers, like the states of New York and California, most issuers are small government entities that place modest amounts of debt. Many of these issues are exempt from federal, state, and local income taxes; these exemptions, in part, determine the investor base for municipal bonds.

The customer base for tax-exempt municipal securities is investors who benefit from income that is exempt from federal income tax. This group includes institutional investors such as insurance companies, mutual funds, and retail investors, especially individuals in high income-tax brackets.

Credit Risk

Municipal securities activities involve differing degrees of credit risk depending on the financial capacity of the issuer. Larger issuers of municipal securities are rated by nationally recognized rating agencies (Moody's, S&P, etc.). Other municipalities achieve an investment-grade rating through the use of credit enhancements, usually in the form of a standby letter of credit issued by a financial institution. Banks are also involved in underwriting and placing nonrated municipal securities. Nonrated issues are typically small and are placed with a limited number of investors. Liquidity in the secondary market is limited, and bank dealers rarely carry nonrated issues in trading inventory.

Management should take steps to limit undue concentrations of credit risk arising from municipal security underwriting and dealing. Exposure to nonrated issuers should be approved through the bank's credit-approval process with appropriate documentation to support the issuer's financial capacity. Activity in nonrated issues outside the bank's target or geographic market should also be avoided. In addition, exposure should be aggregated on a consolidated basis, taking into account additional credit risk arising from traditional banking products (loans, letters of credit, etc.).

Municipal Securities Rulemaking Board

The Securities Act Amendments of 1975 (15 USC 78o-4) extended a comprehensive network of federal regulation to the municipal securities markets. Pursuant to the act, municipal securities brokers and dealers are required to register with the SEC. The act also created a separate, self-regulatory body, the Municipal Securities Rulemaking Board (MSRB), to formulate working rules for the regulation of the municipal securities industry. The Federal Reserve is required to ensure compliance with those rules as they apply to state member banks.

A bank engaged in the business of buying and selling municipal securities must register with the SEC as a municipal securities dealer if it is involved in—

- underwriting or participating in a syndicate or joint account for the purpose of purchasing securities;
- maintaining a trading account or carrying dealer inventory; or
- advertising or listing itself as a dealer in trade publications, or otherwise holding itself out to other dealers or investors as a dealer.

Generally, a bank that buys and sells municipal securities for its investment portfolio or in a fiduciary capacity is not considered a dealer.

If a bank meets the SEC's criteria for registering as a municipal securities dealer, it must maintain a separately identifiable department or division involved in municipal securities dealing that is under the supervision of officers designated by the bank's board of directors. These designated officers are responsible for municipal securities dealer activities and should maintain separate records.

The Federal Reserve conducts a separate examination of the municipal securities dealer activities in banks that engage in such activities. This examination is designed to ensure compliance with the rules and standards formulated by the MSRB. For a complete description of the activities of a municipal securities dealer and detailed procedures performed by the Federal Reserve examiners, see the *Municipal Securities Dealer Bank Examination Manual* issued by the Board of Governors of the Federal Reserve System.

REPURCHASE AGREEMENTS AND SECURITIES LENDING

Repurchase agreements (repos) play an important role in the securities markets. A repo is the simultaneous agreement to sell a security and repurchase it at a later date. Reverse repos are the opposite side of the transaction, securities purchased with a later agreement to resell. From the dealer's perspective, a repo is a financing transaction (liability), and a reverse repo is a lending transaction (asset). Overnight repos are a one-day transaction; anything else is referred to as a "term repo." Approximately 80 percent of the repo market is overnight. Although any security can be used in a repurchase transaction, the overwhelming majority of transactions involve government securities.

Securities dealers use repos as an important source of liquidity. The majority of government securities trading inventory will typically be financed with repos. Reverse repos are used to obtain securities to meet delivery obligations arising from short positions or from the failure to receive the security from another dealer. Reverse repos also are an effective and low-risk means to invest excess cash on a short-term basis.

The repo rate is a money market rate that is lower than the federal funds rate due to the collateralized nature of the transaction. Opportunities also arise to obtain below-market-rate financing. This situation arises when demand exceeds supply for a specific bond issue and it goes on "special." Dealers who own the bond or control it under a reverse repo transaction can earn a premium by lending the security. This premium comes in the form of a below-market-rate financing cost on a repo transaction.

Many of the larger dealers also engage in proprietary trading of a matched book, which consists of a moderate to large volume of offsetting repos and reverse repos. The term "matched book" is misleading as the book is rarely perfectly matched. Although profit may be derived from the capture of a bid/ask spread on matched transactions, profit is more often derived from maturity mismatches. In a falling-rate environment, traders lend long (reverse repos) and borrow short (repos). It is more difficult to profit in rising-rate environments because of the shape of the yield curve, which is usually upward-sloping. The overall size of the matched book and the length of the maturity mismatches will generally decline in a rising environment. Matched books are also used to create opportunities to control securities that may go on special, resulting in potential profit opportunities. Dealers engaging in matched-book trading provide important liquidity to the repo market.

Risk in a matched book should be minimized by establishing prudent limits on the overall size of the book, size of maturity mismatches, and restrictions on the maximum tenor of instruments. The overall risk of a matched book is usually small in relation to other trading portfolios. Maturity mismatches are generally short-term, usually 30 to 60 days, but may extend up to one year. Risk can be quickly neutralized by extending the maturity of assets or liabilities. Financial instruments (futures and forward rate agreements) can also be used to reduce risk.

Securities dealers may also engage in ‘‘dollar-roll’’ transactions involving mortgage-backed securities, which are treated as secured financings for accounting purposes. The ‘‘seller’’ of the security agrees to repurchase a ‘‘substantially identical’’ security from the ‘‘buyer,’’ rather than the same security. Many of the supervisory considerations noted above for repurchase agreements also apply to dollar-roll transactions. However, if the security to be repurchased is not substantially identical to the security sold, the transaction generally should be accounted for as a sale and not as a financing arrangement. The accounting guidance for ‘‘substantially identical’’ is described in American Institute of Certified Public Accountants (AICPA) Statement of Position 90-3, which generally requires debt instruments to have the same primary obligor or guarantor, the same form and type, the identical contractual interest rate, the same maturity or weighted average maturity, and other factors.

In addition, securities dealers may engage in securities lending or borrowing transactions. In substance, these transactions are very similar to repo transactions except the transactions have no stated maturity. The transactions are conducted through open-ended ‘‘loan’’ agreements that may be terminated on short notice by the lender or borrower. Although lending transactions have historically been centered in corporate debt and equity obligations, the market increasingly involves loans of large blocks of U.S. government and federal-agency securities. To participate in this market, a bank may lend securities held in its investment account or trading account. Like repos, securities are lent to cover fails (securities sold but not available for delivery) and short sales. Collateral for the transactions can consist of other marketable securities or standby letters of credit; however, the large majority of transactions are secured by cash. Investors are willing to lend securities due to the additional investment income that can be earned by investing the cash collateral. When a securities loan is terminated, the securities are returned to the lender and the collateral to the borrower.

Credit Risk

Since repurchase agreements and securities lending transactions are collateralized, credit risk is relatively minor if properly controlled. Some dealers have underestimated the credit risk associated with the performance of the counterparty and have not taken adequate steps to ensure their control of the securities serving as collateral. The market volatility of the securities held as collateral can also add to the potential credit risk associated with the transaction.

As an added measure of protection, dealers require customers to provide excess collateral. This excess is referred to as ‘‘margin.’’ The size of the margin will be a function of the volatility of the instrument serving as collateral and the length of the transaction. In addition to initial margin, term repos and security lending arrangements require additional margin if the value of the collateral declines below a specified level. Excess margin is usually returned to the counterparty if the value of the collateral increases. A daily ‘‘mark-to-market’’ or valuation procedure must be in place to ensure that calls for additional collateral are made on a timely basis. The valuation procedures should be independent of the trader and take into account the value of accrued interest on debt securities. It is important to point out that credit risk can arise from both asset transactions (reverse repos and securities borrowed) and liability transactions (repos and securities lent) because of market fluctuations in collateral provided and received. Dealers should take steps to ensure that collateral provided is not excessive.

Policies and procedures should be in place to ensure transactions are conducted only with approved counterparties. Credit-limit approvals should be based on a credit analysis of the borrower. An initial review should be performed before establishing a relationship, with periodic reviews thereafter. Credit reviews should include an analysis of the bor-rower's financial statement, capital, management, earnings, business reputation, and any other relevant factors. Analyses should be performed in an independent department of the lender institution, by persons who routinely perform credit analyses. Analyses performed solely by the person managing the repo or securities lending programs are not sufficient. Credit and concentration limits should take into account other extensions of credit by other departments of the bank or affiliates. Procedures should be established to ensure that credit and concentration limits are not exceeded without proper authorization from management.

Other Uses and Implications of Securities Lending

In addition to lending their own securities, financial institutions have become increasingly involved in lending customers' securities held in custody, safekeeping, trust, or pension accounts. These activities are typically organized within the bank's trust department. Not all institutions that lend securities or plan to do so have relevant experience. Because the securities available for lending often greatly exceed the demand, inexperienced lenders may be tempted to ignore commonly recognized safeguards. Bankruptcies of broker-dealers have heightened regulatory sensitivity to the potential for problems in this area.

Fees received on securities loans are divided between the custodial institution and the customer account that owns the securities. In situations involving cash collateral, part of the interest earned on the temporary investment of cash is returned to the borrower and the remainder is divided between the lender institution and the customer account that owns the securities.

In addition to a review of controls, examiners should take steps to ensure that cash collateral is invested in appropriate instruments. Cash should be invested in high-quality, short-term money market instruments. Longer-term floating-rate instruments may also be appropriate; however, illiquid investments and products with customized features (for example, structured notes with imbedded options) should be avoided. Several banks have reported significant losses associated with inappropriate investments in securities lending areas.

Securities-Lending Capacity

Securities lending may be done in various capacities and with differing associated liabilities. It is important that all parties involved understand in what capacity the lender institution is acting. The relevant capacities are described below.

Principal

A lender institution offering securities from its own account is acting as principal. A lender institution offering customers' securities on an undisclosed basis is also considered to be acting as principal.

Agent

A lender institution offering securities on behalf of a customer-owner is acting as an agent. To be considered a bona fide or "fully disclosed" agent, the lending institution must disclose the names of the borrowers to the customer-owners and the names of the customer-owners to the borrowers (or give notice that names are available upon request). In all cases, the agent's compensation for handling the transaction should be disclosed to the customer-owner. Undisclosed agency transactions, that is, "blind brokerage" transactions in which participants cannot determine the identity of the contra party, are treated as if the lender institution were the principal.

Directed Agent

A lender institution that lends securities at the direction of the customer-owner is acting as a directed agent. The customer directs the lender institution in all aspects of the transaction, including to whom the securities are loaned, the terms of the transaction (rebate rate and maturity/call provisions on the loan), acceptable collateral, investment of any cash collateral, and collateral delivery.

Fiduciary

A lender institution that exercises discretion in offering securities on behalf of and for the benefit of customer-owners is acting as a fiduciary. For supervisory purposes, the underlying relationship may be as agent, trustee, or custodian.

Finder

A finder brings together a borrower and a lender of securities for a fee. Finders do not take possession of the securities or collateral. Delivery of securities and collateral is directly between the borrower and the lender, and the finder does not become involved. The finder is simply a fully disclosed intermediary.

MONEY MARKET INSTRUMENTS

In addition to bank-eligible securities activities, banks may engage in a substantial volume of trading in money market instruments. Federal funds, banker's acceptances, commercial paper, and certificates of deposit are forms of money market instruments. While these instruments may be used as part of the overall funding strategy, many firms actively engage in discretionary or proprietary trading in these instruments. As in matched-book repo activities, profits from trading money market instruments are derived from the bid/ask spread on matched transactions and the net interest spread from maturity mismatches.

This activity may result in overall money market arbitrage. Arbitrage is the coordinated purchase and sale of the same security or its equivalent, for which there is a relative price imbalance in the market. The objective of such activity is to obtain earnings by taking advantage of changing yield spreads. Arbitrage can occur with items such as Eurodollar CDs, banker's acceptances, and federal funds, and with financial instruments such as futures and forwards.

Although the risk of money market trading is relatively straightforward, the potential risk can be significant based on the volume of trading and size of the mismatches. Despite the potential risk, these activities may offer attractive profit opportunities if effectively controlled. Short-term interest-rate markets are very liquid, and risk can be quickly neutralized by changing the maturity profile of either assets or liabilities. Financial instruments (such as futures and forward rate agreements) can also be an effective tool to manage risk. Money market trading may be managed as a separate product line or may be integrated with trading in other interest-rate products (such as swaps, caps, or floors). Examiners should take steps to ensure that appropriate limits are in place for money market trading, including restrictions on aggregate notional size, the size of maturity mismatches, and the maximum tenor of instruments.

Federal Funds

Commercial banks actively use the federal funds market as a mechanism to manage fluctuations in the size and composition of their balance sheet. Federal funds are also an efficient means to manage reserve positions and invest excess cash on a short-term basis. Although transactions are generally unsecured, they can also be secured. The majority of transactions are conducted overnight; however, term transactions are also common. Federal funds trading will often involve term transactions in an attempt to generate positive net interest spread by varying the maturities of assets and liabilities.

Banks have traditionally engaged in federal funds transactions as principal, but an increasing number of banks are conducting business as agent. These agency-based federal funds transactions are not reported on the agent's balance sheet. Dealer banks may also provide federal funds clearing services to their correspondent banks.

Banker's Acceptances

Banker's acceptances are time drafts drawn on and accepted by a bank. They are the customary means of effecting payment for merchandise sold in import-export transactions, as well as a source of financing used extensively in international trade. Banker's acceptances are an obligation of the acceptor bank and an indirect obligation of the drawer. They are normally secured by rights to the goods being financed and are available in a wide variety of principal amounts. Maturities are generally less than nine months. Acceptances are priced like Treasury bills, with a discount figured for the actual number of days to maturity based on a 360-day year. The bank can market acceptances to the general public but must guarantee their performance.

Commercial Paper

Commercial paper is a generic term that is used to describe short-term, unsecured promissory notes issued by well-recognized and generally sound corporations. The largest issuers of commercial paper are corporations, bank holding companies, and finance companies, which use the borrowings as a low-cost alternative to bank financing. Commercial paper is exempt from registration under the Securities Act of 1933 if it meets the following conditions:

- prime quality and negotiable
- not ordinarily purchased by the general public
- issued to facilitate current operational business requirements
- eligible for discounting by a Federal Reserve Bank
- maturity does not exceed nine months

Actively traded commercial paper is ordinarily issued in denominations of at least $100,000 and often in excess of $1 million. Commercial paper issuers usually maintain unused bank credit lines to serve as a source of back-up liquidity or contingency financing, principally in the form of standby letters of credit. Major commercial paper issuers are rated by nationally recognized rating agencies (Moody's, S&P, and others). Other issuers achieve higher ratings through the use of a credit enhancement, usually in the form of a standby letter of credit issued by a financial institution.

Based on Supreme Court rulings, commercial paper was considered a security for purposes of the former Glass-Steagall Act. As a result, banks were generally prohibited from underwriting and dealing in commercial paper. Despite this restriction, banks participated in this market in an "agency capacity." When establishing a commercial paper dealership, many of the larger banks pursued business through an aggressive interpretation of an agency-transaction role. In practice, bank dealers engage in riskless-principal or best-efforts placement of commercial paper. Taking this logic a step further, others actively engage in competitive bidding and intraday distribution of newly issued paper. Because the paper settles on a same-day basis, the transactions are never part of the official end-of-day records of the bank. Although this technical point has been the subject of discussion, the practice has not been subject to regulatory challenge.

Commercial paper may be issued as an interest-bearing instrument or at a discount. Market trades are priced at a current yield, net of accrued interest due the seller or, if the commercial paper was issued at a discount, at a discount figured for the actual number of days to maturity based on a 360-day year.

The sale of commercial paper issued by bank affiliates must conform to legal restrictions and avoid conflicts of interest. Each certificate and confirmation should disclose the facts that the commercial paper is not a deposit and is not insured by the Federal Deposit Insurance Corporation.

Certificates of Deposit

Negotiable certificates of deposit (CDs) issued by money-center banks are actively traded in denominations of $100,000 to $1 million. Interest generally is calculated on a 360-day year and paid at maturity. Secondary-market prices are computed based on current yield, net of accrued interest due the seller. Eurodollar CDs trade like domestic CDs except their yields are usually higher and their maturities are often longer.

Credit-Risk and Funding Concentrations

In addition to market risk, money market policies and guidelines should recognize the credit risk inherent in these products. Federal funds sold and deposit placements are essentially unsecured advances. To avoid undue concentrations of credit risk, activity with these products should be limited to approved counterparties. Limits should be established for each prospective counterparty. Tenor limits should also be considered to reduce the potential for credit deterioration over the life of the transaction. The size of limits should be based on both anticipated activity and the counterparty's financial capacity to perform. The credit analysis should be performed by qualified individuals in a credit department that is independent from the money market dealing function. In assessing the creditworthiness of other organizations, institutions should not rely solely on outside sources, such as standardized ratings provided by independent rating agencies, but should perform their own analysis of a counterparty's or issuer's financial strength. At a minimum, limits should be reassessed and credit analyses updated annually. Once established, limits should be monitored with exceptions documented and approved by the appropriate level of senior management. Exposure should also be aggregated on a consolidated basis with any other credit exposure arising from other product areas. Exposure to foreign bank counterparties should also be aggregated by country of domicile to avoid country-risk concentrations. The limit structure should be reviewed to ensure compliance with the requirements of Regulation F, Limitations on Interbank Liabilities, which places prudent limits on credit exposure to correspondent banks.

Maintaining a presence in the wholesale funding markets requires a strong reputation and increases potential liquidity risk. The prolonged use of a large volume of purchased funds to support a money market trading operation could also reduce the capacity to tap this market, if needed, for core funding. Guidelines should be in place to diversify sources of funding. Contingency plans should include strategies to exit or reduce the profile in these markets if the situation warrants.

OPERATIONS AND INTERNAL CONTROLS

A bank dealer's operational functions should be designed to regulate the custody and movement of securities and to adequately account for trading transactions. Because of the dollar volume and speed of trading activities, operational inefficiencies can quickly result in major problems.

Sound Practices for Front- and Back-Office Operations

Bank dealer activities vary significantly among financial institutions, depending on the size and complexity of the trading products; trading, back-office, and management expertise; and the sophistication of systems. As a result, practices, policies, and procedures in place in one institution may not be necessary in another. The adequacy of internal controls requires sound judgment on the part of the examiner. The following is a list of policies and procedures that should be reviewed:

- Every organization should have comprehensive policies and procedures in place that describe the full range of bank dealer activities performed. These documents, typically organized into manuals, should at a minimum address front- and back-office operations; reconciliation guidelines and frequency; revaluation and accounting guidelines; descriptions of accounts; broker policies; a code of ethics; and the risk-measurement and -management methods, including a comprehensive limit structure.
- Every institution should have existing policies and procedures to ensure the segregation of duties among the trading, control, and payment functions.
- Revaluation sources should be independent from the traders for accounting purposes, risk oversight, and senior management reporting, although revaluation of positions may be conducted by traders to monitor positions.
- Trader and dealer telephone conversations should be taped to facilitate the resolution of disputes and to serve as a valuable source of information to auditors, managers, and examiners.
- Trade tickets and blotters (or their electronic equivalents) should be timely and complete to allow for easy reconciliation and for appropriate position and exposure monitoring. The volume and pace of trading may warrant virtually simultaneous creation of these records in some cases.

- Computer hardware and software applications must have the capacity to accommodate the current and projected level of trading activity. Appropriate disaster-recovery plans should be tested regularly.
- Every institution should have a methodology to identify and justify any off-market transactions. Ideally, off-market transactions would be forbidden.
- A clear institutional policy should exist for personal trading. If such trading is permitted at all, procedures should be established to avoid even the appearance of conflicts of interest.
- Every institution should ensure that the management of after-hours and off-premises trading, if permitted at all, is well documented so that transactions are not omitted from the automated blotter or the bank's records.
- Every institution should ensure that staff is both aware of and complies with internal policies governing the trader-broker relationship.
- Every institution that uses brokers should monitor the patterns of broker usage, be alert to possible undue concentrations of business, and review the list of approved brokers at least annually.
- Every institution that uses brokers should establish a policy that minimizes name substitutions of brokered transactions. All such transactions should be clearly designated as switches, and relevant credit authorities should be involved.
- Every institution that uses brokers for foreign-exchange transactions should establish a clear statement forbidding the lending or borrowing of brokers' points as a method to resolve discrepancies.
- Every organization should have explicit compensation policies to resolve disputed trades for all traded products. Under no circumstances should ''soft-dollar'' (the exchange of services in lieu of dollar compensation) or off-the-books compensation be permitted for dispute resolution.
- Every institution should have know-your-customer policies, and they should be understood and acknowledged by trading and sales staff.
- The designated compliance officer should perform a review of trading practices at least annually. In institutions with a high level of trading activity, interim reviews may be warranted.
- The organization should have an efficient confirmation-matching process that is fully independent from the dealing function. Documentation should be completed and exchanged as close to completion of a transaction as possible.
- Auditors should review trade integrity and monitoring on a schedule in accordance with its appropriate operational-risk designation.
- Organizations that have customers who trade on margin should establish procedures for collateral valuation and segregated custody accounts.

Fails

In some cases, a bank may not receive or deliver a security by settlement date. ''Fails'' to deliver for an extended time or a substantial number of cancellations are sometimes characteristic of poor operational control or questionable trading activities.

Fails should be controlled by prompt reporting and follow-up procedures. The use of multicopy confirmation forms enables operational personnel to retain and file a copy by settlement date and should allow for prompt fail reporting and resolution.

Revaluation

The frequency of independent revaluation should be driven by the level of an institution's trading activity. Trading operations with high levels of activity may need to perform daily revaluation; however, it is important to note that independent revaluations are less critical when inventory is turning over quickly or end-of-day positions are small. In these situations, the majority of profit and loss is realized rather than unrealized. Only unrealized profit and loss on positions carried in inventory are affected by a revaluation. At a minimum, every institution should conduct an independent revaluation at the end of each standard accounting period (monthly or quarterly). There will be situations when certain securities will be difficult to price due to lack of liquidity or recent trading activity. If management relies on trader estimates in these situations, a reasonableness test should be performed by personnel who are independent from the trading function. A matrix-pricing approach may also be employed. This involves the use of prices on similar securities (coupon, credit quality, and tenor) to establish market prices.

Control of Securities

Depository institutions need to adopt procedures to ensure that ownership of securities is adequately documented and controlled. While this documentation and control once involved taking physical possession of the securities either directly or through a third-party custodian, the securities markets are quickly moving to a book-entry system. In this context, safekeeping is more of a concept than a reality. As the markets change, documenting the chain of ownership becomes the primary mechanism to prevent losses arising from a counterparty default. This documentation involves the matching of incoming and outgoing confirmations and frequent reconcilements of all accounts holding securities (Federal Reserve, customer, custodian, and other dealers). When the dealer holds securities on behalf of its customers, similar safeguards also need to be in place. Although this documentation process can be burdensome, it is necessary to protect a dealer's interest in securities owned or controlled. Many active dealers have automated the reconcilement and matching process. This reduces the potential for human error and increases the likelihood that exceptions can be uncovered and resolved quickly.

Because of the relatively short periods of actual ownership associated with repurchase agreements, potential losses could be significant if prudent safeguards are not followed. Significant repo volume or matched-book trading activities only heighten this concern. To further protect their interests, dealers should enter into written agreements with each prospective repurchase-agreement counterparty. Although the industry is moving toward standardized master agreements, some degree of customization may occur. The agreements should be reviewed by legal counsel for their content and compliance with established minimum documentation standards. In general, these agreements should specify the terms of the transaction and the duties of both the buyer and seller. At a minimum, provisions should cover the following issues:

- acceptable types and maturities of collateral securities
- initial acceptable margin for collateral securities of various types and maturities
- margin maintenance, call, default, and sellout provisions
- rights to interest and principal payments
- rights to substitute collateral
- individuals authorized to transact business on behalf of the depository institution and its counterparty

Written agreements should be in place before commencing activities.

TRADING AND CAPITAL-MARKETS ACTIVITIES MANUAL

The *Trading and Capital-Markets Activities Manual*, developed by the Federal Reserve System, is a valuable tool to help examiners understand the complex and often interrelated risks arising from capital-markets activities. The products addressed in the previous subsections and their associated risks are covered in greater detail in the manual.

As noted in the preceding sections, and further addressed in the *Trading and Capital-Markets Activities Manual*, other trading instruments could be included in the bank dealer or money market trading operation. Financial instruments such as futures and forward rate agreements are often used to modify or hedge the risk associated with cash instruments (dealer inventory and money market positions). The bank dealer may also be involved in other instruments including asset-backed securities (mortgage-backed and consumer-receivable-backed). Other departments of the bank may also use securities products as part of an unrelated trading activity. For example, interest-rate-swap traders often use cash bonds to hedge or modify market-risk exposure. In this capacity, the swap desk would be a customer of the government securities dealer. These overlaps in product focus and usage make it critical for examiners to understand the organizational structure and business strategies before establishing examination scope.

OTHER ISSUES

Intercompany Transactions

Examiners should review securities and repurchase-agreement transactions with affiliates to determine compliance with sections 23A and 23B of the Federal Reserve Act. Money market transactions may also be subject to limitations under section 23A; however, these restrictions generally do not apply to transactions between bank subsidiaries that are80 percent or more commonly owned by a bank holding company. Intercompany transactions between securities underwriting affiliates and their bank affiliates should be carefully reviewed to ensure compliance with Board operating standards and sections 23A and 23B.

Agency Relationships

Many dealer banks engage in securities transactions only in an agency capacity. Acting as an agent means meeting customers' investment needs without exposing the firm to the price risk associated with dealing as principal. Risk is relatively low as long as appropriate disclosures are made and the bank does not misrepresent the nature or risk of the security.

Agency-based federal funds transactions are also becoming more common. By serving only as an agent to facilitate the transaction, a bank can meet its correspondent's federal funds needs without inflating the balance sheet and using capital. Examiners should review agency-based money market transactions to ensure that the transactions are structured in a manner that insulates the bank from potential recourse, either moral or contractual. If legal agreements are not structured properly, the courts could conclude that the agent bank was acting a principal. In this situation, the loss could be recognized by the agent bank, not its customer.

Although no single feature can determine whether an agency relationship really exists, the courts have recognized a variety of factors in distinguishing whether the persons to whom ''goods'' were transferred were buyers or merely agents of the transferor. Although some of these distinguishing factors may not apply to federal-funds transactions because they involve the transfer of funds rather than material goods, some parallels can be drawn. An agency relationship would appear to encompass, although not necessarily be limited to, the following elements:

- The agent bank must agree to act on behalf of the seller of the federal funds (''seller'') and not on its own behalf.
- The agent should fully disclose to all parties to the transaction that it is acting as agent on behalf of the seller and not on its own behalf.
- The seller, not the agent bank, must retain title to the federal funds before their sale to a purchasing institution.
- The seller, not the agent bank, must bear the risk of loss associated with the federal-funds sale.
- The agent bank's authority in selling federal funds and accounting for these sales to the seller should be controlled by the seller or by some guidelines to which the seller has agreed. The agent bank should sell only to those banks stipulated on a list of banks approved, reviewed, and confirmed periodically by the seller bank.
- The agent bank should be able to identify the specific parties (sellers and purchasers) to a federal-funds sale and the amount of each transaction for which the agent has acted.
- The agent bank's compensation should generally be based on a predetermined fee schedule or percentage rate (for example, a percentage based on the number or size of transactions). The agent should generally not receive compensation in the form of a spread over a predetermined rate that it pays to the seller. (If the agent bank's compensation is in the form of a spread over the rate it pays to the seller, this situation would appear to be more analogous to acting as a principal and suggests that the transactions should be reported on the ''agent's'' balance sheet.)

By structuring agency agreements to include provisions that encompass these factors and by conducting agency activities accordingly, agent banks can lower the possibility that they would be considered a principal in the event of a failure of a financial institution that had purchased funds through the agent. Generally, as a matter of prudent practice, each bank acting as an agent should have written agreements with principals encompassing the above elements and have a written opinion from legal counsel as to the bona fide nature of the agency relationships.

Selling through an agent should not cause a bank to neglect a credit evaluation of the ultimate purchasers of these funds. Under the more traditional mode of conducting federal-funds transactions, banks sell their federal funds to other banks, which in many instances are larger regional correspondents. These correspondent banks in turn may resell the federal funds to other institutions. Since the correspondent is acting as a principal in these sales, the banks selling the funds to the correspondent are generally not concerned about the creditworthiness of those purchasing the federal funds from the correspondent/principal. Rather, the original selling banks need to focus solely on the creditworthiness of their correspondent banks, with which they should be quite familiar.

However, when conducting federal-funds sales through an agent, selling banks, in addition to considering the financial condition of their agent, should also subject the ultimate purchasing banks to the same type of credit analysis that would be considered reasonable and prudent if the seller banks were lending directly to the ultimate borrowers rather than through agents. Banks selling federal funds through agents should not relinquish their credit-evaluation responsibilities to their agent banks.

REPORTING

Securities held for trading purposes and the income and expense that results from trading activities should be isolated by specific general ledger or journal accounts. The balances in those accounts should be included in the appropriate reporting categories for regulatory reporting.

Instructions for the Consolidated Report of Condition and Income (call report) require that securities, derivative contracts, and other items held in trading accounts be reported consistently at market value, or at the lower of cost or market value, with unrealized gains and losses recognized in current income. For further detail, refer to the glossary section of the call report instructions under ''trading account.'' With either method, the carrying values of trading-security inventories should be evaluated periodically (monthly or quarterly), based on current market prices. The increase or decrease in unrealized appreciation or depreciation resulting from that revaluation should be credited or charged to income. Periodic independent revaluation is the most effective means of measuring the trading decisions of bank management.

For reporting purposes, the trading department's income should include not only revaluation adjustments, but also profits and losses from the sale of securities, and other items related to the purchase and sale of trading securities. Interest income from trading assets, salaries, commissions, and other expenses should be excluded from trading income for reporting purposes; however, these items should be considered by management when evaluating the overall profitability of the business.

When the lender institution is acting as a fully disclosed agent, securities-lending activities need not be reported on the call report. However, lending institutions offering indemnification against loss to their customer-owners should report the associated contingent liability gross in Schedule RC-L as ''other significant commitments and contingencies.''

Recordkeeping and Confirmation Rules

Regulation H contains rules establishing uniform standards for bank recordkeeping, confirmation, and other procedures in executing securities transactions for bank customers. The regulation applies, in general, to those retail commercial activities where the bank effects securities transactions at the direction and for the account of customers. The purpose of the rules is to ensure that purchasers of securities are provided adequate information concerning a transaction and that adequate records and controls are maintained for securities transactions. Under the rules, banks are required to maintain certain detailed records concerning securities transactions, to provide written confirmations to customers under certain circumstances, and to establish certain written policies and procedures. The requirements generally do not apply to banks that make 200 or fewer securities transactions a year for customers (exclusive of transactions in U.S. government and agency obligations) and to transactions subject to the requirements of the MSRB.

Due Bills

A ''due bill'' is an obligation that results when a firm sells a security or money market instrument and receives payment, but does not deliver the item sold. Due bills issued should be considered as borrowings by the issuing firm, and alternatively, due bills received should be considered as lending transactions. Dealers should not issue due bills as a means of obtaining operating funds or when the underlying security can be delivered at settlement. Customers of the dealer enter transactions with an implicit understanding that securities transactions will be promptly executed and settled unless there is a clear understanding to the contrary. Consequently, dealers should promptly disclose the issuance of a due bill to a customer when funds are taken but securities or money market instruments are not delivered to the customer. Such disclosure should reference the applicable transaction; state the reason for the creation of a due bill; describe any collateral securing the due bill; and indicate that to the extent the market value of the collateral is insufficient, the customer may be an unsecured creditor of the dealer.

Due bills that are outstanding for more than three days and are unsecured could be construed as funding and should be reported as ''liabilities for borrowed monies'' on the call report. These balances are subject to reserve requirements imposed by Regulation D.

ESTABLISHING SCOPE

Obtaining an overview of the organization, management structure, products offered, and control environment is a critical step in the examination process. Based on this assessment, an examiner should determine the appropriate resources and skill level. In situations where an institution is active in either the government or municipal securities markets, it is essential to allocate additional resources for GSA and MSRB compliance. The assigned examiners should be familiar with the provisions of GSA and MSRB as well as with the related examination procedures. For active proprietary trading units, it is important to assign examiners who have a reasonable working knowledge of the concepts outlined in the *Trading Activities Manual*.

1. To determine if the policies, practices, procedures, and internal controls regarding bank dealer activities are adequate.
2. To determine if bank officers are operating in conformance with the established guidelines.
3. To evaluate the trading portfolio for credit quality and marketability.
4. To determine the scope and adequacy of the audit compliance functions.
5. To determine compliance with applicable laws and regulations.
6. To ensure investor protection.
7. To initiate corrective action when policies, practices, procedures, or internal controls are deficient or when violations of law or regulations have been noted.

1. If selected for implementation, complete or update the Bank Dealer Activities section of the Internal Control Questionnaire.
2. Based on the evaluation of internal controls and the work performed by internal/external auditors determine the scope of the examination.
3. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examination procedures. Also, obtain a listing of any deficiencies noted in the latest review done by internal/external auditors from the examiner assigned ''Internal Control,'' and determine if corrections have been accomplished.
4. Request that the bank provide the following schedules:
   a. An aged schedule of securities that have been acquired as a result of underwriting activities.
   b. An aged schedule of trading account securities and money market instruments held for trading or arbitrage purposes. Reflect commitments to purchase and sell securities and all joint account interests.
   c. A schedule of short-sale transactions.
   d. An aged schedule of due bills.
   e. A list of bonds borrowed.
   f. An aged schedule of ''fails'' to receive or deliver securities on unsettled contracts.
   g. A schedule of approved securities borrowers and approved limits.
   h. A schedule of loaned securities.
   i. A schedule detailing account names and/or account numbers of the following customer accounts:
      - Own bank trust accounts.
      - Own bank permanent portfolio.
      - Affiliated banks' permanent portfolio accounts.
      - Personal accounts of employees of other banks.
      - Accounts of brokers or other dealers.
      - Personal accounts of employees of other brokers or dealers.
   j. A list of all joint accounts entered into since the last examination.
   k. A list of underwriting since the last examination and whether such securities were acquired by negotiation or competitive bid.
   l. A list of all financial advisory relationships.
5. Agree balances of appropriate schedules to general ledger and review reconciling items for reasonableness.
6. Determine the extent and effectiveness of trading policy supervision by:
   a. Reviewing the abstracted minutes of meetings of the board of directors and/or of any appropriate committee.
   b. Determining that proper authorization for the trading officer or committee has been made.
   c. Ascertaining the limitations or restrictions on delegated authorities.
   d. Evaluating the sufficiency of analytical data used in the most recent board or committee trading department review.
   e. Reviewing the methods of reporting by department supervisors and internal auditors to ensure compliance with established policy and law.
   f. Reaching a conclusion about the effectiveness of director supervision of the bank's trading policy. Prepare a memo for the examiner assigned ''Duties and Responsibilities of Directors'' stating your conclusions. All conclusions should be supported by factual documentation.

(Before continuing, refer to steps 14 and 15. They should be performed in conjunction with the remaining examination steps.)

7. Ascertain the general character of underwriting and direct placement activities and the effectiveness of department management by reviewing underwriter files and ledgers, committee reports and offering statements to determine:
   a. The significance of underwriting activities and direct placements of type III securities as reflected by the volume of sales and profit or loss on operations. Compare current data to comparable prior periods.
   b. Whether there is a recognizable pattern in:
      - The extent of analysis of material

information relating to the ability of the issuer to service the obligation.
  - Rated quality of offerings.
  - Point spread of profit margin for unrated issues.
  - Geographic distribution of issuers.
  - Syndicate participants.
  - Bank's trust department serving as corporate trustee, paying agent and transfer agent for issuers.
  - Trustee, paying agent and transfer agent business being placed with institutions that purchase a significant percentage of the underwriter or private placement offering.

  c. The volume of outstanding bids. Compare current data to comparable prior periods.
  d. The maturity, rated quality and geographic distribution of takedowns from syndicate participations.
  e. The extent of transfer to the bank's own or affiliated investment or trading portfolios or to trust accounts and any policies relating to this practice.

8. Determine the general character of trading account activities and whether the activities are in conformance with stated policy by reviewing departmental reports, budgets and position records for various categories of trading activity and determining:
   a. The significance of present sales volume compared to comparable prior periods and departmental budgets.
   b. Whether the bank's objectives are compatible with the volume of trading activity.
9. Review customer ledgers, securities position ledgers, transaction or purchase and sales journals and analyze the soundness of the bank's trading practices by:
   a. Reviewing a representative sample of agency and contemporaneous principal trades and determining the commission and price mark-up parameters for various sizes and types of transactions.
   b. Selecting principal transactions that have resulted in large profits and determining if the transaction involved:
      - ''Buy-backs'' of previously traded securities.
      - Own bank or affiliated bank portfolios.
      - A security that has unusual quality and maturity characteristics.
   c. Reviewing significant inventory positions taken since the prior examination and determining if:
      - The quality and maturity of the inventory position was compatible with prudent banking practices.
      - The size of the position was within prescribed limits and compatible with a sound trading strategy.
   d. Determining the bank's exposure on offsetting repurchase transactions by:
      - Reviewing the maturities of offsetting re-po and reverse re-po agreements to ascertain the existence, duration, amounts and strategy used to manage unmatched maturity ''gaps'' and extended (over 30 days) maturities.
      - Reviewing records since the last examination to determine the aggregate amounts of:
        - — Matched repurchase transactions.
        - — Reverse re-po financing extended to one or related firms(s).
      - Performing credit analysis of significant concentrations with any single or related entity(ies).
      - Reporting the relationship of those concentrations to the examiners assigned ''Concentration of Credits'' and ''Funds Management.''
10. Determine the extent of risk inherent in trading account securities which have been in inventory in excess of 30 days and:
    a. Determine the dollar volume in extended holdings.
    b. Determine the amounts of identifiable positions with regard to issue, issuer, yield, credit rating, and maturity.
    c. Determine the current market value for individual issues which show an internal valuation mark-down of 10 percent or more.
    d. Perform credit analyses on the issuers of non-rated holdings identified as significant positions.
    e. Perform credit analyses on those issues with valuation write-downs considered significant relative to the scope of trading operations.
    f. Discuss plans for disposal of slow moving inventories with management and determine the reasonableness of those plans in light of current and projected market trends.
11. Using an appropriate technique, select issues

from the schedule of trading account inventory. Test valuation procedures by:

a. Reviewing operating procedures and supporting workpapers and determining if prescribed valuation procedures are being followed.
b. Comparing bank prepared market prices, as of the most recent valuation date, to an independent pricing source (use trade date ''bid'' prices).
c. Investigating any price differences noted.

12. Using an appropriate technique, select transactions from the schedule of short sales and determine:
    a. The degree of speculation reflected by basis point spreads.
    b. Present exposure shown by computing the cost to cover short sales.
    c. If transactions are reversed in a reasonable period of time.
    d. If the bank makes significant use of due-bill transactions to obtain funds for its banking business:
        - Coordinate with the examiner assigned ''Review of Regulatory Reports'' to determine if the bank's reports of condition reflect due bill transactions as ''liabilities for borrowed money.''
        - Report amounts, duration, seasonal patterns and budgeted projections for due bills to the examiner assigned ''Funds Management.''
13. If the bank is involved in agency-based federal funds activity:
    a. At the beginning or in advance of each examination of a banking organization which has been acting as an agent in the purchase and sale of federal funds for other institutions, examiners should obtain certain information which will help them determine the nature and extent of this activity. The information should include:
        - A brief description of the various types of agency relationships (i.e., involving federal funds or other money market activities) and the related transactions.
        - For each type of agency relationship, copies of associated forms, agency agreements, documents, reports and legal opinions. In addition, if the banking organization has documented its analysis of the risks associated with the activity, a copy of the analysis should be requested by the examiner.
        - For each type of agency relationship, a summary of the extent of the activity including:
            - — The number of institutions serviced as principals.
            - — The size range of the institutions (i.e., institutions serviced have total assets ranging from $______ to $______).
            - — General location of sellers and purchasers serviced under agency relationships (i.e., New York State, Midwest, etc.)
            - — Estimate of average daily volume of federal funds or money market instruments purchased and sold under agency relationships and the high and low volume over the period since the last examination inquiry (or since activity was begun, if more recent).
            - — Names of individuals in the bank that are responsible for these agency relationships.
        - A historical file of this information should be maintained in order to determine the nature, extent and growth of these activities over time.
    b. Once the examination work in this area has been started, the examiner should attempt to discern any situation, activity or deficiency in this area that might suggest that an agency relationship does *not* actually exist. A negative response to the following examination guidelines section dealing with agency agreements may signal such a deficiency. In addition, any other money market agency relationships that involve new or unusual financial transactions should be evaluated to determine the nature of the risks involved and compliance, to the extent applicable, with the guidelines.
    c. The examiner should determine that the banking organization's written policies, procedures, and other documentation associated with this activity are consistent with the Federal Reserve System's Examination Guidelines. If the bank does not have written policies the examiner should strongly advise that they be developed due to the complex nature of this activity and the potential risks associated with it.
    d. After reviewing the policies, procedures,

and appropriate documentation, the examiner should be able to respond positively to the following questions:

- Banking organizations acting as *agents in the sale of federal funds*[1]
  - — Has this form of activity been approved by the board of directors?
  - — Are the bank's individual agency arrangements and transactions:
    - supported by written agency agreements, and
    - reviewed and approved by appropriate officers?
  - — Do the written agency agreements that support this activity include provisions indicating that (a negative answer may indicate that the bank is not in fact an agent):
    - the agent bank will be acting *on behalf of the original or principal seller of federal funds (''seller'')* in conducting these activities and not on the agent bank's own behalf?
    - the agency relationship will be fully disclosed to all banks involved in the transactions?
    - the seller, and not the agent bank, must retain legal title to the federal funds before they are sold to a third party bank?
    - the seller, and not the agent bank, bears the risk of loss?
    - the agent bank's authority in selling federal funds and in accounting for this activity to the seller should be controlled by the seller or by standards to which it has agreed? To implement this, does the agreement or its attachments include the following seller-approved items:
      1. lists of banks to whom the agent may sell federal funds,[2] and
      2. limits on the amounts that can be sold to these banks?
  - — Does the agent have a written opinion from its legal counsel as to the bona fide nature of the agency relationship?
  - — Does the accounting and reporting system of the agent bank *enable* it to account for the federal funds transactions on a period basis (i.e., at least weekly) to the sellers? (Although more frequent accounting may not be required by the sellers, the agent on any day should have the capacity to identify for the seller the banks to whom the seller's funds have been sold.)
  - — Does the agent's accounting system identify *each bank* which has purchased federal funds from a particular seller bank and include (at least) the following information for *each bank* in which the funds are being invested?[3]
    - information to clearly identify the name and location of the bank (or other entity)
    - amount of federal funds sold and amount of interest earned
    - terms of transaction, and maturity date
    - lending limits agreed to
  - — Does the agent bank actually disclose to banks or other organizations that are part of these agency-based transactions that it is acting as agent?
  - — Is the agent bank's compensation in the form of a predetermined fee schedule or percentage rate based, for example, on the size of transactions, as opposed to compensation in the form of a spread over the rate that it pays to the seller bank? (If the agent bank's compensation is in the form of a spread over the rate it pays to the selling bank, this situation would appear to be more akin to acting as an intermediary and suggests that the

1. Although it is conceivable that a purchaser could engage an agent to *obtain* federal funds on its behalf, these guidelines focus primarily on situations where the seller has engaged an agent to sell federal funds on its behalf because the associated risks of such transactions are borne by the sellers and their agents.

2. Seller banks could conceivably design their lists of approved banks to encompass a large number of financially sound institutions and still be considered to be fulfilling this supervisory requirement.

3. The entities referred to as ''ultimate purchasers'' or ''ultimate borrowers'' are those that have the *responsibility to repay* the original seller bank, and not any intervening agents that may pass on the federal funds to these purchasers.

transactions should be reported on its balance sheet.)

- Banking organizations that are involved in agency-based federal funds relationships as *sellers*
  - — Does the bank support its transactions with written agency agreements?
  - — Does the seller bank evaluate the credit worthiness of the ultimate borrowers of federal funds and establish limits for each and are these limits periodically reviewed at least every six months?[3,4]
  - — Does the bank periodically (i.e., at least weekly) receive an accounting from the agent which includes the following information for *each bank* to whom the seller bank's federal funds were sold?
    - information to identify name and location of bank
    - amount of federal funds sold and interest earned
    - federal funds sales limits agreed to (if the seller bank is a principal)
  - — Is the bank's management and board of directors aware of and have they approved the agency relationship?
- Do internal and/or external auditors periodically review the policies, procedures, and internal controls associated with this activity and the activity's impact on the earnings and financial condition of the banking organization? Is their evaluation reported to management? (Applies to banks acting as *agents* in the sale of federal funds, *and* those banks involved as *sellers* of federal funds.)
- In addition to the items considered above, the examiner should determine what the impact of these transactions has been on the bank's earnings and financial condition. If the impact has been negative, or if the answer to any of the above questions is negative, the examiner should discuss these matters with bank management and seek remedial action.

14. Analyze the effectiveness of operational controls by reviewing recent cancellations and fail items that are a week or more beyond settlement date and determine:
    a. The amount of extended fails.
    b. The planned disposition of extended fails.
    c. If the control system allows a timely, productive follow-up on unresolved fails.
    d. The reasons for cancellations.
    e. The planned disposition of securities that have been inventoried prior to the recognition of a fail or a cancellation.
15. Determine compliance with applicable laws, rulings, and regulations by performing the following for:
    a. *12 CFR 1.3—Eligible Securities:*
       - Review inventory schedules of underwriting and trading accounts and determine if issues whose par value is in excess of 10 percent of the bank's captial and unimpaired surplus are type I securities.
       - Determine that the total par value of type II investments does not exceed 10 percent of the bank's capital and unimpaired surplus, based on the combination of holdings and permanent portfolio positions in the same securities.
       - Elicit management's comments and review underwriting records on direct placement of type III securities, and determine if the bank is dealing in type III securities for its own account by ascertaining if direct placement issues have been placed in own bank or affiliated investment portfolios or if underwriting proceeds were used to reduce affiliate loans.

    b. *Section 23A of the Federal Reserve Act (12 USC 371(c) and 375)—Preferential Treatment:* Obtain a list of domestic affiliate relationships and a list of directors and principal officers and their business interests from appropriate examiners and determine whether transactions, include securities clearance services, involving affiliates, insiders or their interests are on terms less favorable to the bank than those transactions involving unrelated parties.
    c. *Regulation D (12 CFR 204.2)—Due Bills:*

4. This requirement is intended to mean that seller banks should conduct the type of credit analysis that would be considered reasonable and prudent for a direct federal funds activity (i.e., those federal funds activities not conducted through agents).

- Review outstanding due bills and determine if:
  - — The customer was informed that a due bill would be issued instead of the purchased security.
  - — Safekeeping receipts are sent to safekeeping customers only after the purchased security has been delivered.
- Review due bills outstanding over three business days and determine if they are collateralized or properly reserved.
- Review collateralized due bills and determine if the liability is secured by securities of the same type and of comparable maturity and with a market value at least equal to that of the security that is the subject of the due bill.

d. *Regulation H (12 CFR 208.8(k))—Recordkeeping and Confirmation Requirements:* If the bank effects securities transactions at the direction and for the account of customers, determine if it is in compliance with this regulation by substantiating Internal Control questions 24–35.

16. Test for unsafe and unsound practices and possible violations of the Securities Exchange Act of 1934 by:
   a. Reviewing customer account schedules of own bank and affiliated bank permanent portfolios, trusts, other broker-dealers, employees of own or other banks and other broker-dealers. Use an appropriate technique to select transactions and compare trade prices to independently established market prices as of the date of trade.
   b. Reviewing transactions, including U.S. government tender offer subscription files, involving employees and directors of own or other banks and determine if the funds used in the transactions were misused bank funds or the proceeds of reciprocal or preferential loans.
   c. Reviewing sales to affiliated companies to determine that the sold securities were not subsequently repurchased at an additional mark-up and that gains were not recognized a second time.
   d. Reviewing commercial paper sales journals or confirmations to determine if the bank sells affiliate commercial paper. If so, determine if:
      - The bank sells affiliate-issued commercial paper to institutions and financially sophisticated individuals only.
      - Sales are generally denominated in amounts of $25,000 or more.
      - Each sale confirmation discloses that the affiliate-issued commercial paper is not an insured bank deposit.
   e. Reviewing securities position records and customer ledgers with respect to large volume repetitive purchase and sales transactions and:
      - Independently testing market prices of significant transactions which involve the purchase and resale of the same security to the same or related parties.
      - Investigating the purchase of large blocks of securities from dealer firms just prior to month end and their subsequent resale to the same firm just after the beginning of the next month.
   f. Reviewing lists of approved dealer firms and determining that the approval of any firm that handles a significant volume of agency transactions is based on competitive factors rather than deposit relationships.
   g. Reviewing customer complaint files and determining the reasons for such complaints.
17. Discuss with an appropriate officer and prepare report comments concerning:
   a. The soundness of trading objectives, policies and practices.
   b. The degree of legal and market risk assumed by trading operations.
   c. The effectiveness of analytical, reporting and control systems.
   d. Violations of law.
   e. Internal control deficiencies.
   f. Apparent or potential conflicts of interest.
   g. Other matters of significance.
18. Reach a conclusion regarding the quality of department management and state your conclusions on the management brief provided by the examiner assigned ''Management Assessment.''
19. Update workpapers with any information that will facilitate future examinations.

Review the bank's internal controls, policies, practices and procedures regarding bank dealer activities. The bank's system should be documented in a complete, concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used and other pertinent information. Items marked with an asterisk require substantiation by observation or testing.

This section applies to all bank dealer activities except those involving municipal securities, which are reviewed as part of a separate and distinct Municipal Bond Dealer Examination.

SECURITIES UNDERWRITING TRADING POLICIES

1. Has the board of directors, consistent with its duties and responsibilities, adopted written securities underwriting/trading policies that:
   a. Outline objectives?
   b. Establish limits and/or guidelines for:
      - Price mark-ups?
      - Quality of issues?
      - Maturity of issues?
      - Inventory positions (including when issued (WI) positions)?
      - Amounts of unrealized loss on inventory positions?
      - Length of time an issue will be carried in inventory?
      - Amounts of individual trades or underwriter interests?
      - Acceptability of brokers and syndicate partners?
   c. Recognize possible conflicts of interest and establish appropriate procedures regarding:
      - Deposit and service relationships with municipalities whose issues have underwriting links to the trading department?
      - Deposit relationships with securities firms handling significant volumes of agency transactions or syndicate participations?
      - Transfers made between trading account inventory and investment portfolio(s)?
      - The bank's trust department acting as trustee, paying agent, and transfer agent for issues which have an underwriting relationship with the trading department?
   d. State procedures for periodic, monthly or quarterly, valuation of trading inventories to market value or to the lower of cost or market price?
   e. State procedures for periodic independent verification of valuations of the trading inventories?
   f. Outline methods of internal review and reporting by department supervisors and internal auditors to insure compliance with established policy?
   g. Identify permissible types of securities?
   h. Ensure compliance with the rules of fair practice that:
      - Prohibit any deceptive, dishonest or unfair practice?
      - Adopt formal suitability checklists?
      - Monitor gifts and gratuities?
      - Prohibit materially false or misleading advertisements?
      - Adopt a system to determine the existence of possible control relationships?
      - Prohibit the use of confidential, nonpublic information without written approval of the affected parties?
      - Prohibit improper use of funds held on another's behalf?
      - Allocate responsibility for transactions with own employees and employees of other dealers?
      - Require disclosure on all new issues?
   i. Provide for exceptions to standard policy?
2. Are the underwriting/trading policies reviewed at least quarterly by the board to determine their adequacy in light of changing conditions?
3. Is there a periodic review by the board to assure that the underwriting/trading department is in compliance with its policies?

OFFSETTING RESALE AND REPURCHASE TRANSACTIONS

4. Has the board of directors, consistent with its duties and responsibilities, adopted written offsetting repurchase transaction policies that:
   a. Limit the aggregate amount of offsetting repurchase transactions?
   b. Limit the amounts in unmatched or extended (over 30 days) maturity transactions?
   c. Determine maximum time gaps for unmatched maturity transactions?
   d. Determine minimumly acceptable interest rate spreads for various maturity transactions.
   e. Determine the maximum amount of funds to be extended to any single or related firms through reverse re-po transactions, involving unsold (through forward sales) securities?
   f. Require firms involved in reverse re-po transactions to submit corporate resolutions stating the names and limits of individuals, who are authorized to commit the firm?
   g. Require submission of current financial information by firms involved in reverse re-po transactions?
   h. Provide for periodic credit reviews and approvals for firms involved in reverse re-po transactions?
   i. Specify types of acceptable offsetting repurchase transaction collateral (if so, indicate type __________).
5. Are written collateral control procedures designed so that:
   a. Collateral assignment forms are used?
   b. Collateral assignments of registered securities are accompanied by powers of attorney signed by the registered owner?
      - Registered securities are registered in bank or bank's nominee name when they are assigned as collateral for extended maturity (over 30 days) reverse re-po transactions?
   c. Funds are not disbursed until reverse re-po collateral is delivered into the physical custody of the bank or an independent safekeeping agent?
   d. Funds are only advanced against predetermined collateral margins or discounts?
      - If so, indicate margin or discount percentage __________.
   e. Collateral margins or discounts are predicated upon:
      - The type of security pledged as collateral?
      - Maturity of collateral?
      - Historic and anticipated price volatility of the collateral?
      - Maturity of the reverse re-po agreements?
   f. Maintenance agreements are required to support predetermined collateral margin or discount?
   g. Maintenance agreements are structured to allow margin calls in the event of collateral price declines?
   h. Collateral market value is frequently checked to determine compliance with margin and maintenance requirements (if so, indicate frequency _________)?

CUSTODY AND MOVEMENT OF SECURITIES

*6. Are the bank's procedures such that persons do not have sole custody of securities in that:
   a. They do not have sole physical access to securities?
   b. They do not prepare disposal documents that are not also approved by authorized persons?
   c. For the security custodian, supporting disposal documents are examined or adequately tested by a second custodian?
   d. No person authorizes more than one of the following transactions: execution of trades, receipt and delivery of securities, and collection or disbursement of payment?
7. Are securities physically safeguarded to prevent loss, unauthorized disposal or use? And:
   a. Are negotiable securities kept under dual control?
   b. Are securities counted frequently, on a surprise basis, reconciled to the securities record, and the results of such counts reported to management?

c. Does the bank periodically test for compliance with provisions of its insurance policies regarding custody of securities?

d. For securities in the custody of others:
- Are custody statements agreed periodically to position ledgers and any differences followed up to a conclusion?
- Are statements received from brokers and other dealers reconciled promptly, and any differences followed up to a conclusion?
- Are positions for which no statements are received confirmed periodically, and stale items followed up to a conclusion?

8. Are trading account securities segregated from other bank owned securities or securities held in safekeeping for customers?

*9. Is access to the trading securities vault restricted to authorized employees?

10. Do withdrawal authorizations require countersignature to indicate security count verifications?

11. Is registered mail used for mailing securities, and are adequate receipt files maintained for such mailings (if registered mail is used for some but not all mailings, indicate criteria and reasons)?

12. Are prenumbered forms used to control securities trades, movements and payments?

13. If so, is numerical control of prenumbered forms accounted for periodically by persons independent of those activities?

14. Do alterations to forms governing the trade, movement, and payment of securities require:

*a. Signature of the authorizing party?

b. Use of a change of instruction form?

15. With respect to negotiability of registered securities:

a. Are securities kept in non-negotiable form whenever possible?

b. Are all securities received, and not immediately delivered, transferred to the name of the bank or its nominee and kept in non-negotiable form whenever possible?

c. Are securities received checked for negotiability (endorsements, signature, guarantee, legal opinion, etc.) and for completeness (coupons, warrants, etc.) before they are placed in the vault?

RECORDS MAINTENANCE

16. Does the bank maintain:

a. Order tickets which include:
- Capacity as principal or agent?
- If order is firm or conditional?
- Terms, conditions or instructions and modifications?
- Type of transaction (purchase or sale)?
- Execution price?
- Description of security?
- Date and time of order receipt?
- Date and time of execution?
- Dealer's or customer's name?
- Delivery and payment instructions?
- Terms, conditions, date and time of cancellation of an agency order?

b. Customer confirmations:
- Bank dealer's name, address and phone number?
- Customer's name?
- Designation of whether transaction was a purchase from or sale to the customer?
- Par value of securities?
- Description of securities, including at a minimum:
  - — Name of issuer?
  - — Interest rate?
  - — Maturity date?
  - — Designation, if securities are subject to limited tax?
  - — Subject to redemption prior to maturity (callable)?
  - — Designation, if revenue bonds and the type of revenue?
  - — The name of any company or person in addition to the issuer who is obligated, directly or indirectly, to pay debt service on revenue bonds? (In the case of more than one such obligor, the phrase "multiple obligors" will suffice.)
  - — Dated date, if it affects price or interest calculations?
  - — First interest payment date, if other than semi-annual?
  - — Designation, if securities are "fully registered" or "registered as principal"?
  - — Designation, if securities are "pre-refunded"?

- — Designation, if securities have been "called," maturity date fixed by call notice and amount of call price?
- — Denominations of bearer bonds, if other than denominations of $1,000 and $5,000 par value?
- — Denominations of registered bonds, if other than multiples of $1,000 par value up to $100,000 par value?
- — Denominations of municipal notes?
- Trade date and time of execution, or a statement that time of execution will be furnished upon written request of the customer?
- Settlement date?
- Yield and dollar price? Only the dollar price need to be shown for securities traded at par.
  - — For transactions in callable securities effected on a yield basis, the resulting price calculated to the lowest of price to call premium, par option (callable at par) or to maturity, and if priced to premium call or par option, a statement to that effect and the call or option date and price used in the calculation?
- Amount of accrued interest?
- Extended principal amount?
- Total dollar amount of transaction?
- The capacity in which the bank dealer effected the transaction:
  - — As principal for own account?
  - — As agent for customer?
  - — As agent for a person other than the customer?
  - — As agent for both the customer and another person (dual agent)?
- If a transaction is effected as agent for the customer or as dual agent:
  - — Either the name of the contra-party or a statement that the information will be furnished upon request?
  - — The source and amount of any commission or other remuneration to the bank dealer?
- Payment and delivery instructions?
- Special instructions, such as:
  - — "Ex-legal" (traded without legal opinion)?
  - — "Flat" (traded without interest)?
  - — "In default" as to principal or interest?

c. Dealer confirmations:
- Bank dealer's name, address and telephone number?
- Contra-party identification?
- Designation of purchase from or sale to?
- Par value of securities?
- Description of securities, including at a minimum:
  - — Name of issuer?
  - — Interest rate?
  - — Maturity date?
  - — Designation, if securities are limited tax?
  - — Subject to redemption prior to maturity (callable)?
  - — Designation, if revenue bonds and the type of revenue?
  - — Dated date, if it affects price or interest calculations?
  - — First interest payment date, if other than semi-annual?
  - — Designation, if securities are "fully registered" or "registered as principal"?
  - — Designation, if securities are "pre-refunded"?
  - — Designation, if securities have been "called," maturity date fixed by call notice and amount of call price?
  - — Denominations of bearer bonds, if other than denominations of $1,000 and $5,000 par value?
  - — Denominations of registered bonds, if other than multiples of $1,000 par value up to $100,000 par value?
- CUSIP number, if assigned (effective January 1, 1979)?
- Trade date?
- Settlement date?
- Yield to maturity and resulting dollar price? Only the dollar price need be shown for securities traded at par or on a dollar basis.
  - — For transactions in callable securities effected on a yield basis, the resulting price calculated to the lowest of price to call premium, par option (callable at par) or to maturity?

- — If applicable, the fact that securities are priced to premium call or par option and the call or option date and price used in the calculation?
- Amount of accrued interest?
- Extended principal amount?
- Total dollar amount of transaction?
- Payment and delivery instructions?
- Special instructions, such as:
  - — "Ex-legal" (traded without legal opinion)?
  - — "Flat" (traded without interest)?
  - — "In default" as to principal or interest?

d. Purchase and sale journals or blotters which include:
- Trade date?
- Description of securities?
- Aggregate par value?
- Unit dollar price or yield?
- Aggregate trade price?
- Accrued interest?
- Name of buyer or seller?
- Name of party received from or delivered to?
- Bond or note numbers?
- Indication if securities are in registered form?
- Receipts or disbursements of cash?
- Specific designation of "when issued" transactions?
- Transaction or confirmation numbers recorded in consecutive sequence to insure that transactions are not omitted?
- Other references to documents of original entry?

e. Short sale ledgers which include:
- Sale price?
- Settlement date?
- Present market value?
- Basis point spread?
- Description of collateral?
- Cost of collateral or cost to acquire collateral?
- Carrying charges?

f. Security position ledgers, showing separately for each security positioned for the bank's own account:
- Description of the security?
- Posting date (either trade or settlement date, provided posting date is consistent with other records of original entry)?
- Aggregate par value?
- Cost?
- Average cost?
- Location?
- Count differences classified by the date on which they were discovered?

g. Securities transfer or validation ledgers which include:
- Address where securities were sent?
- Date sent?
- Description of security?
- Aggregate par value?
- If registered securities:
  - — Present name of record?
  - — New name to be registered?
- Old certificate or note numbers?
- New certificate or note numbers?
- Date returned?

h. Securities received and delivered journals or tickets which include:
- Date of receipt or delivery?
- Name of sender and receiver?
- Description of security?
- Aggregate par value?
- Trade and settlement dates?
- Certificate numbers?

i. Cash or wire transfer receipt and disbursement tickets which include:
- Draft or check numbers?
- Customer accounts debited or credited?
- Notation of the original entry item that initiated the transaction?

j. Cash or wire transfer journals which additionally include:
- Draft or check reconcilements?
- Daily totals of cash debits and credits?
- Daily proofs?

k. Fail ledgers which include:
- Description of security?
- Aggregate par value?
- Price?
- Fail date?
- Date included on fail ledger?
- Customer or dealer name?
- Resolution date?
- A distinction between a customer and a dealer fail?
- Follow-up detail regarding efforts to resolve the fail?

l. Securities borrowed and loaned ledgers which include:
- Date of transaction?
- Description of securities?

- Aggregate par value?
- Market value of securities?
- Contra-party name?
- Value at which security was loaned?
- Date returned?
- Description of collateral?
- Aggregate par value of collateral?
- Market value of collateral?
- Collateral safekeeping location?
- Dates of periodic valuations?

m. Records concerning written or oral put options, guarantee and repurchase agreements which include:
- Description of the securities?
- Aggregate par value?
- Terms and conditions of the option, agreement or guarantee?

n. Customer account information which includes:
- Customer's name and residence or principal business address?
- Whether customer is of legal age?
- Occupation?
- Name and address of employer? And:
  - — Whether customer is employed by a securities broker or dealer or by a municipal securities dealer?
- Name and address of beneficial owner or owners of the account if other than customer? And:
  - — Whether transactions are confirmed with such owner or owners?
- Name and address of person(s) authorized to transact business for a corporate, partnership or trusteed account? And:
  - — Copy of powers of attorney, resolutions or other evidence of authority to effect transactions for such an account?
- With respect to borrowing or pledging securities held for the accounts of customers:
  - — Written authorization from the customer authorizing such activities?
- Customer complaints including:
  - — Records of all written customer complaints?
  - — Record of actions taken concerning those complaints?

o. Customer and the bank dealer's own account ledgers which include:
- All purchases and sales of securities?
- All receipts and deliveries of securities?
- All receipts and disbursements of cash?
- All other charges or credits?

p. Records of syndicates' joint accounts or similar accounts formed for the purchase of municipal securities which include:
- Underwriter agreements? And:
  - — Description of the security?
  - — Aggregate par value of the issue?
- Syndicate or selling group agreements? And:
  - — Participants' names and percentages of interest?
  - — Terms and conditions governing the formation and operation of the syndicate?
  - — Date of closing of the syndicate account?
  - — Reconcilement of syndicate profits and expenses?
- Additional requirements for syndicate or underwriting managers which include:
  - — All orders received for the purchase of securities from the syndicate or account, except bids at other than the syndicate price?
  - — All allotments of securities and the price at which sold?
  - — Date of settlement with the issuer?
  - — Date and amount of any good faith deposit made with the issuer?

q. Files which include:
- Advertising and sales literature
- Prospectus delivery information?

r. Internal supervisory records which include:
- Account reconcilement and follow-up?
- Profit analysis by trader?
- Sales production reports?
- Periodic open position reports computed on a trade date or when issued basis?
- Reports of own bank credit extensions used to finance the sale of trading account securities?

PURCHASE AND SALES TRANSACTIONS

17. Are all transactions promptly confirmed in writing to the actual customers or dealers?
18. Are confirmations compared or adequately tested to purchase and sales memoranda and reports of execution of orders, and any differences investigated and corrected (including approval by a designated responsible employee)?
    a. Are confirmations and purchase and sale memoranda checked or adequately tested for computation and terms by a second individual?
19. Are comparisons received from other dealers or brokers compared with confirmations, and any differences promptly investigated?
    a. Are comparisons approved by a designated individual (if so, give name __________)?

CUSTOMER AND DEALER ACCOUNTS

20. Do account bookkeepers periodically transfer to different account sections or otherwise rotate posting assignments?
21. Are letters mailed to customers requesting confirmation of changes of address?
22. Are separate customer account ledgers maintained for:
    - Employees?
    - Affiliates?
    - Own bank's trust accounts?
23. Are customer inquiries and complaints handled exclusively by designated individuals who have no incompatible duties?

RECORDKEEPING AND CONFIRMATION REQUIREMENTS FOR CUSTOMER SECURITIES TRANSACTIONS (REGULATION H)

24. Are chronological records of original entry containing an itemized daily record of all purchases and sales of securities maintained?
25. Do the original entry records reflect:
    a. The account or customer for which each such transaction was effected?
    b. The description of the securities?
    c. The unit and aggregate purchase or sale price (if any)?
    d. The trade date?
    e. The name or other designation of the broker-dealer or other person from whom purchased or to whom sold?

If the bank has had an average of 200 or more securities transactions per year for customers over the prior three-calendar-year period, exclusive of transactions in U.S. government and federal agency obligations, answer questions 26, 27 and 28.

26. Does the bank maintain account records for each customer which reflect:
    a. All purchases and sales of securities?
    b. All receipts and deliveries of securities?
    c. All receipts and disbursements of cash for transactions in securities for such account?
    d. All other debits and credits pertaining to transactions in securities?
27. Does the bank maintain a separate memorandum (order ticket) of each order to purchase or sell securities (whether executed or cancelled) which includes:
    a. The account(s) for which the transaction was effected?
    b. Whether the transaction was a market order, limit order, or subject to special instructions?
    c. The time the order was received by the trader or other bank employee responsible for affecting the transaction?
    d. The time the order was placed with the broker-dealer, or if there was no broker-dealer, the time the order was executed or cancelled?
    e. The price at which the order was executed?
    f. The broker-dealer used?
28. Does the bank maintain a record of all broker-dealers selected by the bank to effect securities transactions and the amount of commissions paid or allocated to each such broker during the calendar year?
29. Does the bank, subsequent to effecting a securities transaction for a customer, mail or otherwise furnish to such customer either a copy of the confirmation of a broker-dealer relating to the securities transaction or a written trade confirmation

of a broker-dealer relating to the securities transaction or a written trade confirmation prepared by the bank?

30. If customer notification is provided by furnishing the customer with a copy of the confirmation of a broker-dealer relating to the transaction, and if the bank is to receive remuneration from the customer or any other source in connection with the transaction, and the remuneration is not determined pursuant to a written agreement between the bank and the customer, does the bank also provide a statement of the source and amount of any remuneration to be received?
31. If customer notification is provided by furnishing the customer with a trade confirmation prepared by the bank, does the confirmation disclose:
    a. The name of the bank?
    b. The name of the customer?
    c. Whether the bank is acting as agent for such customer, as principal for its own account, or in any other capacity?
    d. The date of execution and a statement that the time of execution will be furnished within a reasonable time upon written request of such customer?
    e. The identity, price and number of shares of units (or principal amount in the case of debt securities) of such securities purchased or sold by such customer?
32. For transactions which the bank effects in the capacity of agent, does the bank, in addition to the above, disclose:
    a. The amount of any remuneration received or to be received, directly or indirectly, by any broker-dealer from such customer in connection with the transaction?
    b. The amount of any remuneration received or to be received by the bank from the customer and the source and amount of any other remuneration to be received by the bank in connection with the transaction, unless remuneration is determined pursuant to a written agreement between the bank and the customer?
    c. The name of the broker-dealer used. Where there is no broker-dealer, the name of the person from whom the security was purchased or to whom it was sold, or the fact that such information will be furnished within a reasonable time upon written request?
33. Does the bank maintain the above records and evidence of proper notification for a period of at least three years?
34. Does the bank furnish the written notification described above within five business days from the date of the transaction, or if a broker-dealer is used, within five business days from the receipt by the bank of the broker-dealer's confirmation? If not, does the bank use one of the alternative procedures described in Regulation H?
35. Unless specifically exempted in Regulation H, does the bank have established written policies and procedures ensuring:
    a. That bank officers and employees who make investment recommendations or decisions for the accounts of customers, who particpate in the determination of such recommendations or decisions, or who, in connection with their duties, obtain information concerning which securities are being purchased or sold or recommended for such action, report to the bank, within 10 days after the end of the calendar quarter, all transactions in securities made by them or on their behalf, either at the bank or elsewhere in which they have a beneficial interest (subject to certain exemptions)?
    b. That in the above required report the bank officers and employees identify the securities purchased or sold and indicate the dates of the transactions and whether the transactions were purchases or sales?
    c. The assignment of responsibility for supervision of all officers or employees who (1) transmit orders to or place orders with broker-dealers, or (2) execute transactions in securities for customers?
    d. The fair and equitable allocation of securities and prices to accounts when orders for the same security are received at approximately the same time and are placed for execution either individually or in combination?
    e. Where applicable, and where permissible under local law, the crossing of buy and sell orders on a fair and equitable basis to the parties to the transaction?

OTHER

36. Are the preparation, additions, and posting of subsidiary records performed and/or adequately reviewed by persons who do not also have sole custody of securities?
37. Are subsidiary records reconciled, at least monthly, to the appropriate general ledger accounts and are reconciling items adequately investigated by persons who do not also have sole custody of securities?
38. Are fails to receive and deliver under a separate general ledger control?
    a. Are fail accounts periodically reconciled to the general ledger, and any differences followed up to a conclusion?
    b. Are periodic aging schedules prepared (if so, indicate frequency __________)?
    c. Are stale fail items confirmed and followed up to a conclusion?
    d. Are stale items valued periodically and, if any potential loss is indicated, is a particular effort made to clear such items or to protect the bank from loss by other means?
39. With respect to securities loaned and borrowed positions:
    a. Are details periodically reconciled to the general ledger, and any differences followed up to a conclusion?
    b. Are positions confirmed periodically (if so, indicate frequency ___________)?
40. Is the compensation of all department employees limited to salary and a non-departmentalized bonus or incentive plan?
    a. Are sales representatives' incentive programs based on sales volume and not department income?

CONCLUSION

41. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
42. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

INTRODUCTION

This section will help the examiner perform two separate but related functions:

- evaluate the depth and scope of the formalized policies and procedures the bank uses to manage and control its loan portfolio
- form an overview of the performance of the entire lending operation by consolidating the results of the examination programs from the various lending departments

BANK LOAN POLICY

The purpose of a bank's lending policy is to establish the authority, rules, and framework to operate and administer its loan portfolio effectively; that is, to ensure profitability while managing risk. The policy serves as a framework to set basic standards and procedures in a clear and concise manner. The policy's guidelines should be derived from a careful review of internal and external factors that affect the institution, such as the bank's market position, historical experience, present and prospective trade area, probable future loan and funding trends, facilities, staff capabilities, and technology. Such guidelines, however, must be void of any discriminatory policies or practices.

The complexity and scope of the lending policy and procedures should be appropriate to the size of the institution and the nature of its activities and should be consistent with prudent banking practices and relevant regulatory requirements. Examiners should keep in mind that a loan policy that is appropriate for one bank is not necessarily suitable for another bank. Each bank's policy will differ, given the institution's strategic goals and objectives, coupled with factors such as economic conditions, the experience and ability of the lending personnel, and competition. The policy should be reviewed at least annually to ensure that it is not outdated or ineffective, remains flexible, and continues to meet the needs of the community. Changes in federal and other regulatory requirements also must be incorporated into the policy.

The policy should be broad and not overly restrictive. If carefully formulated and administered by senior management, and clearly communicated and understood through each level of the organization, it greatly helps bank management (1) maintain sound credit-underwriting standards; (2) control and manage risk; (3) evaluate new business opportunities; and (4) identify, administer, and collect problem loans.

The lending policy must clearly state the philosophies and principles that govern safe and sound banking practices and procedures, as well as the mission and objectives of the particular institution. Throughout this manual, considerable emphasis is placed on formal written policies established by the board of directors that management can implement, administer, and amplify. The board of directors, in discharging its duty to both depositors and shareholders, must ensure that loans in the bank's portfolio are made based on the following three objectives:

- to grant loans on a sound and collectible basis
- to invest the bank's funds profitably for the benefit of shareholders and the protection of depositors
- to serve the legitimate credit needs of the bank's community

The written loan policy is the cornerstone for sound lending and loan administration. An adequate loan policy promotes—

- a bank's business and lending philosophy, despite changes in management;
- stability, as it provides a reference for lenders;
- clarity, to minimize confusion concerning lending guidelines; and
- sound objectives for evaluating new business opportunities.

The loan policy should define who will receive credit, what type, and at what price. Other internal factors to be addressed include who will grant the credit and in what amount, as well as what organizational structure will ensure compliance with the bank's guidelines and procedures. As loan authority is spread throughout the organization, the bank must have an efficient internal review and reporting system to monitor adherence to established guidelines. This system should adequately inform the directorate and senior management of how policies are being carried out and should provide them with sufficient information to evaluate the performance of lending officers and the condition of the loan portfolio.

The loan policy should establish (1) what information will be required from the borrower during the application process, (2) what information the borrower will be required to submit while the credit remains outstanding, and (3) which bank personnel are responsible for obtaining the information. In addition, the policy should specify who is responsible for reviewing the adequacy of loan documentation and for citing and correcting documentation exceptions. A high level of documentation exceptions indicates a deficiency in the bank's policy, procedures, monitoring, or enforcement.

A loan policy will differ from loan procedures. A policy represents a plan, a guiding principle, or course of action designed to establish a framework for handling decisions, actions, and other matters, thereby influencing them. A procedure is a set of established methods or steps for performing a task. The lending policy should include issues relevant to all departments of the bank. Written procedures approved and enforced in various departments should be referenced in the bank's general lending policy. The policy must be flexible enough to allow for fast adaptation to changing conditions in the bank's earning assets mix and trade area.

Components of a Sound Lending Policy

As mentioned previously, a bank's loan policy should be appropriate to its size and complexity. However, sound loan policy generally is based on the components described below.

Allowance for loan and lease losses. A sound lending policy establishes a systematic loan-review program to detect and identify problem loans and other portfolio weaknesses. (See the ''Internal Loan Review'' subsection for the requirements of a loan-review program.) Guidelines and methodologies need to be established to determine the adequacy of the bank's allowance for loan and lease losses (ALLL), and they should be based on a conservative analysis of the risk in the loan portfolio. This analysis should ensure that sufficient cushion is maintained to allow for the imprecision inherent in most estimates of expected credit losses. The Interagency Policy Statement on the Allowance for Loan and Lease Losses[1] stipulates that federally insured depository institutions must maintain an ALLL at a level that is adequate to absorb estimated credit losses associated with the loan and lease portfolio, including all binding commitments to lend.

Examiners must evaluate management's estimate of losses existing in the bank's loan portfolio, as well as the methodologies and procedures used in making the estimate. That evaluation provides the basis for determining the adequacy of a bank's allowance for loan and lease losses. (See sections 2070.1 and 2072.1 for further details.)

Collections and charge-offs. The lending policy should define the criteria and procedures for reporting to the board of directors relevant information concerning delinquent obligations. The policy should establish the mechanism for presenting problem loans to the directorate. Reports submitted to the board of directors should include sufficient detail for it to determine the risk factor, loss potential, and alternative courses of action. The policy should outline a follow-up collection-notice procedure that is systematic and progressively stronger. Guidelines should be established to ensure that all accounts are presented to and reviewed by the board of directors or a board committee for charge-off.

Concentrations of credit. The lending policy should encourage both diversification within the portfolio and a balance between maximum yield and minimum risk. Concentrations of credit depend heavily on a key factor, and when weaknesses develop in that key factor, every individual loan within the concentration is affected. The directorate should evaluate the additional risk involved in various concentrations and determine which concentrations should be avoided or limited. The lending policy also should establish thresholds for acceptable concentrations of credit and require that all concentrations be reviewed and reported to the board on a periodic basis.

Institutions that have effective controls to manage and reduce undue concentrations over time need not refuse credit to sound borrowers simply because of the borrower's industry or geographic location. This principle applies to

1. See SR-93-70 (FIS)

prudent loan renewals and rollovers, as well as to new extensions of credit that are underwritten in a sound manner. (See section 2050 for further details.)

Consumer and equal credit opportunity laws. Compliance with the many consumer-related laws, regulations, rulings, interpretations, and policy statements requires complex and detailed policies and procedures that should be addressed in a separate policy. However, the loan policy should require adherence to the Federal Reserve's Regulation B, 12 CFR 202, which implements the Equal Credit Opportunity Act. This regulation prohibits creditors from discriminating against loan applicants on the basis of age, race, color, religion, national origin, sex, marital status, or receipt of income from public assistance programs. As additional prohibitions are added under the regulation, they should be incorporated into the policy statement. Also, the loan policy should include a requirement that the bank give applicants a written notification of rejection of a loan application, a statement of the applicant's rights under the Equal Credit Opportunity Act, and a statement either of the reasons for rejection or of the applicant's right to such information.

Credit files. Obtaining and maintaining complete and accurate information on every relevant detail of a borrower's financial condition is essential to approving credit in a safe and sound manner. The loan policy should establish what information will be required from the borrower during the application process and what information the borrower will be required to submit while the credit remains outstanding. Credit files should be maintained on all borrowing relationships, regardless of size, with the exception of the latitude provided by the Interagency Policy Statement on Documentation of Loans. A current credit file should provide the loan officer, loan committee, and internal and external reviewers with all information necessary to analyze the credit before it is granted and to monitor and evaluate the credit during its life. Such information should (1) identify the borrower's business or occupation; (2) document the borrower's past and current financial condition; (3) state the purposes of all loans granted to the borrower, the sources of repayment, and the repayment programs; and (4) identify the collateral and state its value and the source of the valuation.

Credit files should include all financial statements, credit reports, collateral-inspection documents, reference letters, past loan applications, memoranda, correspondence, and appraisals. In many cases, particularly those involving real estate loans, appraisals and other collateral documentation may be maintained in a separate collateral file.

Documentation requirements will vary according to the type of loan, borrower, and collateral. For example, a bank may not require financial statements from borrowers whose loans are fully secured by certificates of deposit it issues. In a more general sense, information requirements between amortizing consumer loans and commercial or real estate loans vary greatly. More specific examples of the types and frequency of financial information often obtained for various types of credit are detailed in the following paragraphs.

For many consumer installment and residential mortgage loan borrowers, the borrowers' financial information generally is collected only at the time of loan application. The underwriting process for these types of loans emphasizes factors such as the borrower's income and job stability, credit history, and debt load, as well as the loan-to-value requirements for obtained collateral.

In factoring and other asset-backed lending activities, while financial information is a significant part of the underwriting process, collateral is the key component of the lending decision. Close monitoring of the collateral's existence, value, and marketability are essential to sound underwriting of these types of loans.

For typical commercial, commercial real estate, and agricultural loans, significant emphasis is placed on the financial strength, profitability, and cash flow of the core business for loan repayment. Close monitoring of the business's financial condition and profitability throughout the life of the loan is key to the sound administration of these types of credits. Other pertinent information requirements, such as collateral-inspection documentation for agricultural credits or lease/rental information for income-producing commercial real estate credits, may also be necessary to properly administer these loans. As part of the sound underwriting process for these loans, a bank may include loan covenants requiring the business to maintain financial soundness, submit periodic financial statements, and provide other needed information.

As a practice, a bank should not ask for information it does not need to adequately underwrite and monitor the quality of its loans. With proper use of loan covenants, a bank can protect its right to receive additional or more frequent information if a borrower's financial condition deteriorates or collateral values decline. When determining the financial and other information to request from the borrower, bankers should consider the requirements of the underwriting process for particular types of loans and the repayment risks. A bank's loan policy should clearly delineate the type and frequency of such information requirements.

The lending policy also should define the financial-statement requirements for businesses and individuals at various borrowing levels. Specifically, requirements for audited, unaudited, annual, or interim balance sheets; income and cash-flow statements; statements of changes in capital accounts; and supporting notes and schedules should be included, as appropriate. In addition, the lending policy should require external credit checks as appropriate, at the inception of the loan and during periodic updates. The loan policy should be written so that credit-data exceptions would be a violation of the policy.

Distribution by category. Limitations based on aggregate percentages of total loans in commercial, real estate, consumer, or other categories are common. Aggregate percentages for loans to deposits, assets, and capital (with regard to concentrations of credit) would provide guidance for effective portfolio management. Such policies are beneficial but should allow for deviations, with the approval by the board or a board committee. This allows credit to be distributed in response to the community's changing needs. During times of heavy loan demand in one category, an inflexible loan-distribution policy would cause that category to be slighted in favor of another.

Exceptions to the loan policy. A lending policy should require loan officers to present credits they believe are fundamentally sound and worthy of consideration, even though they may not conform with the bank's written lending policy or procedures. The reason for the exception should be detailed in writing and submitted for approval to a designated authority. The directors' loan committee or a similar body should review and approve all exceptions at reasonable intervals. The frequency of exceptions granted may indicate a lessening of underwriting standards on the one hand, or a need to adjust the policy to allow flexibility within safe and sound parameters on the other. The underlying reasons behind frequently granted exceptions should be assessed, and appropriate recommendations should be made accordingly.

Financing other real estate. If the bank wants to finance a parcel of other real estate that it owns, special accounting rules may apply. Consequently, the lending policy should include an outline of certain provisions of Financial Accounting Standards Board (FASB) Statement No. 66, "Accounting for Sales of Other Real Estate."

Geographic limits. A bank's trade area should be clearly delineated and consistent with defined Community Reinvestment Act (CRA) criteria. Loan officers and directors should be fully aware of specific geographic limitations for lending purposes. The bank's defined trade area should not be so large that, given its resources, the bank cannot properly and adequately monitor and administer its credits. A sound loan policy restricts or discourages loan approval for customers outside the trade area. The bank's primary trade area should be distinguished from any secondary trade area, which is especially important for new banks. Specific restrictions or exceptions should be listed separately.

Lender liability. Banking organizations must be careful that their actions to make, administer, and collect loans—including assessing and controlling environmental liability—cannot be construed as taking an active role in the management or day-to-day operations of the borrower's business. Such actions could lead to potential liability under the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA). (See the "Environmental Liability" subsection.)

Limitation on aggregate outstanding loans. Banks should establish guidelines limiting the total amount of loans outstanding in relation to other balance-sheet accounts. This type of control over the loan portfolio usually is expressed relative to deposits and total assets. In setting such limitations, various factors, such as the credit demands of the community, the volatility of deposits, and the credit risks involved, must be considered.

Loan authority. The lending policy should establish limits for all lending officers and ensure controls are in place to monitor compliance with the bank's legal lending limit. An individual officer's lending limit is usually based on his or her experience, tenure, and past adherence to the bank's loan policy. Lending limits also should be set for group authority, allowing a combination of officers or a committee to approve larger loans than the members would be permitted to approve individually. The loan policy should describe the manner in which loans will be approved and ultimately reported to the board of directors, as well as the frequency of any loan committee meetings, as applicable.

Loan pricing. At a minimum, interest rates on loans must be sufficient to cover (1) the cost of the funds loaned, (2) the bank's loan services (including general overhead), and (3) probable losses—while providing for a reasonable profit margin. Policymakers must know these costs before establishing rates. Periodic review allows rates to be adjusted in response to changes in costs, competitive factors, or risks of a particular type of extension of credit. Specific guidelines for other relevant factors, such as compensating balance requirements and fees on commitments, are also germane to pricing credit.

Loan purchases and sales. If sufficient loan demand exists, lending within the bank's trade area is safer and less expensive than purchasing paper from a dealer or a correspondent bank. Direct lending promotes customer relationships, serves the credit needs of customers, and develops additional business. Occasionally, a bank may not be able to advance a loan to a customer for the full amount requested because of individual state lending limitations or other reasons. In such situations, the bank may extend credit to a customer up to its internal or legal lending limit, and sell a participation to a correspondent bank for the amount exceeding the bank's lending limit or the amount it wishes to extend on its own. Generally, such sales arrangements are established before the credit is ultimately approved. These sales should be on a nonrecourse basis by the bank, and the originating and purchasing banks should share in the risks and contractual payments on a pro rata basis. Selling or participating out portions of loans to accommodate the credit needs of customers promotes goodwill, and enables a bank to retain customers who might otherwise seek credit elsewhere.

Conversely, many banks purchase loans or participate in loans originated by others. In some cases, such transactions are conducted with affiliates or members of a chain banking organization, with the goal of benefitting the whole organization. A purchasing bank also may wish to supplement its loan portfolio when loan demand is weak. In still other cases, a bank may purchase or participate in a loan to accommodate an unrelated originating bank with which it has an ongoing business relationship.

Purchasing or selling loans, if done properly, can have a legitimate role in a bank's overall asset and liability management and can contribute to the efficient functioning of the financial system. In addition, these activities help a bank diversify its risks and improve its liquidity.

Banks should avoid purchases of loans that generate unacceptable concentrations of credit. Such concentrations may arise solely from the bank's purchases, or they may arise when loans or participation purchased are aggregated with loans originated and retained by the purchasing bank. The policy should state the limits (1) for the aggregate amount of loans purchased from and sold to any one outside source and (2) of all loans purchased and sold. It should also establish limits for the aggregate amount of loans to particular types of industries. The extent of contingent liability, holdback and reserve requirements, and the manner in which loans will be handled and serviced should be clearly defined. In addition, the policy should require that loans purchased from another source be evaluated in the same manner as loans originated by the bank itself. Guidelines should be established for the type and frequency of credit and other information the bank needs to obtain from the originating institution to keep itself continually updated on the status of the credit. Guidelines also should be established for supplying complete and regularly updated credit information to the purchasers of loans originated and sold by the bank.

Loans to employees, officers, directors, principal shareholders, and their related interests. Loans to insiders are strictly defined in federal statutes and require close supervision to ensure compliance. Federal and state statutes provide the basis for defining insider loans, and they specify requirements and limitations that should be incorporated in the policy (see the Federal Reserve's Regulation O, 12 CFR 215).

The policy should ensure, through a system of controls over authority and funding, that extensions of credit to insiders are legally permissible and that they are made on substantially the same terms and conditions as those prevailing at the time for comparable transactions with other borrowers. Furthermore, the policy should contain guidelines for loans to employees who are not subject to the provisions of Regulation O.

Maximum maturities. Loans should be granted with realistic repayment plans, with the maturity related to the anticipated source of repayment, the purpose of the loan, and the useful life of the collateral. For term loans, a lending policy should state the maximum number of months over which loans may be amortized. Specific procedures should be developed for situations requiring balloon payments and modification of original loan terms. If the bank requires a cleanup (out-of-debt) period for lines of credit, it should be stated explicitly.

Maximum ratio of loan amount to collateral value. The loan policy should set forth procedures for ordering, preparing, and reviewing appraisals for real or personal property pledged as collateral. The bank's lending policy should outline guidelines for appraisals or internal evaluations, including regulatory requirements, and, in the case of renewals or extensions, procedures for possible reappraisals or reevaluations. Acceptable types of appraisals or evaluations should be outlined. Circumstances requiring the use of in-house staff appraisers instead of fee appraisers should be identified. Maximum loan-to-value ratios and the methods of valuation to be used for various types of collateral should be detailed. (See sections 2090 and 2100 for further details.)

The maximum ratio of loan amount to the market value of pledged securities is restricted by the Federal Reserve's Regulation U, 12 CFR 221. The lending policy should set forth margin requirements for all types of securities acceptable as collateral. Margin requirements should be related to the marketability of the security, that is, whether it is actively traded, over the counter, or closely held. The policy also should assign responsibility and set a frequency for periodic pricing of the collateral.

Prohibitions against tying arrangements. In a tying arrangement, the extension of credit, provision of a service, or consideration for credit or service generally is varied or conditioned upon a customer's obtaining or providing some additional product or service from or to the bank or an affiliate. Section 106(b) of the Bank Holding Company Act Amendments of 1970 generally prohibits a bank from tying a product or service to any of its other products or services, including those offered by its affiliates. Certain tying arrangements are permissible when the two products tied are loans, deposits, or trust services available from the same bank, or when the Board has determined that a particular tying arrangement is permissible.[2] To the extent possible, examiners should ascertain that member banks have not extended credit voluntary or involuntary based on impermissible tying arrangements.

Types of loans. The lending policy should state the types of loans management considers desirable or prohibited. It also should set forth guidelines for extensions-of-credit types such as commercial loans; real estate loans; secured and unsecured loans; and off-balance-sheet activities, such as letters of credit and loan commitments. The decision about the types of loans granted should be based on the expertise of the lending officers, the deposit structure of the bank, and the community's anticipated credit demands. Credits involving complex structures or repayment arrangements, or loans secured by collateral that requires more than normal monitoring, should be avoided unless the bank has the personnel, policies, controls, and systems necessary to administer such advances properly. Types of credits that have caused an abnormal loss to the bank should be identified, scrutinized, and controlled within the framework of stated policy. A bank also should consider its overall exposure to term lending relative to its stable funds.

Continued rigorous credit-risk assessment during favorable economic conditions. Internal processes and requirements for loan-underwriting decisions should be consistent with the nature, size, and complexity of the banking organization's activities and with the institution's lending policies. Any departures therefrom can have serious consequences for institutions of all sizes. See SR-99-23. Departures can be evident in three pivotal and related areas:

2. SR-92-41 (FIS)

1. *An undue reliance on optimistic outlooks for prospective borrowers and for continued favorable economic and financial market conditions.* A long and continuing economic expansion can lead banks to more frequently base their decision to lend on a very optimistic assessment of the borrower's operating prospects. Timely principal repayment may often be based on the assumption that the borrower will have ready access to financial markets in the future. Such reliance, especially if across a significant volume of loans, is not consistent with sound credit-risk management. Undue reliance on continued favorable economic conditions can be demonstrated by—

   - dependence on very rapid growth in a borrower's revenue as the ''most likely'' case;
   - heavy reliance on favorable collateral appraisals and valuations that may not be sustainable over the longer term;
   - greater willingness to make loans without scheduled amortization before the loan's final maturity; or
   - ready willingness to waive violations of key covenants, release collateral, or guarantee requirements, or even to restructure loan agreements, without corresponding concessions on the part of the borrower, on the assumption that a favorable environment will allow the borrower to recover quickly.

   Among the adverse effects of undue reliance on a favorable economy is the possibility of delay in properly identifying problem loans. Timely identification of problem loans is critical for providing a full awareness of the institution's risk position, informing management and directors of that position, taking steps to mitigate risk, and properly assessing the adequacy of the allowance for credit losses and capital.[2a]

   Underlying a banking organization's (BO) overly optimistic assessment of a borrower's prospects may be an overreliance on its continued ready access to financial markets on favorable terms. Examples of overreliance include the following:

   - explicit reliance on future, public market debt or equity offerings or on other sources of refinancing as the ultimate source of principal repayment, which presumes that market liquidity and appetite for such instruments will be favorable at the time that the facility is to be repaid
   - ambiguous or poorly supported BO analysis of the repayment sources of the loan's principal (This results in an implicit reliance, for repayment, on some realization of the implied market valuation of the borrower (for example, through refinancing, asset sales, or some form of equity infusion), and presumes, as above, that markets will be receptive to such transactions at the time that the facility is to be repaid.)
   - measuring a borrower's leverage (for example, debt-to-equity) based solely on the market capitalization of the firm without regard to ''book'' equity, and thereby implicitly assuming that currently unrealized appreciation in the value of the firm can be readily realized if needed
   - more generally, extending bank loans with a risk profile that more closely resembles that of an equity investment and under circumstances in which additional bank credit or default are the borrower's only resort if favorable expectations are not met

   As a result of this overreliance, some banking organizations may find themselves with a potentially significant concentration of credit exposure that is at risk to a possible reversal in financial markets. Turmoil in financial markets, however, may contribute to significant liquidity pressures in some sectors of the economy and prevent ready access to financial markets by certain borrowers. Moreover, there is no assurance that any such market turmoil will quickly resolve itself. Under these circumstances, a borrower's ability to raise new funds in public debt or equity markets to repay maturing bank loans is far from guaranteed.

2. *Insufficient consideration of stress testing.*

2a. With respect to these issues, see SR-98-25, ''Sound Credit Risk Management and the Use of Internal Credit Risk Rating Systems at Large Banking Organizations''; SR-99-22, ''Joint Interagency Letter on the Loan Loss Allowance''; and SR-99-18, ''Assessing Capital Adequacy in Relation to Risk at Large Banking Organizations and Others with Complex Risk Profiles.'' As discussed therein, the Federal Reserve's guidance on credit-risk management and mitigation covers both loans and other forms of on- and off-balance-sheet credit exposure.

An institution's lending policies should prescribe meaningful stress testing of the prospective borrower's ability to meet its obligations. Failure to recognize the potential for adverse events—whether specific to the borrower or its industry (for example, a change in the regulatory climate or the emergence of new competitors) or to the economy as a whole (for example, a recession)—can prove costly to a banking organization.

Mechanical reliance on threshold financial ratios (and the "cushion" they imply) is generally not sufficient, particularly for complex loans and loans to leveraged borrowers or others that must perform exceptionally well to meet their financial obligations successfully. Scenario analysis specific to the borrower, its industry, and its business plan is critical to identify the key risks of a loan. Such analysis should have a significant influence on both the decision to extend credit at all and, if credit is extended, on decisions on appropriate loan size, repayment terms, collateral or guarantee requirements, financial covenants, and other elements of the loan's structure.

When properly conducted, meaningful stress testing includes assessing the effect on the borrower when the following situations or events occur:

- unexpected reductions or reversals in revenue growth, including shocks to revenue of the type (or types) and magnitude that would normally be experienced during a recession
- unfavorable movements in market interest rates, especially for firms with high debt burdens
- unplanned increases in capital expenditures due to technological obsolescence or competitive factors
- deterioration in the value of collateral, guarantees, or other potential sources of principal repayment
- adverse developments in key product or input markets
- reversals in or reduced access by the borrower to public debt and equity markets

Proper stress testing typically incorporates an evaluation of the borrower's alternatives for meeting its financial obligations under each scenario, including asset sales, access to alternative funding or refinancing, or ability to raise new equity. In particular, the evaluation should focus not only on the borrower's ability to meet near-term interest obligations, but also on its ability to repay the principal of the obligation.

3. *Weakening of key internal controls in the lending process.* An institution's lending policy should require the use of adequate internal controls within the lending process. Internal controls such as loan review or credit audit are critical for maintaining proper incentives for bank staff to be rigorous and disciplined in their credit analysis and lending decisions. A bank's credit analyses, loan terms and structures, credit decisions, and internal rating assignments should be reviewed in detail by experienced and independent loan-review staff. These reviews provide both motivation for better credit discipline within an institution, and greater comfort for examiners—and management—that internal policies are being followed and the institution continues to adhere to sound lending practice.

   Economic prosperity and relatively low levels of problem loans and credit losses should not encourage institutions to dramatically or suddenly reduce staff resources or portfolio coverage for the loan-review function. Likewise, thorough reviews of individual loans should continue. When economic prosperity and relatively low levels of problem loans and credit losses exist, there may be increasing internal pressure within the institution to reduce loan-review staff, to conduct more limited loan portfolio reviews, and to perform less thorough reviews of individual loans. Although some useful efficiencies may be desired, the danger is that the scope and depth of loan-review activities may be reduced beyond prudent levels over a longer horizon. If reduced too far, the integrity of the lending process and the discipline of identifying unrealistic assumptions and discerning problem loans in a timely fashion may deteriorate, particularly as a result of a downturn in a credit cycle.

Other. Management should establish appropriate policies, procedures, and information systems to ensure that the impact of the bank's lending activities on its interest-rate exposure is carefully analyzed, monitored, and managed. In this regard, consideration should also be given to off-balance-sheet instruments that may be associated with lending arrangements, including commitments, letters of credit, or swaps. (See section 4110 for further details.)

Under the provisions of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) and the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), a financial institution is required to develop, adopt, and maintain policies, procedures, and guidelines consistent with safe and sound banking practices. The federal banking agencies have issued interagency guidelines based on the provisions. Taken together, these guidelines should strengthen supervision of financial institutions and provide guidance in developing and maintaining policies:

- Interagency Policy Statement on Appraisal and Evaluation Guidelines[3]
- Interagency Policy Statement on Supervisory Initiatives/Credit Availability[4]
- Interagency Policy Statement on Allowance for Loan and Lease Losses[5]
- Interagency Policy Statement on Documentation of Loans[6]
- Interagency Guidance on Accounting for Disposition of Other Real Estate Owned[7]
- Interagency Policy Statement on Monitoring Program for the ''Exempt Portion'' of the Loan Portfolio[8]
- Supervisory Policy Regarding Prohibitions Against Tying Arrangements[9]

An institution's policies and procedures as they relate to interagency statements should be reviewed as part of the examination of the institution's overall lending activities.

LOAN ADMINISTRATION

Loan administration is a term that refers to several aspects of lending. It can be used to describe the entire credit-granting process, as well as the monitoring of various lending activities, such as ensuring that loans remain adequately collateralized, properly graded, and appropriately serviced (administered). The servicing of an extension of credit involves tasks ranging from obtaining current financial information to sending out renewal notices and preparing loan agreements. In addition to facilitating the entire lending process, the individual tasks also serve as controls (checks and balances) over the lending activities. Given the wide breadth of responsibilities that the loan administration function encompasses, its organizational structure varies with the size and sophistication of the bank. In larger banks, responsibilities for the various components of loan administration are usually assigned to different departments, while in smaller institutions, a few individuals might handle several of the functional areas. For example, a large bank's independent credit department may be responsible for analyzing borrowers' financial information, making a determination or recommendation as to the quality of the loan (its risk rating or grade), or obtaining/following up on credit-related information and documentation. On the other hand, smaller banks may assign each of these tasks to individual loan officers.

Examiners will encounter many different organizational structures for loan administration. Therefore, when considering the safety and soundness of a bank, they should determine whether it has effective and appropriate internal controls in place. The assessment of loan administration and related internal controls involves evaluating the bank's operations by reviewing the—

- efficiency and effectiveness of loan administration operations;
- ability of the different components to safeguard assets, primarily loans and leases;
- adequacy of the management information systems and accuracy of the systems' reporting;
- adequacy and accuracy of its loan review function (discussed in the next subsection); and
- compliance with prescribed management policies, procedures, applicable laws, and regulations.

For the components of loan administration to function appropriately, management must understand and demonstrate that it recognizes the importance of controls. This includes not only establishing appropriate policies and procedures, but also enforcing them and ensuring that the bank's organizational structure is suitable for its size and complexity. Managers should emphasize integrity and ethical values, as well as hire competent staff. In addition, the follow-

3. See SR-94-50 (FIS); SR-94-35 (FIS); SR-92-33 (FIS)
4. See SR-93-30 (FIS)
5. See SR-93-70 (FIS)
6. See SR-93-26 (IB)
7. See SR-93-42 (FIS)
8. See SR-93-34 (FIS)
9. See SR-92-41 (FIS)

ing factors positively influence loan administration control:

- a board of directors and/or senior management that takes an active role in monitoring lending policies and practices
- a reporting system that provides the bank with the information needed to manage the lending function and make sound credit decisions
- a well-defined lending approval and review system that includes established credit limits; limits and controls over the types of loans made; limits on maturities of loans; and policies on interest rates, pricing, and fee charges
- an independent loan review function that identifies and evaluates existing and potential problem loans in a timely manner
- an independent reporting system that notifies appropriate personnel when financial information, insurance policies, or other loan documentation needs to be obtained
- a system of procedures that correct documentation exceptions

Loan administration is responsible for mitigating the operational risks associated with loan-related transactions, such as approving credit, disbursing loan proceeds, receiving loan payments, recording accrued interest and fee income, posting to subsidiary ledgers, and reconciling subsidiary and general ledgers. Typically, employees working with these types of activities have the capability to transfer funds between accounts on the bank's and customer's behalf, which opens up an area of potential abuse. Additional potential areas for unethical employee behavior include the maintenance of loan notes and related documentation, as well as the credit and collateral files on borrowers. The bank must ensure it has adequate controls in place to avoid any improprieties; controls might include having separate departments for loan activities within a large organizational structure or rotating and/or segregating loan duties in smaller community banks. Some specific issues related to these responsibilities are described below.

Applications and Loan Approval Process

The bank should have written policies and procedures for obtaining and reviewing loan applications and for ensuring sufficient borrower information (both financial and collateral-related) is required and analyzed in support of the loan approval. Approvals should be made in accordance with the bank's written guidelines and should also address the disbursal of loan proceeds. Additional issues that bank policies and procedures should address include—

- the requirement that loan commitments be in writing;
- requirements for letters of credit;
- the requirement for an annual review of borrowers, including a reassessment of the appropriateness of credit lines; and
- the requirement for a process for extending or renewing loans and credit lines.

Exceptions to the bank's written policies and procedures should reflect the appropriate level of approval and should be documented in writing.

Account Records

Bank staff should compare the approved terms for new and renewed extensions of credit (amount, maturity, interest rate, payment schedule) to the note or loan agreement for accuracy. The former should then be compared to the trial balance, if it is automated. If a manual system is used, the approved amount of the extension of credit should be checked against deposit tickets to ensure the correct amount was transferred to the borrower's account. Adjustments to loan accounts or accrued interest receivable accounts should be checked and tested by an individual independent of the loan-processing area. Subsidiary records should be routinely reconciled with the appropriate general ledger accounts.

Payments

Regardless of the type of payment, principal, interest, or fee, certain controls are necessary to ensure the effectiveness of operations, as well as the safeguarding of bank assets. An individual who cannot originate loan entries should perform an independent test of interest, commissions, and fee computations and confirm their accuracy. Payment notices should be prepared by someone other than a loan teller. In addition, loan officers should be prohibited from processing loan payments. Payments received by mail, tellers, or other departments should be separate from the loan-recording function. Supervisory approvals should be required for processing payments that are less than the amount contractually due, pertain to delinquent loans, are received irregularly, or involve waiving late fees. Collection notices should also be handled by someone not associated with loan processing.

Credit File Documentation

The bank should establish and maintain credit files for all borrowers. The bank's written loan policy should detail the minimum acceptable amount of information to be included in a borrower's credit file. The credit file should contain information on the extension of credit that identifies its purpose, source of repayment, repayment terms, and disposition of loan proceeds. Additionally, information should be on file relating to and/or analyzing the borrower's financial condition, including tax returns as appropriate; collateral, its valuation and related hazard insurance; the loan officer's contact with the borrower; and other pertinent documents, such as guarantor information, loan agreements, and loan covenant check sheets. Banks should maintain this information to support their evaluation of the borrower's creditworthiness and to leave a paper trail for auditors. The bank should also implement a file documentation tickler system to help bank personnel obtain updated information on borrowers, thereby facilitating continuous assessment and monitoring of credit risk.

Collateral Records

Banks should maintain a register to document collateral received from and released to borrowers, which should correspond to the actual collateral being held. Negotiable collateral should be maintained under dual control in a fireproof vault. The receiving and releasing of collateral to customers should be handled by individuals other than those who make entries in the collateral register. The bank should issue a receipt to customers for each item of collateral it is holding in safekeeping. Signed customer receipts should be obtained and filed after the collateral is released.

Management Information Systems

Management information systems, an increasingly important component of the loan administration function, allow a bank to manage its lending decisions more efficiently and effectively. Whether the bank uses a computerized or manual system to manage its loan portfolio, the following types of information should be readily available and routinely reviewed by management:

- total loans and commitments
- loans in excess of existing credit limits
- new extensions of credit, credit renewals, and restructured credits
- a listing of all delinquent and/or nonaccrual loans
- credits adversely graded or requiring special attention
- credits to insiders and their related interests
- credits not in compliance with policies, laws, or regulations
- specific lending activity aspects, including automated financial statement spreads of borrowers and analyses of the bank's credit exposure by type, geographic areas, collateral, and large employers

INTERNAL LOAN REVIEW

The internal loan review function should not be merely an after-the-fact, loan-by-loan review, but a process to detect weaknesses in the various levels of an institution's credit approval and monitoring system.

The nature of loan review systems may vary based on an institution's size, complexity, and management practices. For example, a loan review system may include components of a traditional loan review function that is independent of the lending function. Or, it may place some reliance on loan officers. While the former method is preferred, reliance on the lending staff could be appropriate if the loan officers are not permitted sole discretion to assign credit-quality ratings. In addition, the term ''loan review system'' can refer to various responsibilities assigned to credit administration, loan administration, problem-loan workout, or other areas. These responsibilities may range from administering the internal problem loan–reporting process to maintaining the integrity of the credit-grading process (for example, ensuring that changes are made in credit grades as needed) and coordinating the information necessary to assess ALLL adequacy. Regardless of the structure of the loan review function, an effective system should—

- ensure consistent application of the credit-grading system,
- promptly and accurately identify loans with potential or well-defined credit weaknesses and ensure the development and implementation of an appropriate action plan to minimize credit losses,
- project relevant trends that affect the collectibility of the portfolio and isolate potential problem areas,
- act as an information source concerning emerging trends in the portfolio and the bank's area economy,
- provide senior management and the board of directors with an objective and timely assessment of the overall quality of the loan portfolio,
- provide essential information to determine the adequacy of the ALLL,
- assess the adequacy of and adherence to internal credit policies and loan administration procedures, and monitor compliance with relevant laws and regulations,
- ensure that relevant supporting loan documentation has been obtained,
- help develop and revise lending policy and procedures,
- evaluate the activities of lending personnel, and
- provide management with accurate and timely information related to credit quality that can be used for financial and regulatory reporting purposes.

Characteristics of Loan Review Program

To accomplish the preceding loan review objectives effectively, the program must possess the following components:

- a policy that clearly defines responsibilities of the loan review function and that communicates directorate and management support to all personnel involved in the lending function
- a policy that explicitly describes the bank's credit-grading system and grading definitions
- the capacity for objective judgment of loan quality and the autonomy to exercise it
- the freedom to communicate directly, without fear of reprisal, with senior management and the bank's board of directors
- skilled personnel who are experienced in credit analysis and knowledgeable of sound lending operations
- training and continuing education resources for the loan review staff

Credit-Grading Systems

The foundation of any loan review system is accurate and timely credit grading (also referred to as risk rating), which involves assessing credit quality and, ultimately, identifying problem loans. An effective credit-grading system provides that the bank's risk ratings on ''non-pass'' credits be updated periodically (at least quarterly) so that (1) the ALLL is appropriate for the risk contained in the portfolio and (2) strategies relative to workout action plans are up-to-date. Regardless of the type of loan review system employed, an effective credit-grading framework generally places primary reliance on loan officers to identify emerging loan problems. However, given the importance and the subjective nature of credit grading, a loan officer's judgment on the assignment of a particular credit grade to a loan should be subject to review by (1) peers, superiors, or loan committees; (2) an independent, qualified part-time or full-time person(s); (3) an internal department staffed with credit review specialists; or (4) outside credit review consultants. A review of the credit-quality assessment independent of the lending function is preferred because it typically provides a more conservative and realistic assessment of credit quality. Accurate and timely credit grading is a critical component of an effective loan review system. Each institution should ensure that its loan review system includes the following attributes:

- a formal credit-grading system that can be reconciled with the framework used by the federal regulatory agencies[10]

10. An institution may have a credit-grading system that differs from the credit-grading framework used by the Federal Reserve. However, each institution that maintains a credit-grading system that differs from the Federal Reserve's framework should maintain documentation that translates its credit-grading system into the pass/special mention/substandard/doubtful/loss credit-grading framework used by the Federal Reserve. This documentation should be sufficient to enable

- an identification or grouping of loans that warrants the special attention of management, with documentation supporting the reasons a particular loan deserves special attention
- a mechanism for direct, periodic, and timely reporting to senior management and the board of directors on the status of loans identified as needing special attention, and the actions taken by management
- appropriate documentation of the institution's credit loss experience for various components of its loan and lease portfolio[11]

An institution should maintain a written description of its credit-grading system, including a discussion of the factors used to assign appropriate credit grades to loans. Loan grades should reflect the risk of credit losses. In addition, the loan review program should be in writing, and the board of directors should review and approve it at least annually to evidence its endorsement.

Loan Review System Elements

An institution's written policy and documentation of its loan review system should address the following elements:

- qualifications of loan review personnel
- independence of loan review personnel
- frequency of reviews
- scope of reviews
- depth of reviews
- review of findings and follow-up
- workpaper and report distribution, including distribution of reports to senior management and the board of directors

Qualifications of Loan Review Personnel—Persons involved in the loan review function should be selected based on level of education, experience, and extent of formal credit training. They should be knowledgeable of both sound lending practices and the institution's lending guidelines for the types of loans it offers. In addition, loan review personnel should be aware of relevant laws and regulations affecting lending activities.

Independence of Loan Review Personnel—An effective loan review system uses (1) a loan officer's initial identification of emerging problem loans and (2) the credit review of loans by individuals independent of the credit approval decisions. The first element of an effective system recognizes the loan officer's responsibility to continually analyze his or her portfolio and to promptly identify and report problem loans. Due to their frequent contact with borrowers, loan officers can usually identify potential problems before they become apparent to the nonlending staff. However, banks should not rely completely on loan officers for identification of problem loans because they may not be entirely objective in assessing the borrower's credit quality. The second element of an effective loan review system recognizes that loans should be reviewed by individuals that do not have responsibility for the loans they review and that the evaluation of the credit should not be influenced by anyone associated with the loan approval/management process.

While larger institutions typically establish a separate department of credit review specialists, cost and volume considerations may not justify such a system in smaller institutions. As a result, in many smaller institutions, management, a loan committee, or even loan officers may fill this role—or it may be filled by outside consultants who periodically come to the bank and review parts or all of the loan portfolio. Whether or not the institution has an independent loan review department, the loan review function should report directly to the board of directors or a board committee. (Senior management may be responsible for appropriate administrative functions as long as the independence of the loan review function is not compromised.)

Frequency of Reviews—Optimally, the loan review function provides useful, continual feedback on the effectiveness of the lending process to identify any emerging problems. For example, significant credits should be reviewed at least annually, upon renewal, or more frequently when internal or external factors indicate a potential for deteriorating credit quality of a borrower or a particular type of loan or pool of loans. A system of ongoing or periodic portfolio reviews is particularly important to the ALLL

examiners to reconcile the totals for the various credit grades under the institution's system to the Federal Reserve's categories listed above.

11. Institutions are encouraged to maintain records of net credit loss experience for credits in each of the following categories: pass, special mention, substandard, doubtful, and loss.

determination process, which depends on the accurate and timely identification of problem loans.

Scope of Reviews—The review should cover all borrowers whose exposure is significant to the size of the bank. Additionally, each review should typically include the following components of the portfolio under review: a sample of smaller loans; past-due, nonaccrual, renewed, and restructured loans; loans previously classified or designated as special mention by the institution or its examiners; insider loans; and concentrations of credit, including other loans affected by common repayment factors. It is important that the scope-related information indicates that these components have been included in the review of the portfolio and that the percentage of the portfolio selected for review provides reasonable assurance that review results identify major problems in that portion of the portfolio and accurately reflect its quality. On a larger scale, the scope of management's review of the entire loan portfolio should attest to the fact that its reviews identify problem loans significant to the bank and accurately reflect portfolio quality on an ongoing basis. The scope of loan reviews should be approved annually by the institution's board of directors or when significant changes are made to the scope.

Depth of Reviews—Reviews should analyze a number of important aspects of selected loans, including—

- credit quality;
- sufficiency of credit and collateral documentation;
- proper lien perfection;
- proper approval by the loan officer and loan committee(s);
- adherence to any loan-agreement covenants;
- compliance with laws, regulations, and internal policies and procedures; and
- the appropriateness and timeliness of problem-loan identification by loan officers.

Review of Findings and Follow-Up—Findings should be reviewed with appropriate loan officers, department managers, and members of senior management. Management's responses to all noted deficiencies and identified weaknesses should include existing or planned corrective actions and the timeframes for correction. Significant noted deficiencies and identified weaknesses that remain unresolved beyond the assigned correction timeframes should be promptly reported to senior management and, if still unresolved, to the board of directors.

Workpaper and Report Distribution—Workpapers should contain a list of the borrowers included in the scope of the review and all supporting information needed to substantiate the findings. Reports to management discussing the findings of a portfolio review should indicate the "as of" review date; address the credit grading (risk rating) of the individual borrowers (loans) reviewed, as well as of the specific portfolio; assess the adequacy of and adherence to internal policies and procedures; indicate loan, credit file, and collateral deficiencies; and evaluate compliance with laws and regulations. The reports also should include summary analyses supporting the assignment of special-mention or classified designations to borrowers (loans). A summary report to the board of directors should be submitted at least quarterly and include findings relative to the areas previously mentioned for all reviews conducted during that timeframe (more frequently if material adverse trends are noted.) This summary report might include, in addition to the issues found in the reports to management, comparative trends identifying significant changes in the overall quality of the portfolio.

Examination Scope Guidance

An effective loan review function can greatly assist examiners in their review of the bank's loan portfolio. The examination process should evaluate the internal loan-review function by assessing the scope and depth of the review and the quality of the output. While examiners should not rely entirely on the bank's findings, they can limit the scope of their loan examination by developing a comfort level with the bank's internal loan-review function. To determine the reliability, if any, of the internal loan-review function, examiners should assess the adequacy of management's ability to identify problem loans. Two issues should be evaluated in this regard: timeliness and accuracy. The first issue deals with the ability of loan review to distinguish a problem loan and/or borrower from a nonproblem one when it initially becomes a problem. The second issue deals with the accuracy of loan review in identifying the severity of the problem. The Extent that examiners rely on an internal loan-review function depends upon their comfort level with the bank in the aforementioned regard.

The examiner will be able to determine the degree to which the bank's loan review function can be relied upon by reviewing prior examination criticisms, as well as management's response to them, and a sufficient sample of the bank's portfolio. Whether the borrower being reviewed as a part of the sampling process is a pass or nonpass credit, examiners should consider narrowing the scope of the pass credits included in the loan examination if they concur with the bank's risk ratings. However, examiners still should continue their analysis of all ''nonpass'' credits due to their importance to the adequacy of the ALLL.

NONACCRUAL LOANS

Loans and lease-financing receivables are to be placed on nonaccrual status if (1) principal or interest has been in default for 90 days or more, unless the loan is both well secured and in the process of collection; (2) payment in full of principal or interest is not expected; or (3) they are maintained on a cash basis because the financial condition of the borrower has deteriorated.

Definition of ''well secured'' and ''in the process of collection''—A debt is ''well secured'' if it is secured (1) by collateral in the form of liens on or pledges of real or personal property, including securities, that have a realizable value sufficient to discharge the debt (including accrued interest) in full or (2) by the guarantee of a financially responsible party. A debt is ''in the process of collection'' if collection of the asset is proceeding in due course either (1) through legal action, including judgment enforcement procedures, or (2) through collection efforts (not involving legal action) that are reasonably expected to result in repayment of the debt or in its restoration to a current status in the near future. Statutory bad debt, ''A paper,'' is defined in section 5204 of the U.S. Revised Statutes (12 USC 56) as all debts to a bank on which interest is past due and unpaid for six months, unless the same is well secured and in the process of collection. Delinquent loans that are not covered under the definition of statutory bad debt are designated ''B paper.''

Exceptions—A loan does *not* need to be placed on nonaccrual status if (1) the criteria for amortization specified in AICPA Practice Bulletin No. 6 are met with respect to a loan acquired at a discount from an unaffiliated third party, including those that the seller has maintained on nonaccrual status, or (2) the loan is a consumer loan or secured by a one- to four-family residential property. However, the bank may elect to carry these loans on a nonaccrual status. Also, if a bank has a significant consumer or residential mortgage loan portfolio in relation to its total loans and tier 1 capital, a thorough review of the delinquency status should be performed to ensure that the bank has not materially misstated its financial condition and earnings.

Treatment of Cash Payments and Criteria for the Cash-Basis Treatment of Income—When a bank places a loan on nonaccrual status, it must consider how to account for subsequent payments. When the collectibility of the remaining book balance of a loan on nonaccrual status is uncertain, any payments received must be applied to reduce principal to the extent necessary to eliminate such doubt. Placing an asset on nonaccrual status does not require a charge-off, in whole or in part, of the asset's principal. However, *any identified loss* must be charged off.

When a loan is on nonaccrual status, some or all of the cash interest payments received may be treated as interest income on a cash basis, as long as the remaining book balance of the asset after the charge-off, if any, is deemed fully collectible. A bank's determination of the collectibility of an asset's remaining book balance must be supported by a current, well-documented credit evaluation of the borrower's financial condition and repayment prospects.

When recognition of interest income on a cash basis is appropriate, the amount of income recognized should be limited to what would have been accrued on the loan's remaining book balance at the contractual rate. Any cash interest payments received over this limit (and not applied to reduce the loan's remaining book balance) should be recorded as recoveries of prior charge-offs until these charge-offs have been fully recovered. (A bank should have a well-defined policy governing the treatment of interest income and the charge-off of accrued interest receivables.)

Treatment of Previously Accrued But Uncollected Interest—When a bank places a loan on nonaccrual status, its policy should address an appropriate treatment of previously accrued but uncollected interest. One acceptable method is to reverse all previously accrued but uncollected interest against appropriate income and balance-sheet accounts. For interest accrued in the current accounting period, the entry is made directly against the interest income account. For prior accounting periods, if accrued-interest provisions to the ALLL were not made, the amount of accrued but uncollected interest should be charged against current earnings. Also for prior accounting periods when provisions to the ALLL for possible loss of interest had been made, the bank generally reverses the accrued but uncollected interest by charging the ALLL to the extent of those specific provisions. Generally accepted accounting principles do not require the write-off of previously accrued interest if principal and interest are ultimately protected by sound collateral values. A bank is expected to have a well-defined policy, subject to examiner review, governing the write-off of accrued interest.

Treatment of Multiple Extensions of Credit to One Borrower—As a general rule, nonaccrual status for an asset should be determined by assessing its collectibility, repayment ability, and performance. Thus, when one loan to a borrower is placed in nonaccrual status, a bank does not automatically have to place all of that borrower's other extensions of credit in nonaccrual status. The bank should evaluate its other extensions of credit to that borrower to determine if one or more of them also should be placed in nonaccrual status.

Restoration to Accrual Status—As a general rule, a nonaccrual loan may be restored to accrual status when (1) its principal and interest are no longer past due and unpaid, and the bank expects repayment of the remaining principal and interest, or (2) when it otherwise becomes well secured and in the process of collection. Before restoring a loan to accrual status, the bank should consider the borrower's prospects for continuing future contractual payments. If reasonable doubt exists, reinstatement may not be appropriate.

To meet the first test, the bank must have received payment of the past-due principal and interest, unless the loan has been formally restructured and qualifies for accrual status under the restructured terms, or the asset has been acquired at a discount from an unaffiliated third party due to uncertainty about the amounts or timing of future cash flows and meets the amortization criteria (that is, accretion of discount) specified in AICPA Practice Bulletin No. 6.

A nonaccrual loan is considered in the process of collection if the borrower has resumed paying contractual interest and principal payments, even if the past-due amount has not been brought totally current. These loans may be returned to accrual status provided two criteria are met: All principal and interest amounts due (including arrearages) are reasonably assured of repayment within a reasonable period, and the borrower has a sustained period of performance (generally a minimum of six months) in accordance with the contractual terms.

Until the loan is restored to accrual status, cash payments received must be treated according to the criteria stated above. In addition, after a formal restructuring, if the loan that has been returned to accrual status later meets the criteria for placement in nonaccrual status (as a result of past-due status based on its modified terms or for any other reason), the asset must be placed on nonaccrual status.

Treatment of Nonaccrual Loans with Partial Charge-Offs—GAAP and regulatory reporting requirements do not explicitly address whether partial charge-offs associated with a nonaccrual loan (that has not been formally restructured) must be fully recovered before a loan can be restored to accrual status.

According to call report instructions, restoration to accrual status is permitted when (1) the loan has been brought fully current with respect to principal and interest and (2) the bank expects the loan's full contractual balance (including any amounts charged off), plus interest, will be fully collectible under the terms of the loan. Thus, to return a partially charged-off loan that has been brought fully current to accrual status, the bank should determine if it expects to receive the full amount of principal and interest called for by the loan's terms.

When the contractual principal and interest of a loan have been brought fully current, and the borrower's financial condition and repayment prospects have improved so that the full contractual principal (including any amounts charged off) and interest is expected to be repaid, the loan may be restored to accrual status *without* having to first recover the charge-off. Conversely, this treatment would be inappropriate when the charge-off indicates continuing doubt about the collectibility of principal or interest.

The reasons for restoring a partially charged-off loan to accrual status must be documented. These actions should be supported by a current, well-documented credit evaluation of the borrower's financial condition and prospects for full repayment of contractual principal (including any amounts charged off) and interest. This documentation will be subject to review by examiners.

Examiner Review—Some states have promulgated regulations or adopted policies for nonaccrual of interest on delinquent loans that may differ from the above procedures. In these cases, the bank should comply with the more restrictive policy. The examiner should ensure that the bank is complying with such guidelines. In all cases, each bank should formulate its own policies to ensure that net income is not being overstated. These policies are subject to examiner review.

RESTRUCTURED OR RENEGOTIATED "TROUBLED" DEBT

In a "troubled-debt restructuring," a bank grants a borrower concessions (for example, a reduction of interest or principal payments) that it would not otherwise consider for economic or legal reasons related to a borrower's financial difficulties. Renegotiated "troubled" debt includes those loans and lease-financing receivables restructured or renegotiated to provide concessions to the borrower. A loan extended or renewed at a stated rate equal to the current interest rate for new debt with similar risk is not considered renegotiated debt. For further information, see the instructions for the Reports of Condition and Income; FASB Statement No. 15, "Accounting by Debtors and Creditors for Troubled Debt Restructurings"; and FASB Statement No. 114, "Accounting by Creditors for Impairment of Loan," which amends FASB 15 to require creditors to measure all loans that are restructured in a troubled-debt restructuring involving only a modification of terms in accordance with FASB 114.[12]

A bank should develop a policy for renegotiated troubled debt to ensure that such items are identified, monitored, and properly accounted for and controlled. These restructurings should occur infrequently. If not, the bank is probably experiencing significant problems. Before troubled-debt concessions are made to a borrower, it is a good practice to have the transactions receive prior approval of the board of directors or a board committee. All these transactions should be reported to the board of directors upon enactment.

Bankers may be involved in formally restructuring loans when borrowers experience financial difficulties or in light of the borrower's condition and repayment prospects. These actions, if consistent with prudent lending principles and supervisory practices, can improve a bank's collection prospects. GAAP and regulatory reporting requirements provide a reporting framework that may alleviate some of the lender's concerns about working constructively with borrowers experiencing financial difficulties. The accounting standards for troubled-debt restructurings are set forth in FASB Statement No. 15.

The interagency policy statement on credit availability, issued March 1, 1991, clarifies a number of supervisory policies on restructured-loan issues. Two of these clarifications indicate that when certain criteria are met, (1) nonaccrual assets can be restored to accrual status when subject to formal restructurings in accordance with FASB Statement No. 15, and (2) restructurings that yield a market rate of interest would not have to be included in restructured loan

12. FASB establishes a new approach for recognizing impairment on problem loans and new disclosure requirements for impaired loans for financial reporting purposes. FASB 118 amends FASB 114 to allow creditors to use existing methods for recognizing interest income on impaired loans. This statement also clarifies the existing accounting for in-substance foreclosure. Under the new impairment standard and related amendments to FASB 15, a collateral-dependent real estate loan (i.e., a loan for which repayment is expected to be provided solely by the underlying collateral) would be reported as OREO only if the lender has taken possession of the collateral. For other collateral-dependent real estate loans, loss recognition would be based on the fair value of the collateral if foreclosure is probable. However, these loans would no longer be reported as OREO. Rather, they would remain in the loan category. In light of the significance of these changes to accounting standards, the Federal Reserve is reevaluating regulatory disclosure and nonaccrual requirements and expects to issue revised policies at a later date. (See SR-93-30 (FIS).)

amounts reported in the years following the restructuring. These clarifications, which are consistent with GAAP, have been fully incorporated into the instructions for the Reports of Condition and Income (call reports).

Nonaccrual Assets Subject to FASB Statement No. 15 Restructurings

A loan or other debt instrument that has been formally restructured to ensure repayment and performance need not be maintained in nonaccrual status. In deciding whether to return an asset to accruing status, payment performance that had been sustained for a reasonable time before the restructuring may be considered. For example, a loan may have been restructured, in part, to reduce the amount of the borrower's contractual payments. It may be that the amount and frequency of payments under the restructured terms do not exceed those of the payments that the borrower had made over a sustained period, within a reasonable time before the restructuring. In this situation, if the lender is reasonably assured of repayment and performance according to the modified terms, the loan can be immediately restored to accrual status.

Clearly, a period of sustained performance, whether before or after the date of the restructuring, is very important in determining whether there is reasonable assurance of repayment and performance. In certain circumstances, other information may be sufficient to demonstrate an improvement in the borrower's condition or in economic conditions that may affect the borrower's ability to repay. This information may reduce the need to rely on the borrower's performance to date in assessing repayment prospects. For example, if the borrower has obtained substantial and reliable sales, lease, or rental contracts or if other important developments are expected to significantly increase the borrower's cash flow and debt-service capacity and strength, then the borrower's commitment to repay may be sufficient. A preponderance of such evidence may be sufficient to warrant returning a restructured loan to accrual status. The restructured terms must reasonably ensure performance and full repayment.

It is imperative that the reasons for restoring restructured debt to accrual status be documented. A restoration should be supported by a current, well-documented evaluation of the borrower's financial condition and prospects for repayment. This documentation will be reviewed by examiners.

The formal restructuring of a loan or other debt instrument should be undertaken in ways that will improve the likelihood that the credit will be repaid in full in accordance with reasonably restructured repayment terms. A restructured loan may not be restored to accrual status unless there is reasonable assurance of repayment and performance under its modified terms in accordance with a reasonable repayment schedule. Regulatory reporting requirements and GAAP do *not* require a banking organization that restructures a loan to grant excessive concessions, forgive principle, or take other steps not commensurate with the borrower's ability to repay to use the reporting treatment specified in FASB Statement No. 15. Furthermore, the restructured terms may include prudent contingent payment provisions that permit an institution to obtain appropriate recovery of concessions granted in the restructuring, if the borrower's condition substantially improves.

Moreover, while restructured debt that qualifies for accrual status and yields a market rate of interest must be disclosed as a FASB Statement No. 15 troubled debt in the year of the restructuring, it need not be disclosed in subsequent years. This clarification was particularly important because, while this guidance is derived from FASB Statement No. 15 and is generally followed for Securities and Exchange Commission reporting purposes, previously it was not clear that this treatment could be followed for call report purposes.

Reporting Guidance on Loan Fees and Interest

The accounting standards for nonrefundable fees and costs associated with lending, committing to lend, and purchasing a loan or group of loans are set forth in FASB Statement No. 91, "Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases." In general, this statement says loan-origination fees should be deferred and recognized over the life of the related loan as an adjustment of yield. The statement applies to all types of loans, as well as to debt securities (but not to loans or securities carried at market value), and to all types of lenders. It must be applied to all lending and leasing transactions in fiscal years beginning after December 15, 1987. Earlier application is encouraged, and retroactive application is permitted. For further information, see FASB Statement No. 91 and instructions for preparing the Report of Condition and Income.

TRANSFER OF LOW-QUALITY LOANS OR OTHER ASSETS

Low-quality loans include those classified or specially mentioned at the most recent examination or loans that would most likely be classified or specially mentioned if subjected to a review. In addition, low-quality loans include past-due loans, nonaccrual loans, loans on which the terms have been renegotiated because of a borrower's poor financial condition, and any other loans the examiner believes are questionable. Other assets of questionable quality include depreciated or subinvestment-grade securities and other real estate. A low-quality asset shall not be acceptable as collateral for a loan or extension of credit to, or guarantee, acceptance, or letter of credit issued on behalf of an affiliate. Furthermore, a low-quality asset cannot be involved in a loan participation or an asset swap.

The transfer of low-quality loans or other assets from one depository institution to another may raise supervisory concerns. These transfers may be made to avoid detection and classification during regulatory examinations and may be accomplished through participation, purchases/sales, and asset swaps with other affiliated or nonaffiliated financial institutions. Section 23A of the Federal Reserve Act, 12 USC 371c, prohibits bank purchases of low-quality assets from an affiliate. Examiners should be alert to situations in which an institution's intention appears to be concealing low-quality assets to avoid examiners' scrutiny and possible classification.

During bank examinations, examiners are requested to identify situations when low-quality assets have been transferred between the institution being examined and another depository institution. The transfer of assets to avoid supervisory review is a highly improper and unsound banking practice and, if an affiliate is involved, is a violation of section 23A of the Federal Reserve Act. If necessary, it should be addressed through formal supervisory enforcement action.

Any transfers of low-quality or questionable assets should be brought to the attention of Reserve Bank supervisory personnel. In turn, these individuals should notify the local offices of primary federal and state regulators (if applicable) of the other depository institutions involved in the transaction. For example, Reserve Banks should notify the primary federal and state regulators (if applicable) of any depository institution to which a state member bank or holding company is transferring or has transferred low-quality loans. Reserve Banks should also notify the primary federal and state regulators (if applicable) of any depository institution from which a state member bank or holding company is acquiring or has acquired low-quality loans. This procedure applies to transfers involving savings and loan associations, savings banks, and commercial banking organizations.

If the examiner determines a permissible transfer of assets was undertaken, he or she should ensure the assets have been properly recorded at fair market value on the books of the acquiring institution. If the transfer involved the parent holding company or a nonbank affiliate, the examiner should determine if the transaction also was recorded properly on the affiliate's books.[13]

Whenever asset transfers occur, examiners should determine whether the assets in question were independently and completely evaluated for conformance with bank policy and procedures. Examiners should be guided by the inspection procedures outlined in section 2020.7.2 of the *Bank Holding Company Supervision Manual*.

ENVIRONMENTAL LIABILITY

Banks may be liable for cleaning up hazardous substance contamination under both federal and state environmental liability statutes. This liability can arise through a bank's ownership or acquisition of real estate, in its role as a creditor, or in a fiduciary role. Banks may also be exposed to environmental liability indirectly through the increased possibility that a borrower's creditworthiness may be impaired by a liability to pay for cleanup of contaminated property, even if the property does not secure bank debt.

13. See SR-83-24 (FIS).

The Comprehensive Environmental Response, Compensation and Liability Act (CERCLA), the federal superfund statute, authorizes the Environmental Protection Agency (EPA) to clean up hazardous waste sites and to recover costs associated with the cleanup from entities specified in the statute. While the superfund statute is the primary federal law dealing with hazardous substance contamination, numerous other federal and state statutes establish environmental liability that could place banks at risk.

CERCLA defines who is subject to liability for the costs of cleaning up hazardous substance contamination. The definition includes ''. . . the owner and operator of a vessel or a facility, (or) any person who at the time of disposal of any hazardous substance owned or operated any facility at which such hazardous substances were disposed of . . . .''[14] Under the statute, a person or entity that transports or arranges to transport hazardous substances can also be held liable for cleaning up contamination.

The superfund statute imposes a standard of strict liability, which means the government does not have to prove that the owners or operators knew about or caused the hazardous substance contamination in order for them to be liable for the cleanup costs. Moreover, liability under the statute is joint and several, which allows the government to seek recovery of the entire cost from any individual party that is liable for those costs under CERCLA.

CERCLA provides an exemption for secured creditors in the definition of ''owner and operator'' by stating that these terms do not include ''. . . a person, who, without participating in the management of a vessel or facility, holds indicia of ownership primarily to protect his security interest in the vessel or facility.''[15] However, this exception has not provided banks with an effective defense from liability because courts have limited its applicability. Specifically, courts have held that some lenders' actions to protect their security interests have resulted in the bank ''participating in the management of a vessel or facility,'' thereby voiding the exemption. Additionally, once the title to a foreclosed property passes to the bank, some courts have held that the exemption no longer applies and that the bank is liable under the superfund statute as an ''owner'' of the property. Under some circumstances, CERCLA may exempt landowners who acquire property without knowing about existing conditions (the ''innocent landowner defense''). However, the courts have applied a stringent standard to qualify for this defense. Since the statute provides little guidance as to what constitutes the appropriate timing and degree of due diligence to successfully employ this exemption, banks should exercise caution before relying on it.

14. CERCLA, section 107(a).
15. CERCLA, section 101(20)(A).

Overview of Environmental Hazards

Environmental risk can be characterized as adverse consequences that result from generating or handling hazardous substances or from being associated with the aftermath of contamination.

Hazardous substance contamination is most often associated with industrial or manufacturing processes that involve chemicals as ingredients or waste products. For years, these types of hazardous substances were frequently disposed of in landfills or dumped on industrial sites. However, hazardous substances are also found in many other lines of business. The following examples demonstrate the diverse sources of hazardous substances, but by no means cover them all:

- farmers and ranchers (fuel, fertilizers, herbicides, insecticides, and feedlot runoff)
- dry cleaners (various cleaning solvents)
- service station and convenience store operators (underground storage tanks)
- fertilizer and chemical dealers and applicators (storage and transportation of chemicals)
- lawn care businesses (application of lawn chemicals)
- trucking firms (transportation of substances such as fuel or chemicals)

Environmental liability has had the greatest impact on the real estate industry. Not only has land itself been contaminated with toxic substances, construction methods for projects such as commercial buildings have used materials that have been subsequently determined to be hazardous—resulting in significant declines in project values. For example, asbestos was commonly used in commercial construction from the 1950s to the late 1970s. Asbestos has since been found to be a health hazard and now, in many cases, must be removed or its effects abated by enclosing or otherwise sealing off the contaminated areas.

Another common source of hazardous substance contamination is underground storage tanks. Leaks from these tanks not only contaminate the surrounding ground, but often flow into ground water and travel a significant distance from the original contamination site. As contamination spreads to other sites, cleanup costs escalate.

Effect on Banks—A bank may encounter losses from environmental liability through direct ownership, lending and trust activities, or mergers or acquisitions of borrowers. The greatest risk to a bank is the possibility of being held solely liable for costly environmental cleanups. Under the doctrine of joint and several liability, a bank may find itself solely responsible for cleaning up a contaminated site at a cost that exceeds any outstanding loan balance or property value.

Direct Ownership

A bank may be held liable for the cleanup of hazardous substance contamination in situations when it—

- takes title to property through foreclosure or acquires property to satisfy debts previously contracted;
- owns or acquires for future expansion premises that have been contaminated by hazardous substances; or
- owns, acquires, or merges with another entity involved in activities that might result in a finding of environmental liability.

Lending Activity—While real estate loans present the greatest risk, almost any type of loan, unsecured or secured, can expose a bank to the effects of environmental liability. A borrower who is required to pay for the cleanup of a contaminated property may be unable to provide the necessary funds both to remove contaminated materials and to service the debt. Even if the bank does not have a security interest in the borrower's real estate, it must be aware that significant cleanup costs could threaten the borrower's solvency and net worth (and jeopardize the collection of working-capital or equipment loans). If the loan is secured by the contaminated real estate, the bank may find that the property value has declined dramatically, depending on the degree of contamination. In determining whether to foreclose, the bank must compare the estimated cleanup costs against the value of the collateral. In many cases, this estimated cost has been well in excess of the outstanding loan balance, and the bank has elected to abandon its security interest in the property and charge off the loan. This situation occurs because some courts have not allowed banks that have foreclosed on a property to avail themselves of the secured-creditor exemption. These rulings have been based on a strict reading of the superfund statute that provides the exemption to ''security interests'' only.

A bank may also expose itself to environmental liability in its role as a secured or unsecured creditor if it involves bank personnel or contractors engaged by the bank in day-to-day management of the facility or takes actions designed to make the contaminated property salable, possibly resulting in further contamination.

Bank Premises—Banks may also be exposed to environmental liability for property held as bank premises. A review of historical uses of properties to be acquired for relocation or future expansion should provide insight into the likelihood that contamination may have occurred and whether additional steps may be warranted.

Mergers and Acquisitions of Borrowers—Borrowers may face environmental risk through the activities of subsidiaries or by merging with or acquiring other companies whose activities result in environmental liability. Some courts have held that for the purposes of determining liability under the superfund statute, the corporate veil may not protect parent companies that participate in the day-to-day operations of their subsidiaries from environmental liability and court-imposed cleanup costs. Additionally, borrowers and, ultimately, banks can be held liable for contamination that occurred before they owned or used the real estate.

Protection Against Environmental Liability

Banks may avoid or mitigate potential environmental liability by having sound policies and procedures designed to identify, assess, and control environmental liability. The following discussion briefly describes methods that banks may employ to minimize potential environmental liability.

Loan policies and procedures should address methods for identifying potential environmental problems relating to credit requests. The loan policy should describe an appropriate degree of due diligence investigation required for credit requests. Borrowers in high-risk industries or localities should be investigated more stringently than borrowers in low-risk industries or localities.

After a loan is granted, periodic credit analysis of the borrower's ability to repay should include an assessment of environmental risk. If the credit is secured by real property collateral, the bank should remain aware of the property's uses and the potential environmental risk associated with those uses. Even if the credit is not secured by real property, periodic credit reviews should determine whether repayment prospects may be jeopardized by any activities that might expose the borrower to environmental liability.

The first step in identifying environmental risk is an environmental review. These reviews may be performed by loan officers or others. They typically identify past uses of the property; evaluate regulatory compliance, if applicable; and identify potential problems. The reviewer should interview persons familiar with present and past uses of the facility and property, review relevant records and documents, and inspect the site.

When the environmental review reveals possible hazardous substance contamination, an environmental assessment or audit may be required. Environmental assessments are made by personnel trained in identifying potential environmental hazards and provide a more thorough inspection of the facility and property. Environmental audits differ markedly from environmental assessments because independent environmental engineers are employed to investigate the property in great detail. Engineers test for hazardous substance contamination, which might require collecting and analyzing air samples, surface soil samples, or subsurface soil samples or drilling wells to sample ground water.

Other measures some banks use to help identify and minimize environmental liability to the bank include obtaining indemnities from borrowers for any cleanup costs incurred by the bank and writing affirmative covenants into loan agreements (and attendant default provisions) that require the borrower to comply with all applicable environmental regulations. Although these measures may provide some aid in identifying and minimizing potential environmental liability, their effectiveness depends on the financial strength of the borrower and does not represent a substitute for environmental reviews, assessments, and audits.

Banks must be careful that any policies and procedures undertaken to assess and control environmental liability cannot be construed as taking an active role in the management or day-to-day operations of the borrower's business. Some activities that courts could consider active participation in the management of the borrower's business and that could subject the bank to potential liability include—

- having bank employees serve as members of the borrower's board of directors or actively participate in board decisions,
- assisting in day-to-day management and operating decisions, and
- actively determining management changes.

These considerations are especially important when the bank is actively involved in loan workouts or debt restructuring.

LOAN PROBLEMS

The failure of directors to establish a sound lending policy, require management to establish adequate written procedures, and monitor and administer the lending function within established guidelines has resulted in substantial problems for many institutions. Loan problems may be caused by a number of factors affecting the bank or its borrowers. For a discussion of the indicators of troubled commercial real estate loans, see the 2090 sections of this manual. The major sources and causes of problem credits are explained below.

Competition—Competition among banks for size and community influence may result in compromising credit principles and making or acquiring unsound loans. The ultimate cost of unsound loans always outweighs temporary gains in growth and influence.

Complacency—The following items manifest complacency and should always be guarded against:

- lack of adequate supervision of long-term and familiar borrowers

- dependence on oral information the borrower furnished in lieu of reliable and verifiable financial data
- optimistic interpretation of known credit weaknesses based on past survival of recurrent hazards and distress
- ignorance or disregard of warning signs about the borrower, economy, region, industry, or other related factors

Compromise of Credit Principles—Bank management, for various reasons, may grant loans carrying undue risks or unsatisfactory terms, with full knowledge of the violation of sound credit principles. The reasons management may compromise basic credit principles include timidity in dealing with individuals with dominating personalities or influential connections, friendships, or personal conflicts of interest. Self-dealing, salary incentives, and bonuses based on loan portfolio growth, as well as competitive pressures also may lead to a compromise of credit principles.

Failure to Obtain or Enforce Repayment Agreements—Loans granted without a clear repayment agreement are, at the very least, a departure from fundamental banking principles. These loans are likely to become significant problems. A more common problem, but just as undesirable, occurs when the bank and borrower agree on repayment or progressive liquidation of a loan, but the bank fails to collect the principal payments when and how it should. A study of loan losses will show that, in many cases, amortization never equalled the principal payments the borrower agreed to make. Good lending and good borrowing both require consistent liquidation.

Incomplete Credit Information—Complete credit information is necessary to make a reasonable and accurate determination of a borrower's financial condition and repayment capacity. Adequate and comparative financial statements, operating statements, and other pertinent statistical data should be available. Other essential information, such as the purpose of the borrowing and the intended plan and repayment source, progress reports, inspections, and memoranda of outside information and loan conferences, should be contained in the bank's credit files. The lack of adequate credit information can limit management's ability to react quickly and effectively when problems develop.

Lack of Supervision—Many loans that are sound at their inception develop into problems and losses because of ineffective supervision. This lack of supervision usually results from a lack of knowledge about the borrower's affairs over the lifetime of the loan.

Overlending—In one sense, overlending could come under the heading of technical incompetence. However, overlending is a weakness found in some lenders that are otherwise competent. Loans beyond the borrower's reasonable capacity to repay are unsound. Nowhere are technical competence and credit judgment more important than in determining a sound borrower's safe, maximum loan level.

Poor Selection of Risks—When banks are willing to assume more than normal risk levels, they often experience serious loan problems. The following general loan types may fall within the category of poor risk selection:

- loans in which the bank advances an excessive proportion of the required capital relative to the borrower's equity investment
- loans based more on the expectation of successfully completing a business transaction than on the existing net worth and repayment capacity
- loans for the speculative purchase of securities or goods
- loans collateralized by marketable assets carried without adequate margins of security
- loans made for other benefits, such as control of large deposit balances in the bank, instead of sound net worth, collateral, or repayment capacity
- loans secured solely by the nonmarketable stock of a local corporation, made in conjunction with loans directly to that corporation (The bank may consider itself forced to finance the corporation far beyond warranted limits to avoid loss on a loan that relies on the corporation's stock.)
- loans predicated on collateral of uncertain liquidation value (A moderate amount of these loans, when recognized by bank management as subject to inherent weakness, may cause few problems. However, the bank can encounter trouble if this practice becomes the rule.)

Revenue-Driven Lending—The loan portfolio is usually a bank's most important revenue-producing asset. The earnings factor, however, must never compromise sound credit judgment and allow credits carrying undue risks or unsatisfactory repayment terms to be granted. Unsound loans usually cost far more than the revenue they produce.

Self-Dealing—Self-dealing is found in many serious problem banks. Self-dealing often takes the form of an overextension of credit on an unsound basis to directors or principal shareholders, or to their related interests, who have improperly used their positions to obtain funds in the form of unjustified loans (or sometimes as fees, salaries, or payments for goods or services). Officers, who hold their positions at the pleasure of the board may be pressured to approve loan requests by insiders that, coming from customers, would have been rejected. In that situation, management may attempt to defend unsound loans or other self-dealing practices by bank insiders.

Technical Incompetence—All able and experienced bankers should possess the technical ability to analyze financial statements and to obtain and evaluate other credit information. When this ability is absent, unwarranted losses are certain to develop. Credit incompetence of management should be discussed promptly with the board of directors.

LOAN BROKERAGE AND SERVICING ACTIVITIES

Loan brokerage and servicing activities are undertaken by mortgage banking enterprises and the mortgage banking operations of commercial banks. Mortgage banking activities consist primarily of two separate but related activities: (1) the origination or acquisition of mortgage loans and the sale of the loans to permanent investors and/or (2) the subsequent long-term servicing of the loans. A mortgage banking enterprise usually retains the right to service mortgage loans it sells to permanent investors. An enterprise's right to service mortgage loans other than its own is an intangible asset that may be acquired separately. The rights to service mortgage loans are purchased and sold frequently. Mortgage loans are acquired to sell to permanent investors from a variety of sources, including applications received directly from borrowers (in-house originations), purchases from brokers, purchases from investors, and conversions of various forms of interim financing to permanent financing. A service fee, usually based on a percentage of the outstanding principal balance of the mortgage loan, is received for performing loan-administration functions. When servicing fees exceed the cost of performing servicing functions, the existing contractual right to service mortgage loans has economic value.

A number of bank services may result in assets and liabilities that do not have to be entered on the general ledger. These services are considered off-balance-sheet activities and may include the origination, sale, and servicing of various loans. Servicing and accounting activities cover functions related to initially recording the loan, collecting and recording payments, and reporting loan transactions and balances (including reporting past-due loans). Unlike the other activities in this section, servicing and accounting activities are not directly related to credit risk. However, some aspects of accounting and servicing activities, such as the accounting system's ability to produce accurate past-due loan reports, indirectly contribute to controlling credit risk. Also, poorly designed or ineffective servicing and accounting activities can contribute to increased risk in areas besides credit, such as fraud and insider abuse.

The origination, sale, and servicing of various types of loans usually have been associated with mortgage loans. But increasingly, origination and servicing activity has also been observed in government-guaranteed loans (or portions thereof), consumer loans, and commercial loans. Improper management and control of these activities by the servicer presents certain supervisory concerns. If the bank servicer is continually originating additional loans to be serviced, the bank may find itself responsible for servicing more loans than it can prudently manage. Failure to properly administer loans may lead to legal or financial liabilities that could adversely affect the bank's capital.

Examiners should review the extent and nature of servicing activities to ensure that they are conducted in a safe and sound manner. Loan-origination fees and related direct loan-origination costs of loans held-for-sale should be capitalized as part of the carrying amount of the related loan and should not be amortized. A premium paid for the right to service loans ordinarily is capitalized and equivalent to the cost of acquiring that right. Fees for services performed by third parties and loan-placement fees are recognized as revenue when all significant services have been performed. Improper practices should be criticized.

Risk Management and the Valuation and Hedging of Mortgage-Servicing Assets Arising from Mortgage Banking Activities

A bank's board of directors and senior management are expected to take into account the potential exposure of both earnings and capital to changes in a bank's mortgage banking assets and operations under expected and stressed market conditions. Banks are expected to have comprehensive documentation that adequately substantiates and validates the carrying values of its mortgage-servicing assets (MSAs) and the underlying assumptions used to derive those values. The analyses and processes should be fully documented to support the amortization and timely recognition of impairment of the bank's MSAs. (See SR-03-4.)

The guidance that follows focuses on the risks associated with these aspects of mortgage banking: valuation and modeling processes, hedging activities, management information systems, and internal audit processes. When banks originate mortgage loans, they often sell the loans into the secondary market. Yet banks often retain and recognize the servicing of those MSAs, which are complex and volatile assets that are subject to interest-rate risk. MSAs can become impaired as interest rates fall and borrowers refinance or prepay their mortgage loans. This impairment can lead to earnings volatility and the erosion of capital, if the risks inherent in the MSAs are not properly hedged.

Banks are expected to follow Financial Accounting Standards Board Statement No. 140 (FAS 140), "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities," when accounting for MSAs. In summary, FAS 140 requires the following accounting treatment for servicing assets (including MSAs):[16]

- initially record servicing assets at fair value, presumably the price paid if purchased, or at their allocated carrying amount based on relative fair values if retained in a sale or securitization;[17]
- amortize servicing assets in proportion to, and over the period of, estimated net servicing income; and
- stratify servicing assets based on one or more of the predominant risk characteristics of the underlying financial assets, assess the strata for impairment based on fair value, and report them on the balance sheet at the lower of unamortized cost or fair value through the use of valuation allowances.

Fair value is defined in FAS 140 as the amount at which an asset could be bought or sold in a current transaction between willing parties, that is, other than in a forced or liquidation sale. Quoted market prices in active markets for similar assets provide the best evidence of fair value and must be used as the basis for the measurement, if available. If quoted market prices are not available, the estimate of fair value must be based on the best information available. The estimate of fair value must consider prices for similar assets and the results of valuation techniques to the extent available.

Examination Concerns on the Valuation of Mortgage-Servicing Assets

Banks involved in mortgage-servicing operations should use market-based assumptions that are reasonable and supportable in estimating the fair value of servicing assets. Specifically, bulk, flow, and daily MSA or loan pricing activities observed in the market should be evaluated to ensure that a bank's MSA valuation assumptions are reasonable and consistent with market activity for similar assets. Many banks also use models to estimate the fair value of their MSAs and substantiate their modeled estimate of MSA fair value by comparing the model output with general or high-level peer surveys. Such a comparison, however, is often performed without adequate consideration of the specific attributes of the bank's own MSAs.

16. Further guidance on the accounting for servicing assets and liabilities can be found in the instructions for the Reports of Condition and Income (call report); FAS 140 FASB Staff Implementation Guide; and the AICPA Statement on Auditing Standards 101, "Auditing Fair Value Measurements and Disclosures."

17. FAS 140 indicates: "Typically, the benefits of servicing are expected to be more than adequate compensation to a servicer for performing the servicing, and the contract results in a servicing asset. However, if the benefits of servicing are not expected to adequately compensate a servicer for performing the servicing, the contract results in a servicing liability."

Examiners should consider the following concerns as an indication that additional scrutiny is necessary:

- *The use of unsupported prepayment speeds, discount rates, and other assumptions in MSA valuation models.*
  (Assumptions are unsupported when they are not benchmarked to market participants' assumptions and the bank's actual portfolio performance across each product type.)
- *Questionable, inappropriate, or unsupported items in the valuation models (examples include retention benefits,*[18] *deferred tax benefits, captive reinsurance premiums, and income from cross-selling activities).*
  (The inclusion of these items in the MSA valuation must be appropriate under generally accepted accounting principles (GAAP) and must also be consistent with what a willing buyer would pay for the mortgage-servicing contract. For example, when the inclusion of retention benefits as part of the MSA valuation is not adequately supported with market data, such inclusion will result in an overstatement of reported mortgage-servicing assets. Therefore, the inclusion will be deemed an unsafe and unsound practice.)
- *Disregard of comparable market data coupled with overreliance on peer-group surveys as a means of supporting assumptions and the fair value of MSAs.*
  (Management may use survey data for comparative purposes; however, such data are not a measure of or substitute for fair value.)
- *Frequent changing of assumptions from period to period for no compelling reason, and undocumented policies and procedures relating to the MSA valuation process and oversight of that process.*
- *Inconsistencies in the MSA valuation assumptions used in valuation, bidding, pricing, and hedging activities as well as, where relevant, in mortgage-related activities in other aspects of a bank's business.*
- *Poor segregation of duties from an organizational perspective between the valuation, hedging, and accounting functions.*
- *Failure to properly stratify MSAs for impairment-testing purposes.*
  (FAS 140 requires MSAs to be stratified based on one or more of the predominant risk characteristics of the underlying mortgage loans. Such characteristics may include financial asset type, size, interest rate, origination date, term, and geographic location. Banks are expected to identify a sufficient number of risk characteristics to adequately stratify each MSA and provide for a reasonable and valid impairment assessment. Stratification practices that ignore predominant risk characteristics are a supervisory concern.)
- *Inadequate amortization of the remaining cost basis of MSAs, particularly during periods of high prepayments.*
  (Inadequate amortization often occurs because prepayment models are not adequately calibrated to periods of high prepayments. When these models underestimate runoff, the amount and period of estimated net servicing income are overstated.)
- *Continued use of a valuation allowance for the impairment of a stratum of MSAs when repayment of the underlying loans at a rate faster than originally projected indicates the existence of an impairment for which a direct write-down should be recorded.*
- *Failure to assess actual cash-flow performance.*
  (The actual cash flows received from the serviced portfolio must be established in order to determine the benefit of MSAs to the bank.)
- *Failure to validate or update models for new information.*
  (Inaccuracies in valuation models can result in erroneous MSA values and affect future hedging performance. Models should be inventoried and periodically revalidated, including an independent assessment of all key assumptions.)

18. Retention benefits arise from the portion of the serviced portfolio that is expected to be refinanced with the bank in the future.

Risk Management of Mortgage Banking Activities

The Federal Reserve expects state member banks to perform mortgage banking operations in a safe and sound manner. Management should ensure that detailed policies and procedures are in place to monitor and control mortgage banking activities, including loan production, pipeline (unclosed loans) and warehouse (closed loans) administration, secondary-market transactions, servicing operations, and management (including hedging) of mortgage-servicing assets. Reports and limits should focus on key risks, profitability, and proper accounting practices.

MSAs possess interest rate–related option characteristics that may weaken a bank's earnings and capital strength when interest rates change. Accordingly, banks engaged in mortgage banking activities should fully comply with all aspects of the federal banking agencies' policy on interest-rate risk.[19] In addition, banks with significant mortgage banking operations or mortgage-servicing assets should incorporate these activities into their critical planning processes and risk-management oversight. The planning process should include careful consideration of how the mortgage banking activities affect the bank's overall strategic, business, and asset/liability plans. Risk-management considerations include the potential exposure of both earnings and capital to changes in the value and performance of mortgage banking assets under expected and stressed market conditions. Furthermore, a bank's board of directors should establish limits on investments in mortgage banking assets and evaluate and monitor such investment concentrations (on the basis of both asset and capital levels) on a regular basis.

During examinations of mortgage banking activities, examiners should review mortgage banking policies, procedures, and management information systems to ensure that the directors, managers, and auditors are adequately addressing the following matters.

Valuation and Modeling Processes

- *Comprehensive documentation standards for all aspects of mortgage banking, including mortgage-servicing assets.*
  (In particular, management should substantiate and validate the initial carrying amounts assigned to each pool of MSAs and the underlying assumptions, as well as the results of periodic reviews of each asset's subsequent carrying amount and fair value. The validation process should compare actual performance with predicted performance. Management should ensure proper accounting treatment for MSAs on a continuing basis.)
- *MSA impairment analyses that use reasonable and supportable assumptions.*
  (Analyses should employ realistic estimates of adequate compensation,[20] future revenues, prepayment speeds, market-servicing costs, mortgage-default rates, and discount rates. Fair values should be based on market prices and underlying valuation assumptions for transactions in the marketplace involving similar MSAs. Management should avoid relying solely on peer-group surveys or the use of unsupportable assumptions. The Federal Reserve encourages banks to obtain periodic third-party valuations by qualified market professionals to support the fair values of their MSAs and to update internal models.)
- *Comparison of assumptions used in valuation models to the bank's actual experience in order to substantiate the value of MSAs.*
  (Management should measure the actual performance of MSAs by analyzing gross monthly cash flows of servicing assets relative to the assumptions and projections used in each quarterly valuation. In addition, a comparison of the first month's actual cash received on new MSAs with the projected gross cash flows can help validate the reasonableness of initial MSA values prior to the impact of prepayments and discount rates. "Economic value" analysis is a critical tool in understanding the profitability of mortgage servicing to a bank; however, it is *not* a substitute for the estimation of the fair value of MSAs under GAAP.)
- *Review and approval of results and assumptions by management.*
  (Given the sensitivity of the MSA valuation to changes in assumptions and valuation policy, any such changes should be reviewed and approved by management and, where appropriate, by the board of directors.)
- *Comparison of models used throughout the company including valuation, hedging, pricing, and bulk acquisition.*
  (Companies often use multiple models and assumption sets in determining the values for MSAs depending on their purpose—pricing versus valuation. Any inconsistencies between these values should be identified, supported, and reconciled.)

19. See SR-96-13, Joint Agency Policy Statement on Interest Rate Risk (June 26, 1996), and section 4090.1.

20. As defined in FAS 140, "adequate compensation" is "the amount of benefits of servicing [i.e., revenues from contractually specified servicing fees, late charges, and other ancillary sources] that would fairly compensate a substitute servicer should one be required, which includes the profit that would be demanded in the marketplace."

- *Appropriate amortization practices.*
(Amortization of the remaining cost basis of MSAs should reflect actual prepayment experience. Amortization speeds should correspond to and be adjusted to reflect changes in the estimated remaining net servicing income period.)
- *Timely recognition of impairment.*
(Banks must evaluate MSAs for impairment at least quarterly to ensure amounts reported in the call report[21] are accurately stated. Banks will generally be expected to record a direct write-down of MSAs when, and for the amount by which, any portion of the unamortized cost of a mortgage-servicing asset is not likely to be recovered in the future.)

Mortgage Banking Hedging Activities

- *Systems to measure and control interest-rate risk.*
(Hedging activities should be well developed and communicated to responsible personnel. Successful hedging systems will mitigate the impact of prepayments on MSA values and the effects of interest-rate risk in the mortgage pipeline and warehouse.)
- *Approved hedging products and strategies.*
(Management should ensure appropriate systems and internal controls are in place to oversee hedging activities, including monitoring the effectiveness of hedging strategies and reviewing concentrations of hedge instruments and counterparties.)
- *Hedge accounting policies and procedures.*
(Banks should ensure their hedge accounting methods are adequately documented and consistent with GAAP.)

Management Information Systems

- *Accurate financial reporting systems, controls, and limits.*
(At a minimum, the board should receive information on hedged and unhedged positions, mark-to-market analyses, warehouse aging, the valuation of MSAs, various rate shock-scenario and risk exposures, the creation of economic value, and policy exceptions whenever material exposure to MSAs exists.)
- *Systems that track quality-control exceptions.*
(Quality-control reports should be analyzed to determine credit quality, loan characteristics and demographics, trends, and sources of problems. Sound quality-control programs are also beneficial in the early detection of deteriorating production quality and salability, as well as in the prevention and detection of fraudulent activities.)
- *Systems that track and collect required mortgage loan documents.*
(Management should ensure adequate control processes are in place for both front-end-closing and post-closing loan documents. If mortgages are not properly documented, a bank may be forced to hold unsold mortgages for extended periods or repurchase mortgages that have been sold. Further, management should ensure that adequate analyses are performed and allowances are established for estimated probable losses arising from documentation deficiencies on closed loans.)
- *Systems that monitor and manage the risks associated with third-party originated loans.*
(Banks often originate loans through broker and correspondent channels. Management should ensure that prudent risk-management systems are in place for broker and correspondent approvals and ongoing monitoring, including controls on the appraisal and credit-underwriting process of third-party originated loans. Adequate due diligence of third-party relationships is necessary to help prevent the origination of loans that are of poor credit quality or are fraudulent. Delegated underwriting to brokers or correspondents warrants close supervision from senior management.)

Internal Audit

- *Adequate internal audit coverage.*
(Because of the variety of risks inherent in mortgage banking activities, internal auditors should evaluate the risks of and controls over their bank's mortgage banking operations. They should report audit findings, including identified control weaknesses, directly to the audit committee of the board or to the board itself. Board and management should ensure that internal audit staff possess the necessary qualifications and expertise to review mortgage banking activities or obtain assistance from qualified external sources.)

21. Schedule RC-M, Memoranda, Item 2.a.

REGULATION O

The Federal Reserve's Regulation O (12 CFR 215) governs any extension of credit, including overdrafts, by a member bank to an executive officer, director, or principal shareholder of (1) the member bank, (2) a bank holding company of which the member bank is a subsidiary, and (3) any other subsidiary of that bank holding company. The regulation also applies to any extension of credit by a member bank to (1) a company controlled by such a person and (2) a political or campaign committee that benefits or is controlled by such a person. Regulation O also implements the reporting requirements for credit extensions by a member bank to its executive officers, directors, or principal shareholders or to the related interests of such persons (insiders).

Business transactions between a member bank and insiders require close supervisory review. Most of these transactions are soundly structured and have a legitimate business purpose so that all parties are treated equitably. However, absent the protection of an arm's-length transaction, the potential for or appearance of abuse is greater and requires intensified regulatory review. Examiners should pay close attention to all credit extensions of a member bank to its insiders and their related interests. The terms of the credit, particularly interest-rate and collateral terms, may not be preferential, and the credit may not involve more than a normal repayment risk. Examiners must also ensure that the amount of credit extended to an insider or a related interest, both to a single borrower and in the aggregate, conforms to the provisions of Regulation O.

A member bank's extension of credit may be considered abusive or self-serving if its terms are unfavorable to the lender or if the credit would not have been extended on the same terms absent the official relationship. That is, it would be improbable that each party to the credit would have entered into the credit transaction under the same terms if the relationship did not exist. When a transaction appears questionable, a complete inquiry into the facts and circumstances should be undertaken so that a legal determination can be obtained. If credit extensions appear to circumvent the intent of Regulation O, they should be identified and discussed with management and disclosed in the examination report for follow-up review and possible formal corrective action by regulatory authorities. (See Regulation O for further details.)

EXAMINATION OF THE LENDING FUNCTION

Banks are expected to clearly delineate their lending objectives, policies, and procedures in writing. Lending practices are then expected to adhere to policies and procedures, with exceptions properly justified and documented. The complexity and scope of a bank's lending policy and procedures should be appropriate to the bank's size and the nature of its activities, and they should be consistent with prudent banking practices and relevant regulatory requirements.

Historically, examiners have primarily identified loan-portfolio-management concerns through a detailed review of credits and credit documentation. This approach remains valid, but it must be combined with a full evaluation of a bank's lending objectives, policy, and procedures. Therefore, the scope of each examination should encompass a review of the bank's lending policy and procedures and an assessment of how lending practices adhere to the policy and procedures.

When conducting a review of loan portfolio management, examiners should pay particular attention to management's approach to and handling of the following:

- monitoring of lending practices by individual lending officers
- identification of concentrations of credit
- documentation of credit and collateral exceptions
- identification of problem credits
- accounting for nonaccrual loans and for renegotiated and restructured loans
- collection of past-due loans

In addition, examiners should be aware of any evidence of self-dealing in lending transactions.

An examiner's final assessment of a bank's lending function should consider the adequacy of internal policy and procedures, the effectiveness of management oversight and control, and the overall quality of the loan portfolio. Moreover, consideration should be given to all pertinent internal and external factors, including the continuity of management; bank's historical lending experience; and current and projected economic condition for the bank's market area, particularly for any industries in which the bank has concentrations of credit.

Supervisors and examiners should watch for indications of insufficiently rigorous risk assessment. In particular, examiners should be alert to circumstances indicating excessive reliance on strong economic conditions and robust financial markets, such as (1) borrowers whose financial capacity is inadequate to service their debts or (2) inadequate stress testing. Examiners also should be attentive when reviewing an institution's assessment and monitoring of credit risk to ensure that undue reliance on favorable conditions does not lead the institution to delay recognition of emerging weaknesses in some loans.[22]

If examiners observe significant and undue reliance on favorable assumptions about borrowers or the economy and about financial markets more generally—or observe that this reliance has slowed the institution's recognition of loan problems—they should carefully consider downgrading, under the applicable supervisory rating framework, an institution's risk-management, management, or asset-quality ratings (or all three). If those assumptions are deemed sufficiently significant to the institution, examiners should also consider downgrading its capital adequacy rating. Similarly, if supervisors or examiners find that loan-review activities or other internal-control and risk-management processes have been weakened by staff turnover, failure to commit sufficient resources, or inadequate training, such findings should be considered in supervisory ratings as well.

When developing their findings, examiners should review internal risk-management loan-review systems, conduct sufficient loan reviews, and perform transaction testing of the lending function to determine accurately the quality of bank loan portfolios and other credit exposures. If deficiencies in lending practices or credit discipline are indicated as a result of the pre-examination risk assessment or of performing the examination, sufficient supervisory resources should be committed to in-depth reviews, including transaction testing. Adequate, in-depth reviews and transaction testing should be performed to ensure that the Reserve Bank achieves a full understanding of the nature, scope, and implications of the deficiencies.

Important findings should be noted in the examination or report. Plans for remedial actions should be discussed with bank management and the boards of directors, as appropriate. In addition, any identified weaknesses or deficiencies that could adversely affect affiliated insured depository institutions should be conveyed to the insured institution's primary federal or state supervisor.

22. Examiners should recognize that an increase in classified or special-mention loans is not per se an indication of lax lending standards. Examiners should review and consider the nature of such increases and surrounding circumstances as they reach their conclusions about the asset quality and risk management of an institution.

1. To determine if policies, practices, procedures, and internal controls regarding loan portfolio management are adequate.
2. To determine if bank officers are operating in conformance with the established guidelines.
3. To determine the scope and adequacy of the audit and loan-review functions.
4. To determine the overall quality of the loan portfolio and how that quality relates to the soundness of the bank.
5. To be alert to indications of insufficiently rigorous risk assessment at banking institutions, particularly excessive reliance on strong economic conditions and robust financial markets to support the capacity of borrowers to service their debts, and inadequate stress testing.
6. To be attentive when reviewing an institution's lending policies and its assessment and monitoring of credit risk to ensure that undue reliance on favorable conditions does not lead to the delayed recognition of emerging weaknesses in some loans.
7. To ascertain whether there has been significant and undue reliance by the institution on favorable assumptions about borrowers or the economy and financial markets. If so, to carefully consider downgrading, under the applicable supervisory rating framework, an institution's risk-management, management, or asset-quality ratings (or all three). If the institution's assumptions are deemed sufficiently significant, to consider downgrading its capital adequacy rating.
8. To determine that management has implemented satisfactory policies, procedures, and controls to address the risks inherent in mortgage banking activities.
9. To determine if the banking organization's loan-review activities or other internal-control and risk-management processes have been weakened by staff turnover, failure to commit sufficient resources, inadequate training, and reduced scope or less thorough internal loan reviews. To incorporate such findings into the determination of supervisory ratings.
10. To prepare information regarding the bank's lending function in a concise, reportable format.
11. To determine compliance with laws and regulations.
12. To initiate corrective action when policies, practices, procedures, or internal controls are deficient or when violations of law or regulations have been noted.

FIRST-DAY LETTER, PREEXAMINATION ANALYSIS

1. If selected for implementation, complete or update the loan portfolio management section of the internal control questionnaire.
2. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining procedures.
3. Request reports on the following from the bank, by department, as of the examination date, unless otherwise specified:
   a. past-due loans covering—
      - single-payment notes 30 days or more past maturity;
      - single-payment notes with interest due at specified intervals and demand notes on which interest is due and unpaid for 30 days or more; and
      - consumer, mortgage, or term loans, payable in regular installments on which one installment is due and unpaid for 30 days or more.

      The following information should be included:
      - name of the obligor
      - original amount of the loan
      - outstanding amount of the loan
      - date the loan was made
      - due date
      - terms of the loan
      - number of payments the loan is delinquent
      - date of the borrower's last payment
      - interest billing cycle
      - date up to which interest is paid

      For larger loans, the report should also include the purpose of the loan and any action being taken.

   b. loans in a nonaccrual status
   c. loans on which interest is not being collected in accordance with the terms of the loan
   d. loans whose terms have been modified by a reduction of interest rate or principal payment, by a deferral of interest or principal, or by other restructuring of repayment terms
   e. since the previous examination, loans transferred, either in whole or in part, to another lending institution as a result of a sale, participation, or asset swap
   f. since the previous examination, loans acquired from another lending institution as a result of a purchase, participation, or asset swap
   g. loans considered "problem loans" by management (This report may be either as of the examination date or as submitted to the officer's loan-review committee, loan and discount committee, or board of directors.)
   h. loan commitments and contingent liabilities
   i. loans secured by stock of other banks and rights, interests, or powers of a savings and loan association
   j. extensions of credit to employees, officers, directors, and principal shareholders and their interests specifying which officers are considered executive officers
   k. extensions of credit to executive officers, directors, and principal shareholders and their interests of correspondent banks
   l. a list of correspondent banks
   m. miscellaneous loan debit and credit suspense accounts
   n. current interest-rate structure
   o. officers' current lending authority
   p. the nature and extent of servicing activities, including—
      - the aggregate volume and types of serviced loans,
      - the dollar volume of loans originated from out of territory,
      - the number of originations and sales year-to-date compared with the same period in the previous year, and
      - fee income from sales and servicing year-to-date compared with the same period in the previous year.
   q. extensions of credit in the form of overnight overdrafts resulting from wire transfer activities
4. Obtain the following information:
   a. a copy of written policies covering all lending functions
   b. a statement of whether a standing committee administers the lending function
   c. copies of reports furnished to the board for meetings

d. lists of directors, executive officers, and principal shareholders and their interests
e. a summary of the officer's borrowing report (debts to own and other banks)

5. Obtain a copy of the latest reports furnished to the loan and discount committee.
6. Review the lending policies and updates thereto and determine, as loans and other extensions of credit are being reviewed, whether the institution's lending practices adhere to the board of directors' lending policies.
7. Abstract appropriate excerpts of the lending policies and updates on the following:
   a. distribution of loans by category
   b. geographic limitations
   c. industrial concentration limitations
   d. allowable or desirable ratios of loans to other balance-sheet accounts
   e. lending authorities of committees and officers
   f. any prohibited types of loans
   g. maximum maturities for various types of loans
   h. interest-rate structure
   i. minimum downpayments for various types of loans
   j. collateral-appraisal policies including—
      - persons authorized to perform appraisals and
      - lending values of various types of property
   k. financial information requirements by types of loans
   l. limitations and guidelines for purchasing and selling loans either directly or through participations or swaps
   m. guidelines for supplying complete and regularly updated credit information to purchasers of loans that the bank originated
   n. guidelines for obtaining complete and regularly updated credit information on loans purchased from others
   o. guidelines for loans to major stockholders, directors, officers, or their interests
   p. guidelines for determining the creditworthiness of any institution or customer on whose behalf the bank executes funds transfers
   q. loan pricing policies and practices indicating that the institution may be unduly weighting the short-term benefit of retaining or attracting new customers through price concessions, while not giving sufficient consideration to potential longer-term consequences
   r. policies reflecting any indications of insufficiently rigorous risk assessments, and, in particular, an excessive reliance on strong economic conditions and robust financial markets to support the capacity of borrowers to service their debts, as well as inadequate stress testing of the assumptions underlying the risk assessment
   s. policies involving the institution's assessments and monitoring of credit risk to ensure that an undue reliance on favorable conditions does not lead the institution to delay recognition of emerging weaknesses in some loans

LENDING POLICIES AND PROCEDURES, ASSET/LIABILITY MANAGEMENT

1. When more than one lending policy exists, determine that policies are internally consistent by reviewing the guidelines previously obtained.
2. Review minutes of the bank's loan and discount committee meetings to obtain—
   a. present members and their attendance record,
   b. the scope of work performed, and
   c. any information deemed useful in the examination of specific loan categories or other areas of the bank.
3. Compare reports furnished to the board and the loan and discount committee and those received from the bank in step 3 above to determine any material differences and that they are transmitted to the board in a timely manner.
4. Perform the following steps for past-due loans:
   a. Compare the following to determine any material inconsistencies:
      - the past-due loan schedule received in step 3
      - delinquency reports submitted to the board
      - list of loans considered "problem" loans by management
      - delinquency lists submitted for regulatory purposes

b. Scan the delinquency lists submitted to the board to determine that reports are sufficiently detailed to evaluate risk factors.
c. Compile current aggregate totals of past-due paper including unplanned overdrafts not paid in 30 days.

5. Perform the following using the loan commitments and contingent liabilities schedule obtained in step 3:
   a. Reconcile appropriate contingencies totals to memorandum ledger controls.
   b. Review reconciling items for reasonableness.
6. Consult with the examiner responsible for the asset/liability management analysis to determine the appropriate maturity breakdown of loans needed for the analysis. If requested, have the examiners assigned to the various loan areas compile the information using bank records or other appropriate sources. See ‘‘Instructions for the Report of Examination,’’ section 6000.1, for considerations to be taken into account when compiling maturity information for the gap analysis

LOAN PORTFOLIO REVIEW AND ANALYSIS

1. Review the information received and perform the following for—
   a. *Loan participations, loan purchases or sales, loan swaps.* The procedures are designed to ensure that loan transfers involving state member banks, bank holding companies, and nonbank affiliates are carefully evaluated to determine if they were carried out to avoid classification, and to determine the effect of the transfer on the condition of the institution. In addition, the procedures are designed to ensure that the primary regulator of the other financial institution involved in the transfer is notified.
      - Check participation certificates and records and determine that the parties share in the risks and contractual payments on a pro rata basis.
      - Ascertain whether loans are purchased on a recourse basis and that loans are sold on a nonrecourse basis.
      - Determine that the bank does not buy back or pay interest on defaulted loans in contradiction of the underlying agreement.
      - Compare the volume of loans purchased and sold with the total portfolio.
      - Determine that the bank has sufficient expertise to properly evaluate the volume of loans purchased and sold.
      - Determine if loans are sold primarily to accommodate overline needs of customers or to generate fee income.
      - Determine if loans are purchased or sold to affiliates or other companies in a chain banking organization; if so, determine that the purchasing companies are given sufficient information to properly evaluate the credit. (Section 23A of the Federal Reserve Act prohibits transfers of low-quality assets between affiliates. See section 4050.1, ‘‘Bank-Related Organizations.’’)
      - Investigate any situations in which assets were transferred before the date of examination to determine if any were transferred to avoid possible criticism during the examination.
      - Determine whether any of the loans transferred were nonperforming at the time of transfer, classified at the previous examination, or for any other reason considered to be of questionable quality.
      - Review the bank’s policies and procedures to determine whether assets or participations purchased by the bank are given an independent, complete, and adequate credit evaluation. If the bank is a holding company subsidiary or a member of a chain banking organization, review asset purchases or participations from affiliates or other known members of the chain to determine if the asset purchases are given an *arm’s-length* and *independent* credit evaluation by the purchasing bank.
      - Determine that any assets purchased by the bank are properly reflected on its books at fair market value (while fair market value may be difficult to determine, it should at a minimum reflect both the rate of return being earned on such assets and an appropriate risk premium). Determine that appropriate write-offs are taken on any

assets sold by the bank at less than book value.

- Determine that transactions involving transfers of low-quality assets to the parent holding company or a nonbank affiliate are properly reflected at fair market value on the books of both the bank and the holding company affiliate.
- If poor-quality assets were transferred to or from another financial institution for which the Federal Reserve is not the primary regulator, prepare a memorandum to be submitted to the Reserve Bank supervisory personnel. The Reserve Bank will then inform the local office of the primary federal regulator of the other institution involved in the transfer. The memorandum should include the following information, as applicable:
  - — name of originating and receiving institutions
  - — type of assets involved and type of transfer (i.e., participation, purchase or sale, swap)
  - — date (or dates) of transfer
  - — total number and dollar amount of assets transferred
  - — status of the assets when transferred (e.g., nonperforming, classified, etc.)
  - — any other information that would be helpful to the other regulator
- Review the sale and purchase of U.S. government–guaranteed loans and sale premiums.
  - — Recommendations for originating and selling institutions:
    (1) Examiners should review the extent and nature of activities in connection with the sale of government-guaranteed loans. Lax or improper management of the selling institution's servicing responsibilities should be criticized. Out-of-trade-area lending for the purpose of resale of any portion of U.S. government–guaranteed loans should be carefully reviewed to ensure that the practice is conducted in a safe and sound manner.
    (2) All income, including servicing fees and premiums charged in lieu of servicing fees, associated with the sale of U.S. government–guaranteed loans should be recognized only as earned and amortized to appropriate income accounts over the life of the loan.
  - — Recommendations for purchasing institutions:
    (1) Purchasers of U.S. government–guaranteed loans should be aware that the purchase premiums are not guaranteed and are not paid by the guaranteeing federal agency when the loans are prepaid. Because payment of premiums that do not reasonably relate to the yield on the loan can distort published financial reports by overstating the value of a financial institution's assets, it will generally be viewed as an unsafe and unsound banking practice for a financial institution to pay purchase premiums that result in a significant overstatement in the value of bank assets.
    (2) Many government-guaranteed loans currently being originated and sold are variable rate. These variable-rate loans normally should not trade at anything more than a modest premium or discount from par. Examiners should carefully review any loans being sold or purchased at significant premiums and criticize any involvement with excessive premiums as an unsafe and unsound business practice. Excessive purchase premiums will be classified loss. The loans will be required to be revalued to the market value at the time of the acquisition and the excessive premiums will be charged against current earnings.

    In addition, any unamortized loan premium on a government-guaranteed loan must be immediately charged against income if the loan is prepaid, regardless of whether payment is received from the borrower or the guaranteeing agency.

b. *Loans serviced.*
   - Determine that the bank exercises similar controls and procedures over loans serviced for others as it does for loans in its own portfolio.
   - Determine that the bank, as lead or agent in a credit, exercises similar controls and procedures over syndications and participations sold as it does for loans in its own portfolio.
   - Ascertain whether the serviced loans are subject to a repurchase agreement or are backed by a standby letter of credit from the originating bank.
   - Compare the volume of serviced loans with the total portfolio.
   - Determine if out-of-territory originations are significant relative to loans serviced.
   - Determine if the volume of loans originated, sold, and serviced is consistent with the loan-servicing capabilities of management.
   - Ascertain that servicing fees and premiums charged in lieu of fees are amortized over the life of the loan.

2. Obtain the listing of Uniform Review of Shared National Credits and update the listing based on information obtained in step 3 above.
3. Distribute the applicable schedules and other information obtained in the preceding steps to the examiners performing the loan-examination procedures. Request that the examiners test the accuracy of the information. Also, request that they perform appropriate steps in the separate section Concentration of Credits.
4. Determine the general distribution characteristics of the loan portfolio by—
   a. determining the percentage of total loans in specific classes and
   b. comparing loan-category distributions with policy guidelines.
5. *Internal loan review.* Obtain the results of loan department examinations and perform the following:
   a. Determine any nonadherence to internally established policies, practices, procedures, and controls.
   b. Compare the various department results to determine the extent of nonadherence and if it is systemwide.
   c. Organize internal-guideline exceptions in order of their relative importance.
   d. Determine the aggregate amount of statutory bad debts. (See section 4070.1, ‘‘Dividends.’’)
   e. Organize and prepare a listing of violations of law and regulations.
   f. Review loan classifications and assets listed for special mention to determine—
      - inclusion of all necessary information and
      - substantiation of classification.
   g. Determine the aggregate amount of paper criticized in each of the four levels of criticism.
   h. Compile a listing of all loans not supported by current and satisfactory credit information.
   i. Compile a listing of all loans not supported by complete collateral documentation.
   j. Determine the aggregate amount of out-of-area paper.
   k. Compile a listing of low-quality loans transferred to or from another lending institution through purchases or sales or participations or swaps, and submit it to Reserve Bank supervisory personnel.
   l. Review the separate procedures for Concentration of Credits and determine—
      - if all necessary data are included,
      - if there is substantiation for including specific items in the report of examination as a concentration, and
      - if the concentration is undue or unwarranted.
   m. Compute the following ratios and compare with computations from prior examinations:
      - aggregate classified paper to primary capital
      - weighted classified paper to primary capital
      - aggregate past-due paper to loans outstanding

MORTGAGE BANKING ACTIVITIES

1. Review the mortgage banking policies, pro-

cedures, and management information systems.
2. Determine whether additional examination scrutiny is needed based on the examination concerns listed in section 2040.1.
3. Determine whether the directors, managers, and auditors are adequately evaluating, monitoring, and maintaining internal controls over the valuation and modeling processes, hedging activities, management information systems, and the internal audit function.
4. Review the bank's mortgage-servicing operations and determine if market-based assumptions are used and that they are reasonable and supportable for estimating the fair value of servicing assets.
   a. Ascertain whether management uses bulk, flow, and daily mortgage-servicing asset (MSA) or loan pricing activities observed in the market to evaluate the bank's MSA valuation assumptions.
   b. Determine if those assumptions are reasonable and consistent with the market activity for similar assets.
5. With respect to management, determine—
   a. if detailed policies and procedures are in place to monitor and control mortgage banking activities, including loan production, pipeline (unclosed loans) and warehouse (closed loans) administration, secondary-market transactions, servicing operations, and management (including hedging) of mortgage-servicing assets; and
   b. if reports and limits focus on key risks, profitability, and proper accounting practices.
6. When conducting a review of mortgage banking activities, determine whether the bank complies with SR-96-13 and the June 26, 1996, Joint Agency Policy Statement on Interest Rate Risk.

PROBLEM LOANS AND CLASSIFICATION

1. Forward the total loss and doubtful classifications and the total of statutory bad debts (''A'' paper) to the examiner assigned to analyze the adequacy of capital.
2. Compare management's list of ''problem'' loans from step 3 (under ''First-Day Letter, Preexamination Analysis'') with the listing of classified loans to determine the extent of management's knowledge of its own loan problems.
3. Determine, through information previously generated, the causes of existing problems or weaknesses within the system that present potential for future problems.

ALLOWANCE FOR LOAN AND LEASE LOSSES (ALLL)

1. Forward the following information to the examiner assigned to review the ALLL:
   a. a listing of loans considered ''problem loans'' by management
   b. a listing of classified loans

DISCUSSIONS WITH MANAGEMENT

1. Discuss results of the examination of the lending function with senior management of the bank.
2. During discussion with senior management, structure inquiries to—
   a. gain insight into the general management lending philosophy and
   b. elicit management responses for correction of deficiencies.

REGULATION O

1. During the course of all examinations of the commercial activities of state member banks, determine whether the bank and its executive officers and principal shareholders have complied with the reporting and disclosure requirements of Regulation O (12 CFR 215) and the appropriate statutes and the established policies of the board of directors. Civil money penalties may be assessed for noncompliance. Specific matters that should be addressed are as follows:
   a. *Reports of examination.*
      - Each report of examination of the commercial activities of state member banks should contain information as to the bank's compliance with titles VIII and IX of the Financial Institutions

Regulatory and Interest Rate Control Act (FIRA), as amended by the Garn–St Germain Act. Violations should be reported, as appropriate, in the following sections of the report of examination:
— examiner's comments and conclusions
— audit and internal controls
— violations of law and regulations
— extensions of credit to bank officials

b. *Schedule RC-M.*
- The information from this schedule should be reviewed in connection with verifying the accuracy and completeness of the Report of Condition. Complete and accurate preparation of this schedule is particularly important because Schedule RC-M provides valuable data on possible insider abuse, and it contains information that will be used in response to public requests for information concerning loans to executive officers and principal shareholders.
- Examiners should verify that the bank has established procedures for compliance with the requirements of Regulation O for disclosure of extensions of credit from itself and from correspondent banks to its executive officers and principal shareholders. The bank should maintain records of all public requests for information and the disposition of such requests.
- Records of requests for information and the disposition of such requests may be disposed of by banks after two years from the date of request.

c. *Form FFIEC 004.*
- During examinations, determine that each bank has notified its executive officers and principal shareholders of the annual reporting requirements of FIRA pertaining to their reporting of loans from correspondent banks, has provided such officers and shareholders with a list of the bank's correspondent banks, and has made available to such officers and shareholders a copy of Form FFIEC 004 (or a similar form).
- During examinations, review FFIEC 004 forms (or similar forms) filed with the bank to determine that they were filed in a timely manner and that information has been reported as required.
- Information reported in boxes F through M of Form FFIEC 004 concerning terms and conditions of an extension of credit may indicate the possibility of preferential lending practices[1] at a correspondent bank. These possibilities should be referred by examiners to Reserve Banks for such additional action as may be required under the particular circumstances.
- During examinations of correspondent banks (as defined in Regulation O), loans to executive officers, directors, and principal shareholders of respondent banks should be reviewed for any evidence of preferential lending as prohibited by title VIII. Such loans should be reviewed to determine whether they were made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with other persons; involve more than normal risk (classified or specially mentioned); or have other unfavorable features, such as not being supported by adequate credit information or being in violation of state lending limitations.

EXAMINATION REPORTING, RATINGS ASSIGNMENT, AND WORKPAPER RETENTION

1. Write, in the appropriate report format, general remarks, which may include—
   a. the scope of the examination of the lending function;
   b. the quality of internal policies, practices, procedures, and controls over the lending functions;
   c. the general level of adherence to internal policies, practices, procedures, and controls;
   d. the scope and adequacy of the internal loan-review system;
   e. the quality of the entire loan portfolio;
   f. the competency of management with respect to the lending function;
   g. causes of existing problems;

1. Preferential lending practices may constitute a violation of title VIII of FIRA, which became effective March 10, 1979.

   h. expectations for continued sound lending or correction of existing deficiencies;
   i. promises made by management for correction of deficiencies; and
   j. loans to insiders and their interests.
2. If appropriate and after careful consideration, recommend downgrading, under the applicable supervisory rating framework, the institution's risk-management, management, or asset-quality ratings (or all three), and downgrading its capital adequacy rating (if assumptions are sufficiently significant) when there is significant and undue reliance on favorable assumptions about borrowers, the economy, and financial markets, or when that reliance has slowed the recognition of loan problems.
3. Compile or prepare all information that provides substantiation for the general remarks.
4. Update the workpapers with any information that will facilitate future examinations.

Review the bank's internal controls, policies, practices, and procedures for managing the bank's loan portfolio. The bank's system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flow charts, copies of forms used, and other pertinent information.

LENDING POLICIES AND PROCEDURES

1. Has the board of directors, consistent with its duties and responsibilities, adopted written loan portfolio management policies and objectives that—
   a. establish suggested guidelines for the distribution of loans in the commercial, real estate, and installment categories?
   b. establish geographic limits for loans?
   c. establish suggested guidelines for aggregate outstanding loans in relation to other balance-sheet categories?
   d. establish the loan authority of committees and individual lending officers?
   e. define acceptable types of loans?
   f. establish maximum maturities for various types of loans?
   g. establish loan pricing?
   h. establish an appraisal policy?
   i. establish the minimum financial information required at the inception of credit?
   j. establish limits and guidelines for purchasing paper?
   k. establish guidelines for loans to bank directors, officers, principal shareholders, and their related interests?
   l. establish collection procedures?
   m. define the duties and responsibilities of loan officers and loan committees?
   n. outline loan portfolio management objectives that acknowledge—
      - concentrations of credit within specific industries?
      - the need to employ personnel with specialized knowledge and experience?
      - community service obligations?
      - possible conflicts of interests?
2. Are loan portfolio management policies and objectives reviewed at least annually to determine if they are compatible with changing market conditions?
3. Are the following reported to the board of directors or its committees (indicate which) at their regular meetings (at least monthly):
   a. past-due single-payment notes? (If so, indicate the minimum days past due for them to be included ________.)
   b. notes on which interest only is past due? (If so, indicate the minimum days past due for them to be included ________.)
   c. term loans on which one installment is past due? (If so, indicate the minimum days due for them to be included ________.)
   d. total outstanding loan commitments?
   e. loans requiring special attention?
   f. new loans and loan renewals or restructured loans?
4. Are reports submitted to the board or its committees rechecked by a designated individual for possible omissions before their submission?
5. Are written applications required for all loans?
6. Does the bank maintain credit files for all borrowers?
7. Does the credit file contain information on—
   a. the purpose of the loan?
   b. the planned repayment schedule?
   c. the disposition of loan proceeds?
8. Does the bank require periodic submission of financial statements by all borrowers whose loans are not fully secured by readily marketable collateral?
9. Is a tickler file maintained to ensure that current financial information is requested and received?
10. Does the bank require submission of audited financial statements based on the dollar amount of the commitment? (If so, state the dollar minimum for requiring $________.)
11. Does the bank perform a credit investigation on proposed and existing borrowers for new loan applications?
12. Is it required that all loan commitments be in writing?
13. Are lines of credit reviewed and updated at least annually?
14. Are borrowers' outstanding liabilities checked to appropriate lines of credit before

granting them additional advances?

15. Does the bank employ a procedure for disclosure of a loan or combination of loans that are or will be secured by 25 percent of another insured financial institution's stock?
16. Does the bank employ procedures to ensure compliance with the requirements of the Lost and Stolen Securities Program (17 CFR 240.17f-l)? (See Internal Control Questionnaire questions 6–15 of section 4150.1 ''Review of Regulatory Reports.'')
17. Is there an internal-review system (it may be a function of the internal audit department) that covers each department and does it—
    a. recheck interest, discount, and maturity-date computations?
    b. reexamine notes for proper execution, receipt of all required supporting papers, and proper disclosure forms?
    c. determine that loan approvals are within the limits of the bank's lending authorities?
    d. determine that notes bear the initial of the loan officer?
    e. ascertain that new loans are within the limitations set for the borrower by corporate resolution?
    f. recheck the liability ledger to determine that new loans have been accurately posted?
18. Does the bank have a loan-review section or the equivalent?
19. Is the loan-review section independent of the lending function?
20. Are the initial results of the loan-review process submitted to a person or committee that is also independent of the lending function?
21. Are all loans exceeding a certain dollar amount selected for review?
22. Do lending officers recommend loans for review?
23. Is a method, other than those detailed in steps 21 or 22, used to select loans for review? (If so, provide details.)
24. Are internal reviews conducted at least annually for all lending areas?
25. In an officer-identification system, are guidelines in effect that define the consequences of an officer's withholding a loan from the review process?
26. Is the bank's problem-loan list periodically updated by the lending officers?
27. Does the bank maintain a list of loans reviewed, indicating the date of the review and the credit rating?
28. Does the loan-review section prepare summations to substantiate credit ratings, including pass loans?
29. Are loan-review summations maintained in a central location or in appropriate credit files?
30. Are follow-up procedures in effect for internally classified loans, including an update memorandum to the appropriate credit file?
31. Are officers and employees prohibited from holding blank signed notes in anticipation of future borrowings?
32. Are paid and renewed notes cancelled and promptly returned to customers?
33. Are loan records retained in accordance with the record-retention policy and legal requirements?
34. Are new notes microfilmed daily?
35. Is a systematic and progressively stronger follow-up notice procedure used for delinquent loans?
36. Does the bank maintain loan interest-rate schedules for various types of loans?
37. Does the bank periodically update interest-rate schedules? If so, state the normal frequency of updates ________.
38. Does the bank maintain records in sufficient detail to generate the following information by type of advance:
    a. the cost of funds loaned?
    b. the cost of servicing loans, including overhead?
    c. the cost factor of probable losses?
    d. the programmed profit margin?
39. Has the bank conducted industry studies for those industries in which it is a substantial lender?
40. Are loan proceeds either credited to customers' accounts or released through issuance of official bank checks payable to the borrower?
41. Is a record of charged-off loans maintained by a person other than the one who has custody of the notes or receives payment? Is this record checked against the notes at least annually?
42. Are adequate procedures in effect with respect to recoveries?

MORTGAGE BANKING ACTIVITIES

1. Are the assumptions used in the bank's valuation models supported when these assumptions are not benchmarked to market participants' assumptions and to the bank's actual portfolio performance across each product type?
2. Are there questionable, inappropriate, or unsupported items in the valuation models (for example, retention benefits, deferred tax benefits, captive reinsurance premiums, or income from cross-selling activities). The inclusion of such items in the bank's mortgage-servicing asset (MSA) valuation must be appropriate under generally accepted accounting principles (GAAP) and must also be consistent with what a willing buyer would pay for the mortgage-servicing contract.
3. Does bank management use comparable market data as a means of supporting model assumptions and the fair value of MSAs?
4. Does bank management frequently change the assumptions it uses in its MSA valuation models from period to period for no compelling reason?
5. Are there inconsistencies in the MSA valuation assumptions used in valuation, bidding, pricing, and hedging activities as well as, where relevant, in mortgage-related activities in other aspects of the bank's business?
6. Is there satisfactory segregation of duties from an organizational perspective between the valuation, hedging, and accounting functions for the bank's mortgage banking activities?
7. Does bank management use appropriate amortization practices for its MSAs?
8. Does the bank properly stratify MSAs for impairment-testing purposes?
9. Do the bank's MSA impairment analyses use reasonable and supportable assumptions?
10. Does bank management use a valuation allowance for the impairment of a stratum of MSAs when repayment of the underlying loans at a rate faster than originally projected indicates the existence of an impairment for which a direct write-down should be recorded?
11. Does bank management evaluate MSAs for impairment at least quarterly to ensure that amounts reported in the call report are accurately stated?
12. Does bank management measure the actual performance of MSAs by analyzing gross monthly cash flows of servicing assets relative to the assumptions and projections used in each quarterly valuation?
13. Does bank management validate or update models for new information?
14. Does bank management periodically inventory and revalidate its MSA valuation models, including an independent assessment of all key assumptions?
15. Does the bank obtain periodic third-party valuations by qualified market professionals to support the fair values of its MSAs and to update its internal models?
16. Does the bank have comprehensive documentation standards for all aspects of mortgage banking, including mortgage-servicing assets?
17. Does bank management and, where appropriate, the board of directors, review and approve results and assumptions of the bank's MSA valuation models?
18. Does bank management compare models used throughout the company, including valuation, hedging, pricing, and bulk acquisition, to identify inconsistencies? Are identified inconsistencies satisfactorily supported?
19. Does the bank have systems to measure and control interest-rate risk?
20. Does bank management ensure that appropriate systems and internal controls are in place to oversee hedging activities, including monitoring the effectiveness of hedging strategies and reviewing concentrations of hedge instruments and counterparties?
21. Does bank management ensure that the bank's hedge accounting methods are adequately documented and consistent with GAAP?
22. Does the bank's board receive information on hedged and unhedged positions, mark-to-market analyses, warehouse aging, the valuation of MSAs, various rate shock scenarios and risk exposures, the creation of economic value, and policy exceptions whenever material exposure to MSAs exists?
23. Does the bank have satisfactory systems that track quality-control exceptions?
24. Does bank management analyze the bank's

quality-control reports to determine credit quality, loan characteristics and demographics, trends, and sources of problems?

25. Does the bank have satisfactory systems that track and collect required mortgage loan documents?
26. Does bank management ensure that adequate control processes are in place for both front-end-closing and post-closing loan documents?
27. Does the bank have satisfactory systems that monitor and manage the risks associated with third-party originated loans?
28. Does bank management ensure prudent risk-management systems are in place for broker and correspondent approvals and ongoing monitoring, including controls on the appraisal and credit-underwriting process of third-party originated loans?
29. Is the bank's internal audit coverage of its mortgage banking activities adequate?

CONCLUSION

1. Is the foregoing information considered an adequate basis for evaluating internal control; that is, there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly and indicate any additional examination procedures deemed necessary.
2. Based on a composite evaluation as evidenced by answers to the foregoing questions, is internal control considered adequate?

INTRODUCTION

A concentration of credit generally consists of direct or indirect (1) extensions of credit and (2) contingent obligations that, when aggregated, exceed 25 percent of the bank's capital structure (tier 1 capital plus the allowance for loan and lease losses). A concentration exists when the extensions of credit or other obligations possess similar risk characteristics. Typically, loans to related groups of borrowers, loans collateralized by a single security or securities with common characteristics, and loans to borrowers with common characteristics within an industry have been included in homogeneous risk groupings when assessing asset concentrations. Furthermore, a concentration may include the aggregate of all types of credit to or investment in a particular homogeneous risk grouping.

Limitations imposed by the various state and federal legal lending limits were intended to prevent an individual or a relatively small group from borrowing an undue amount of the bank's resources and to safeguard the bank's depositors by spreading the loans among a relatively large number of persons engaged in different businesses. However, lending limits alone are not sufficient to prevent and control concentrations of credit. Policy guidance for risk diversification should be formulated in conformity with both legal and prudent investment restrictions. Before bank management can limit the bank's involvement or perform the necessary review, it must recognize the various types of concentrations and implement systems to retrieve the information necessary to monitor and report concentrations. The Federal Reserve expects management to identify, measure, monitor, and control concentrations.

TYPES OF CREDIT CONCENTRATIONS

There are numerous possibilities for determining concentrations within a loan portfolio. In evaluating a potential concentration, it is important to determine the key factors germane to the credits. Concentrations that are commonly identified in a loan portfolio include the following:

- Loans to a group of borrowers, perhaps unrelated, predicated on the collateral support afforded by a debt or equity issue of a corporation. Regardless of whether the issuing entity is a listed concern or a closely held enterprise, a concentration may exist in the underlying collateral.
- Loans that are dependent on a particular agricultural crop or livestock herd. Banking institutions located in farming, dairying, or livestock areas may grant substantially all their loans to individuals or concerns engaged in and dependent on the agricultural industry. Concentrations of this type are commonplace and may be necessary if these banks are to adequately serve the needs of their communities.
- The aggregate amount of interim construction loans that do not have firm, permanent take-out commitments. In the event that permanent financing is not obtainable, the bank will have to continue financing the projects. This longer term financing subjects the bank to additional liquidity and possibly interest-rate risks, as well as to risks associated with the real estate itself.
- Loans to groups of borrowers who handle a product from the same industry. Although the borrowers may appear to be independent from one another, their financial conditions may be affected similarly if a slowdown occurs in their economic sector.

Concentrations may also occur in banks located in towns that are economically dominated by one or only a few business enterprises. In these situations, banks may extend a substantial amount of credit to these companies and to a large percentage of the companies' employees. If economic or other events cause the enterprise's operations to slow down or stop, heavy unemployment may result—with other job opportunities in the area limited or nonexistent.

In identifying asset concentrations, commercial and residential real estate loans can be viewed separately when their performance is not subject to similar economic or financial risks. In the same vein, commercial real estate development loans need not be grouped with residential real estate development loans, especially when the residential developer has firm, reliable purchase contracts for the sale of the homes upon their completion. Even within the commercial development and construction sector, distinctions for concentration purposes may be made, when appropriate, between those loans that have firm take-out commitments and those that do not. Groups or classes of real estate loans should, of course, be combined and viewed as concentrations when they do share significant common characteristics and are similarly affected by adverse economic, financial, or business developments.

IDENTIFYING LOAN CONCENTRATIONS

The examiner should understand and evaluate the effectiveness of the internal policies, systems, and controls that an institution uses to monitor and manage the risk associated with asset concentrations. Every institution should maintain adequate records that may be used to identify asset concentrations. The degree of sophistication of the reporting records will vary by the size of institution. For example, larger institutions may have the automated capability to segregate loans by Standard Industrial Classification (SIC) codes, while smaller institutions may generate asset concentration listings manually.

Regardless of the identification system used by the institution, the accuracy of listed concentrations, as well as the appropriateness of concentrations, should be verified during the examination. All new and any existing asset concentrations should be reported monthly to the institution's board of directors or other appropriate committee for review.

RISK MANAGEMENT OF ASSET CONCENTRATIONS

Institutions with asset concentrations are expected to have in place effective policies, systems, and internal controls to monitor and manage this risk. The bank's board of directors is responsible for establishing appropriate risk parameters and for monitoring exposure, as well as for evaluating the methods used by management to manage and control concentration risk. Furthermore, the Board's Regulation F addresses exposure that may arise from a bank's relationship with its correspondents. Concentrations that involve excessive or undue risks require close scrutiny by the bank and should be reduced over a reasonable period of time. Banking organizations with a need to reduce asset concentrations are normally expected to develop a plan that is realistic, prudent, and achievable in view of their particular circumstances and market conditions.

The purpose of an institution's policies should be to improve the overall quality of its portfolio. Institutions that have effective internal controls to manage and reduce excessive concentrations over a reasonable period of time need not automatically refuse credit to sound borrowers because of their particular industry or geographic location. Furthermore, a bank may be able to reduce the risks associated with concentrations through the strengthening of individual credits. For example, the bank may be able to obtain additional collateral or guarantees. In the event of deterioration, the bank's position would be improved because the additional collateral or guarantees provide a cushion against losses.

When concentration levels have been built up over an extended period, it may take time, in some cases several years, to achieve a more balanced and diversified portfolio mix. Given the institution's trade area, lack of economic diversity, or geographic location, reducing the existing concentration in the near term may be impossible. If a concentration does exist, the banking organization should have adequate systems and controls for reducing undue or excessive concentrations in accordance with a prudent plan. Strong credit policies and loan administration standards should provide adequate control for the risks associated with new loans. The institution should also maintain adequate capital to protect the institution while its portfolio is being restructured. For identified asset concentrations, bank management should be aware of not only the particular company's or industry's recent trends, but also of its future prospects.

Alternatives for Reducing Concentrations

Some alternatives for institutions whose asset concentrations are not likely to be reduced in the near term are described below.

Increased Holdings of Capital

To compensate for the additional risk that may be associated with an asset concentration, a bank may elect to maintain a higher capital ratio than would be required under the risk-based capital guidelines. This additional capital would provide support in the event the concentration adversely affects the organization's financial position.

Increased Allowance for Loan and Lease Losses

The banking organization may choose to factor a cushion for loan concentrations into its determination of an adequate allowance for loan and lease losses a basis-point cushion for loan concentrations in determining the minimum level. This cushion would be available to absorb some deterioration in loan concentrations.

Loan Participations

If a banking institution has a concentration, it may be possible to sell a portion of the loan portfolio in the secondary market to reduce its dependency on an asset group. If the institution is not large enough to participate in the secondary market, an alternative might be to sell loans, without recourse, to a correspondent bank that is also attempting to diversify its loan portfolio.

Government Guarantee Programs

Another possible solution to reduce the risk associated with a loan concentration is to seek government guarantees of originated loans. In some cases, a government agency may be willing to guarantee (or insure) a portion of agricultural or small-business loans, thereby reducing the risk to the originating bank.

1. To determine if the policies, practices, procedures, and internal controls regarding concentrations of credit are adequate.
2. To determine if bank officers are operating in conformance with the established guidelines.
3. To determine the existence of any concentrations of credit.
4. To determine if any concentrations of credit represent a hazard to the soundness of the bank.
5. To determine that concentrations of credit do not violate applicable banking statutes.
6. To initiate corrective action when policies, practices, procedures, or internal controls are deficient.

Examiners should obtain or prepare the information necessary to perform the appropriate procedural steps.

1. If selected for implementation, complete or update the Concentrations of Credits section of the Internal Control Questionnaire.
2. Based on the evaluation of internal controls, determine the scope of the examination.
3. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examination procedures.
4. Request the bank's schedules of concentrations that are reported to the board of directors and/or senior management at regular intervals and—
   a. if schedules are not current, update and/or have bank personnel update them as of the examination date and
   b. request that other examiners review the schedules for reasonableness relative to information developed in performing the examination procedures for the various departments.
5. If schedules of concentrations are not maintained or if the listing is incomplete, prepare or obtain the following schedules of obligations that exceed 25 percent of the bank's capital structure—
   a. loans collateralized by a common security
   b. loans, contingent liabilities, and/or other obligations to one borrower or a related group of borrowers
   c. loans dependent upon a particular crop or herd
   d. aggregate loans to major employers in the service area, their employees, and their major suppliers
   e. loans within industry groups
   f. out-of-normal territory loans
   g. all construction or development loans without firm takeout commitments.
6. If the schedules were prepared by others, review them for reasonableness relative to information developed in performing the examination procedures for the various loan areas.
7. Obtain a listing of due from bank accounts.
8. Obtain from the examiner assigned ''Investment Securities'' the schedule of investments and money market instruments that exceed 10 percent of the bank's capital structure.
9. Combine the schedules obtained in steps 4 through 8 and determine concentrations that equal or exceed 25 percent of the bank's capital structure. The remaining procedures apply only to these concentrations.
10. From the schedule of loans collateraled by a common security, eliminate all borrowers for whom the common security can be considered excess collateral, then review—
    a. the trend in market prices and
    b. current financial information, if appropriate.
11. For loans dependent upon a particular crop or herd—
    a. review the bank's files for information on market conditions, future markets, and estimated prices and
    b. determine any adverse trends that might affect payment of the concentrations.
12. For loans dependent upon major employers—
    a. review financial and other available information on the company and evaluate its ability to continue as an ongoing entity,
    b. review excerpts from trade papers or periodicals in bank files to determine that bank management is adequately informed on the business activity of the company, and
    c. note any adverse trends that might affect the collectibility of the loans in the concentrations.
13. For loans within industry groups—
    a. review financial and other available information on each industry and evaluate its ability to continue as a viable industry,
    b. review the bank's files to determine that management is adequately informed on the activities of the industry, and
    c. determine any adverse trends that might affect the collectibility of the loans included in the concentrations.
14. For due from bank accounts, inquire as to the reasonableness of the account relative to the activity and services provided.
15. Discuss with management—

a. the adequacy of written policies regarding concentrations of credit,
b. the manner in which the bank's officers are operating in conformance with established policies,
c. concentrations that will appear in the report of examination, and
d. any matter requiring immediate attention.

16. Prepare, in appropriate form, all information regarding concentrations for inclusion in the report of examination. A comment should be made regarding each concentration, particularly regarding the percentage of the bank's capital accounts (total capital) that the total of each concentration represents. Examiners should avoid direct requests for reduction in the concentration unless facts are included that would support this action.
17. Update the workpapers with any information that will facilitate future examinations.

Review the bank's internal controls, policies, practices, and procedures relating to concentrations of credit. The bank's system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flow charts, copies of forms used, and other pertinent information.

POLICIES

1. Has a policy been adopted that specifically addresses concentrations of credits?
2. Does the policy include deposits and other financial transactions with financial institutions?
3. Have controls been instituted to monitor the following types of concentrations:
   a. loans and other obligations of one borrower
   b. loans predicated on the collateral support afforded by a debt or equity issue of a corporation
   c. loans to a company dominant in the local economy, its employees, and major suppliers
   d. loans dependent upon one crop or herd
   e. loans dependent upon one industry group
   f. loans considered out of normal territory
4. Are periodic reports of concentrations required to be submitted to the board or its committee for review (if so, state frequency ________)?
5. Are the periodic reports checked for accuracy by someone other than the preparer before being submitted to the board or its committee?
6. When concentrations exist predicated upon a particular crop or herd of livestock, does the bank attempt to diversify the inherent potential risk by means of—
   a. participations or
   b. arrangements with governmental agencies such as—
      - guarantees or
      - lending arrangements?
7. When concentrations exist predicated upon a particular industry, does the bank make a periodic review of industry trends?

CONCLUSION

8. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly and indicate any additional examination procedures deemed necessary.
9. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

INTRODUCTION

The criteria used to assign quality ratings to extensions of credit that exhibit potential problems or well-defined weaknesses are primarily based upon the degree of risk and the likelihood of orderly repayment, and their effect on a bank's safety and soundness. Extensions of credit that exhibit potential weaknesses are categorized as ‘‘special mention,’’ while those that exhibit well-defined weaknesses and a distinct possibility of loss are assigned to the more general category of ‘‘classified.’’ The term classified is subdivided into more specific subcategories ranging from least to most severe: ‘‘substandard,’’ ‘‘doubtful,’’ and ‘‘loss.’’ The amount of classified extensions of credit as a percent of capital represents the standard measure of expressing the overall quality of a bank's loan portfolio.

These classification guidelines are only applied to individual credits, even if entire portions or segments of the industry to which the borrower belongs are experiencing financial difficulties. The evaluation of each extension of credit should be based upon the fundamental characteristics affecting the collectibility of that particular credit. The problems broadly associated with some sectors or segments of an industry, such as certain commercial real estate markets, should not lead to overly pessimistic assessments of particular credits in the same industry that are not affected by the problems of the troubled sector(s).

ASSESSMENT OF CREDIT QUALITY

The evaluation of each credit should be based upon the fundamentals of the particular credit, including, at a minimum—

- the overall financial condition and resources of the borrower, including the current and stabilized cash flow (capacity);
- the credit history of the borrower;
- the borrower's or principal's character;
- the purpose of the credit relative to the source of repayment; and
- the types of secondary sources of repayment available, such as guarantor support and the collateral's value and cash flow, when they are not a primary source of repayment. (Undue reliance on secondary sources of repayment should be questioned, and the bank's policy about permitting such a practice should be reviewed.)

The longer the tenure of the borrower's extension of credit or contractual right to obtain funds, the greater the risk of some adverse development in the borrower's ability to repay the funds. This is because confidence in the borrower's repayment ability is based upon the borrower's past financial performance as well as projections of future performance. Failure of the borrower to meet its financial projections is a credit weakness, but does not necessarily mean the extension of credit should be considered as special mention or be classified. On the other hand, the inability to generate sufficient cash flow to service the debt is a well-defined weakness that jeopardizes the repayment of the debt and, in most cases, merits classification. When determining which credit-quality-rating category is appropriate, the examiner should consider the extent of the shortfall in the operating figures, the support provided by any pledged collateral, and/or the support provided by cosigners, endorsers, or guarantors.

Delinquent Extensions of Credit

One of the key indicators of a problem credit is a borrower's inability to meet the contractual repayment terms of an extension of credit. When this occurs, the extension of credit is identified as past due or delinquent. Examiners divide delinquent credits into two main categories for the purpose of a bank examination: ‘‘A’’ delinquent extensions of credit and ‘‘B’’ delinquent extensions of credit. Extensions of credit are also referred to as ‘‘paper’’ because the legal obligation, for example the note, loan, or credit agreement, is typically recorded on a paper form. The designation of ‘‘A’’ paper is given to any extension of credit that is considered to be a statutory bad debt. Statutory bad debts are defined in section 5204 of the Revised Statutes (12 USC 56) as all debts due to a bank on which interest is past due and unpaid for a period of six months, unless the extension of credit is well secured and in the process of collection. Delinquent credits that are not covered under the definition of statutory bad debt are designated as ‘‘B’’ paper. In either case, special mention or classified extensions of credit are often found to be delinquent. An extension of credit that is *not* delinquent also may be identified as special mention or classified. Nondelinquent extensions of credit (also referred to as ‘‘performing’’ or ‘‘current’’) should be classified when well-defined weaknesses exist that jeopardize repayment. Examples of well-defined weaknesses include the lack of credible support for full repayment from reliable sources, or a significant departure from the intended source of repayment. This latter weakness warrants concern because a delinquent credit may have been brought current through loan or credit modifications, refinancing, or additional advances.

SPECIAL MENTION CATEGORY

A special mention extension of credit is defined as having potential weaknesses that deserve management’s close attention. If left uncorrected, these potential weaknesses may, *at some future date*, result in the deterioration of the repayment prospects for the credit or the institution’s credit position. Special mention credits are not considered as part of the classified extensions of credit category and do not expose an institution to sufficient risk to warrant classification.

Extensions of credit that might be detailed in this category include those in which—

- the lending officer may be unable to properly supervise the credit because of an inadequate loan or credit agreement;
- questions exist regarding the condition of and/or control over collateral;
- economic or market conditions may unfavorably affect the obligor in the future;
- a declining trend in the obligor’s operations or an imbalanced position in the balance sheet exists, but not to the point that repayment is jeopardized; and
- other deviations from prudent lending practices are present.

The special mention category should not be used to identify an extension of credit that has as its sole weakness credit-data or documentation exceptions not material to the repayment of the credit. It should also not be used to list extensions of credit that contain risks usually associated with that particular type of lending. Any extension of credit involves certain risks, regardless of the collateral or the borrower’s capacity and willingness to repay the debt.

For example, an extension of credit secured by accounts receivable has a certain degree of risk, but the risk must have increased beyond that which existed at origination to categorize the credit as special mention. Other characteristics of accounts receivable warranting identification as special mention include a rapid increase in receivables without bank knowledge of the causative factors, concentrations in receivables lacking proper credit support, or lack of on-site audits of the bank’s borrower.

CLASSIFICATION CATEGORIES

Split Classifications

When classifying a particular credit, it may not be appropriate to list the entire balance under one credit-quality category. This situation is commonly referred to as a ‘‘split classification’’ and may be appropriate in certain instances, especially when there is more certainty regarding the collectibility of one portion of an extension of credit than another. Split classifications may also involve special mention as well as ‘‘pass’’ credits, those that are neither special mention nor classified. Extensions of credit that exhibit well-defined credit weaknesses may warrant classification based on the description of the following three classification categories.[1]

Substandard Extensions of Credit

A ‘‘substandard’’ extension of credit is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Extensions of credit so classified must have a well-defined weakness or

1. Guidelines for the uniform classification of consumer-installment extensions of credit and credit card plans, as well as classification guidelines for troubled commercial real estate credits, are discussed in detail in sections 2130.1 and 2090.1, respectively

weaknesses that jeopardize the liquidation[2] of the debt. They are characterized by the distinct possibility that the bank will sustain some loss if the deficiencies are not corrected. Loss potential, while existing in the aggregate amount of substandard credits, does not have to exist in individual extensions of credit classified substandard.

Doubtful Extensions of Credit

An extension of credit classified ''doubtful'' has all the weaknesses inherent in one classified substandard, with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable. The possibility of loss is extremely high, but because of certain important and reasonably specific pending factors that may work to the advantage of and strengthen the credit, its classification as an estimated loss is deferred until its more exact status may be determined. Pending factors may include a proposed merger or acquisition, liquidation proceedings, capital injection, perfecting liens on additional collateral, or refinancing plans.

Examiners should avoid classifying an entire credit as doubtful when collection of a specific portion appears highly probable. An example of proper use of the doubtful category is the case of a company being liquidated, with the trustee-in-bankruptcy indicating a minimum disbursement of 40 percent and a maximum of 65 percent to unsecured creditors, including the bank. In this situation, estimates are based on liquidation-value appraisals with actual values yet to be realized. By definition, the only portion of the credit that is doubtful is the 25 percent difference between 40 and 65 percent. A proper classification of such a credit would show 40 percent substandard, 25 percent doubtful, and 35 percent loss.

Examiners should generally avoid repeating a doubtful classification at subsequent examinations, as the time between examinations should be sufficient to resolve pending factors. This is not to say that situations do not occur when continuation of the doubtful classification is warranted. However, the examiner should avoid undue continuation if repeatedly, over the course of time, pending events do not occur and repayment is again deferred awaiting new developments.

Loss Extensions of Credit

Extensions of credit classified ''loss'' are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the credit has absolutely no recovery or salvage value, but rather that it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be effected in the future. Banks should not be allowed to attempt long-term recoveries while the credit remains on the bank's books. Losses should be taken in the period in which they surface as uncollectible.

In some cases, examiners should determine a reasonable carrying value for a distressed extension of credit and require a write-down through a charge to the allowance for loan and lease losses, or to other operating expenses in the case of an ''other asset.'' Such a determination should be based on tangible facts recorded in the bank's credit file and contained in reports on problem credits submitted to the board of directors or its committee, and not solely on verbal assurances from a bank officer.

SITUATIONS NOT REQUIRING CLASSIFICATION

It is generally not necessary to classify extensions of credit and contingent liabilities that are adequately protected by the current sound worth and debt-service capacity of the borrower, guarantor, or the underlying collateral. Further, a performing extension of credit should not automatically be identified as special mention, classified, or charged off solely because the value of the underlying collateral has declined to an amount that is less than the balance outstanding. Extensions of credit to sound borrowers that are refinanced or renewed in accordance with pru-

2. This terminology is used in the original classification definitions as set forth in the 1938 Accord and its amendments. The term ''liquidation'' refers to the orderly repayment of the debt and not to a forced sale of the loan or its underlying collateral.

dent underwriting standards should not be categorized as special mention unless a potential weakness exists, or classified unless a well-defined weakness exists that jeopardizes repayment. The existence of special mention or classified extensions of credit should not be identified as an imprudent banking practice, as long as the institution has a well-conceived and effective workout plan for such borrowers, and effective internal controls to manage the level of these extensions of credit.

Partially Charged-Off Extensions of Credit

When an institution has charged off a portion of a credit and the remaining recorded balance of the credit (1) is being serviced (based upon reliable sources) and (2) is reasonably assured of collection, categorization of the remaining recorded balance as special mention or classified may not be appropriate.[3] For example, when the remaining recorded balance of an extension of credit is secured by readily marketable collateral, the portion that is secured by this collateral would generally not be identified as special mention or classified. This would be appropriate, however, if potential or well-defined weaknesses, respectively, continue to be present in the remaining recorded balance. In such cases, the remaining recorded balance would generally receive a credit rating no more severe than substandard.

A more severe credit rating than substandard for the remaining recorded balance would be appropriate if the loss exposure cannot be reasonably determined, for example, when significant risk exposures are perceived, such as might be the case in bankruptcy or for credits collateralized by properties subject to environmental hazards. In addition, classification of the remaining recorded balance would be appropriate when sources of repayment are considered unreliable.

Formally Restructured Extensions of Credit

Restructured troubled debt should be identified in the institution's internal credit-review system and closely monitored by management. When analyzing a formally restructured extension of credit, the examiner should focus on the ability of the borrower to repay the credit in accordance with its *modified terms*.[4] With formally restructured credits, it is frequently necessary to charge off a portion of the principal, due to the borrower's difficulties in meeting the contractual payments. In these circumstances, the same credit-risk assessment given to nonrestructured credits with partial charge-offs (see the previous subsection) would also generally be appropriate for a formally restructured credit. This includes *not* identifying the remaining recorded balance as special mention or classified if unwarranted. The assignment of special mention status to a formally restructured credit would be appropriate, if, after the restructuring, potential weaknesses remained. It would also be appropriate to classify a formally restructured extension of credit when well-defined weaknesses exist that jeopardize the orderly repayment of the credit, based upon its reasonable modified terms. For a further discussion of troubled debt restructurings, see the glossary section of the Instructions for the Consolidated Reports of Condition and Income and "Loan Portfolio Management," section 2040.1.

ROLE OF GUARANTEES

The primary focus of a review of an extension of credit's quality is the original source of repayment and the borrower's ability and intent to fulfill the obligation without reliance on guarantors.[5] In situations involving troubled credits, however, the assessment of credit quality should also be based upon the support provided by guarantees. As a result, the lending institution

3. The accrual/nonaccrual status of the credit must continue to be determined in accordance with the glossary section of the Instructions for the Consolidated Reports of Condition and Income (call report). Thus, while these partially charged-off credits may qualify for nonaccrual treatment, cash-basis recognition of income will be appropriate when the criteria specified in the call report guidance are met.

4. An example of a restructured commercial real estate credit that does *not* have reasonable modified terms would be a mortgage that requires interest payments *only*, but no principal payments, despite the fact that the underlying collateral generates sufficient cash flow to pay both.

5. Some credits are originated based primarily upon the financial strength of the guarantor, who is, in substance, the primary source of repayment. In such circumstances, examiners generally assess the collectibility of the credit based upon the guarantor's ability to repay the credit.

must have sufficient information concerning the guarantor's financial condition, income, liquidity, cash flow, contingent liabilities, and other relevant factors (including credit ratings, when available) to demonstrate the guarantor's financial capacity to fulfill the obligation.

Examiner Treatment of Guarantees

A guarantee should provide support for repayment of indebtedness, in whole or in part, and be legally enforceable. It is predicated upon both the guarantor's financial capacity and willingness to provide support for a credit.

To assess the financial capacity of a guarantor and determine whether the guarantor can honor its contingent liabilities in the event required, examiners normally rely on their own analysis of a guarantor's financial strength. This includes an evaluation of the financial statements and the number and amount of guarantees currently committed to.

A guarantor's willingness to perform is assumed, unless there is evidence to the contrary. Since a guarantee is obtained with the intent of improving the repayment prospects of a credit, a guarantor may add sufficient strength to preclude or reduce the severity of the risk assessment.

Examiners should consider and analyze the following guarantee-related factors during the course of their review of extensions of credit:

- The degree to which the guarantors have demonstrated their ability and willingness to fulfill previous guarantees.
- Whether previously required performance under guarantees was voluntary or was the result of legal or other actions by the lender. Examiners should give limited credence, if any, to guarantees from obligors who have reneged on obligations in the past, unless there is clear evidence that the guarantor has the ability and intent to honor the specific guarantee under review.
- The economic incentives for performance by guarantors. This includes—
  - — guarantors who have already partially performed under the guarantee;
  - — guarantors who have other significant investments in the project;
  - — guarantors whose other sound projects are cross-collateralized or otherwise intertwined with the credit; or
  - — guarantees collateralized by readily marketable assets that are under the control of a third party.
- The extent to which guarantees are legally enforceable, although in general this is the only type of guarantee that should be relied upon.
  - — Collection of funds under a guarantee should not be subject to significant delays or undue complexities or uncertainties that might render legal enforceability questionable.
  - — Although the bank may have a legally enforceable guarantee, it may decide not to enforce it. The examiner's judgment should be favorably affected by previous extensions of credit evidencing the timely enforcement and successful collection of guarantees.
- The type of the guarantee. Some guarantees for real estate projects are limited in that they only pertain to the development and construction phases of a project. As such, these limited guarantees cannot be relied upon to support a troubled credit after the completion of these phases.

OFF-BALANCE-SHEET ITEMS

The principal off-balance-sheet credit-related transactions likely to be encountered during loan reviews are loan commitments, commercial letters of credit, and standby letters of credit. When evaluating off-balance-sheet credit transactions for the purpose of assigning a credit-quality rating, the examiner should carefully consider whether the bank is irrevocably committed to advance additional funds under the credit agreement. If the bank must continue to fund the commitment and a potential weakness exists that, if left uncorrected, may at some future date result in the deterioration of repayment prospects or the bank's credit position, the amount of the commitment may be categorized as special mention. If there is a well-defined weakness that jeopardizes repayment of a commitment, classification may be warranted. If an amount is classified, it should be separated into two components: the direct amount (the amount that has already been advanced) and the indirect amount (the amount that must be advanced in the future).

Loan Commitments

Loan commitments are defined as legally binding obligations to extend credit (other than in the form of retail credit cards, check credit, and related plans) for which a fee or other compensation is typically received. Different types of loan commitments vary based upon the nature of the credit granted. Loan-commitment credit risk stems from the possibility that the creditworthiness of the customer will deteriorate between the time the commitment is made and the funds are advanced. (See ''Contingent Claims from Off-Balance-Sheet Activities,'' section 4110.1.)

Commercial Letters of Credit

Commercial letters of credit involve a buyer of goods and a seller of goods and are instruments issued by a bank serving as an intermediary between the two for the resultant payment for the goods. Commercial letters of credit are customarily used to facilitate international trade due to the distances involved, as well as differences in legal, political, and business practices. Additionally, there may be a lack of familiarity between the buyer and seller. As a result, the bank substitutes its credit in place of the buyer's credit and promises on behalf of its customer to pay predetermined amounts of money to the seller against the delivery of documents indicating shipment of goods and representing title to those goods. If the shipping documents are in order, the bank is obligated to pay the seller through the issuance of a sight or time draft. The bank is then reimbursed by its customer for the amount of the shipment plus a fee for conducting the transaction.

Given the nature of the bank's commitment to pay for the goods on behalf of its customer, a commercial letter of credit is typically irrevocable. This means that it cannot be cancelled or revoked without the consent of all parties concerned. As a result, there is added credit risk for the issuing bank since it cannot cancel its commitment in the event the credit standing of its customer deteriorates, even if the deterioration occurs before the shipment of the goods.

Standby Letters of Credit

Most standby letters of credit (SLCs) are unsecured and involve substituting the bank's credit standing for that of the bank's customer on behalf of a beneficiary. This occurs when the beneficiary needs to ensure that the bank's customer is able to honor its commitment to deliver the goods or services by the agreed-upon time and with the agreed-upon quality. For credit-analysis purposes, SLCs are to be treated like loans and represent just one type of extension of credit relative to the overall exposure extended by the bank to the borrower. SLCs can be divided into two main groups: ''financial SLCs'' and ''nonfinancial SLCs.'' Financial SLCs essentially guarantee repayment of financial instruments and are commonly used to ''guarantee'' payment on behalf of customers, issuers of commercial paper, or municipalities (relative to tax-exempt securities). Nonfinancial SLCs are essentially used as bid and performance bonds to ''guarantee'' completion of projects, such as building or road construction, or to guarantee penalty payment in case a supplier is unable to deliver goods or services under a contract.

REQUIRED LOAN WRITE-UPS

A full loan write-up (see criteria below) is required for all significant or material classified or specially mentioned assets if (1) management disagrees with the disposition accorded by the examiner, or (2) the institution will be rated composite 3, 4, or 5. The write-ups will be used to support the classifications to management and, in the case of problem banks, to support any necessary follow-up supervisory actions.

An abbreviated write-up may be appropriate for other loans to illustrate a credit-administration weakness or to formalize certain decisions, document agreements, and clarify action plans for management. For example, bank management may have agreed to either collect or charge off a loan classified doubtful by the next call report date or to reverse interest accruals and place the loan on nonaccrual status. These agreements may be expressed in the report through a brief comment under the classification write-up.

The examiner may find it beneficial to list extensions of credit alphabetically by department and/or branch. When more than one borrower is relevant to a single write-up, the alphabetization of the prime borrower or the parent corporation should determine the credit's position in the list. All other parties to the credit, including cosigners, endorsers, and guarantors, should be indicated directly under the maker of the notes or embodied within the write-up.

Although classifications and items listed for special mention may be listed alphabetically on the report page, examiners may elect to format the listing or write-ups in other ways to illustrate examination findings or conclusions. For example, examiners may wish to group classifications into categories of weakness and to use these listings to support loan-administration comments without providing a write-up for each classified item.

Notwithstanding this guidance, examiners have the flexibility of writing up more than the criticized assets, including any special mention credits, if deemed necessary. The decision to increase the number of write-ups should be based on factors such as the overall financial condition of the bank, quality of the loan portfolio, or adequacy of loan portfolio administration.

It is important that a sufficient number of write-ups with appropriate content be provided to support the examiner's assessment of the bank's problem loans, leases, and other extensions of credit. The write-ups should also support any comments pertaining to credit-administration policies and practices as they relate to this component of the bank's loan portfolio.

General Guidelines for Write-Ups of Special Mention and Classified Extensions of Credit

Extension of credit write-ups may be in a narrative or bullet format, similar to the write-ups of shared national credits, where appropriate. When the special mention or classified credit consists of numerous extensions of credit to one borrower, or when multiple borrowers are discussed in one write-up, the write-up should be structured to clearly identify the credit facilities being discussed. For example, each extension of credit could be numbered when multiple credits are involved.

Before a write-up is prepared, the examiner should recheck central information files or other sources in the bank to determine that all of the obligor's debt, including related debt,[6] has been noted and included. The examiner should consider identifying accrued interest receivable as special mention or classified, especially when the cumulative effect on classified percentages is significant or the accrued interest is appropriately classified loss.

Even though the length of a write-up may be limited, the information and observations contained in the write-up must substantiate the credit's treatment as a special mention or classified credit. To prepare a write-up that brings out pertinent and fundamental facts, an examiner needs to have a thorough understanding of all the factors relative to the extension of credit. An ineffective presentation of the facts weakens a write-up and frequently casts doubt on the accuracy of the risk assessment. The examiner might consider emphasizing deviations from prudent banking practices as well as loan policy and procedure deficiencies that are pertinent to the credit's problems. When portions of a borrower's indebtedness are assigned to different risk categories, including portions identified as "pass," the examiner's comments should clearly set forth the reason for the split-rating treatment. A full write-up on items adversely classified or listed as special mention must provide sufficient detail to support the examiner's judgment concerning the rating assigned. To ensure that the write-ups provide a clear, concise, and logical discussion of material credit weaknesses, the following minimum categories of information should be presented, preferably in the order listed (see SR-99-24):

1. *A general description of the obligation.*
   - *Amount of exposure (both outstanding and contingent or undrawn) as follows:*
     — Summarize total related and contingent borrowings, including amounts previously charged off and recovered.
     — List the borrower's total related liabilities outstanding. Amounts making up this total refer to credits in which the borrower may have a related interest and is directly or indirectly obligated to repay, such as partnerships and joint ventures. The rule for determining what

6. The term "related" refers to direct and indirect obligations.

is included in related debt (aggregating debt), which ultimately has to do with ascertaining compliance with legal lending limits, is governed by state law.

— List and identify the obligor's contingent liabilities to the bank under examination. Contingent liabilities include items such as unadvanced portions of a line of credit or extension of credit (commitments), guarantees or endorsements, and commercial and standby letters of credit. Although contingent liabilities to other lenders represent an important component of the financial analysis of the obligor, they should not be listed in the write-up unless they are particularly relevant to the situation, or are portions of both related and contingent liabilities that represent participations purchased from and sold to other lenders. The latter example should be listed even though the entire relationship may not have been identified as special mention or classified. Additionally, only the classified portion of extensions of credit or contingent liabilities of the bank under examination should be listed in the appropriate column(s) of the classified asset page.

• *The obligor and the obligor's location and type of business or occupation.* For the type of business or occupation of the obligor, indicate whether the business is a proprietorship, partnership, joint venture, or corporation. This information can be used to compare the purpose of the credit with the source(s) of repayment, and to compare the credit's structure with the obligor's repayment ability. The general identification of occupation, such as professional or wage earner, may not be definitive enough, so it may be necessary to indicate that, for example, the extension of credit is to a medical doctor.

Types of businesses may be clearly indicated in the borrower's business name and may not require additional comment. For example, Apex Supermarket and Ajax Sporting Goods Store imply a retail supermarket and a retail sporting goods store. However, examiners should not be misled in their analysis of the credit; likewise, the write-up reviewer should not be misled by assuming that a borrower is necessarily in the same line of business indicated by the borrower's business name. In the preceding example, if the borrower is primarily a wholesale grocery or sporting goods supplier, or if it radically deviates from the type of business indicated in its business name, the situation should be clarified. It is important to state the borrower's position in the marketing process—manufacturer, wholesaler, or retailer—and to indicate the types of goods or services.

• *Description and value of collateral.* The type of lien, collateral description and its condition and marketability, as well as the collateral's current value, date of valuation, and basis for the valuation, should be included. If values are estimated, the write-up should indicate the source of the valuation, such as the obligor's recent financial statement, an independent appraisal, or an internal management report. If valuations are not available, a statement to that effect should be included. A bank's failure to obtain collateral valuations, when available, is cause for criticism. Also include any other pertinent information that might impede or facilitate the possible sale of the collateral to repay the extension of credit.

When problem borrowers are involved, the sale of the collateral often becomes the sole or primary source of repayment. As a result, the valuation of the collateral becomes especially important when describing the credit, as described in the specific examples below.

If real estate is pledged to secure the credit, the write-up should provide a description of the property, the lien status, the amount of any prior lien, and the appraised value. If multiple parcels are securing the credit, appraised values should be listed for each parcel, including the date of the appraisal and the basis for the value. When bank staff or examiners' challenges to appraisal assumptions are supported, the resulting adjustment in value for credit-analysis purposes should be indicated. If the property held as collateral has tenants, its cash flow should be noted and the financial strength of the major lessees commented upon, if appropriate.

If the collateral represents shares of or an interest in a closely held company, the shares or ownership interest held should be indicated in relation to the total shares outstanding, and the financial condition of the closely held company should be summarized in the write-up. Additionally, the approximate value of the closely held company, as indicated by its financial statements, should be compared for consistency with the value of the company as indicated on the principal's or partner's personal financial statement. The values often do not correlate to the extent they should, which typically indicates overvaluation of the asset on the balance sheet of the entity owning the shares or ownership interest.

If a blanket lien on assets, such as receivables, inventory, or equipment, is pledged as collateral, the current estimated value of each asset type should be shown separately. The basis for these values can come from various sources, which should be indicated:

— If receivables are pledged as collateral for an asset-based extension of credit, a current aging report and an assessment of the appropriateness of the advance ratio is usually necessary to determine their collectibility and value.

— If inventory is pledged as collateral for an asset-based extension of credit, an assessment of the appropriateness of the advance ratio is necessary. Additionally, the value varies with the condition and marketability of the inventory.

— If listed securities or commodities are pledged as collateral, the market value and date of valuation should be noted.

- *Notation if borrower is an insider or a related interest of an insider.*
- *Guarantors and a brief description of their ability to act as a source of repayment.* If the financial strength of guarantors has changed significantly since the initial guarantee of the credit facility, this should be noted. The relationship of the guarantors to the borrower should be identified, including a brief description of the guarantors' ability (financial strength) to serve as a source of repayment independent of the borrower. Any collateral supporting the guarantees should also be stated. See the previous subsection, ''Role of Guarantees,'' and SR-91-24 for further guidance on considering guarantees for credit-analysis purposes.
- *Amounts previously classified.*
- *Repayment terms and historical performance, including prior charge-offs, and current delinquency status (with notation if the credit is currently on nonaccrual status).* Any changes to the original repayment terms, whether initiated by bank management or the obligor, should be detailed with an appropriate analysis of the changes included in the write-up. Renewals, extensions, and rewritten notes that deviate from the stated purpose and repayment expectations, as approved by management, should be discussed in light of their effect on the quality of the credit. Restructurings should be discussed in terms of their reasonable objectives, focusing on the prospects for full repayment in accordance with the modified terms.

  It may be prudent to state the purpose of the credit. The purpose can be compared with the intended source of repayment for appropriateness. For example, a working capital extension of credit generally should not depend on the sale of real estate for repayment. Additionally, the obligor's prior business experience should correlate to the credit's purpose.

2. *A summary listing of weaknesses resulting in classification or special mention treatment.*
3. *A reference to any identified deficiencies in the item that will support loan-administration or violation comments elsewhere in the report.* This information may consist of deficiencies in credit and collateral documentation or violations of law that have a material impact on credit quality. Loan-portfolio-administration performance includes, but is not limited to—
   - changes in asset quality since the last examination;
   - the appropriateness of loan-underwriting standards;
   - the adequacy of—
     — loan documentation;
     — management information systems;
     — internal control systems; and
     — loan-loss reserves;
   - the accuracy of internal loan-rating systems;
   - the ability and experience of lending officers, as well as other personnel managing the lending function; and
   - changes in lending policies or procedures since the last examination.

4. *If management disagrees with the classification, a statement to that effect along with management's rationale.* Information could include selected data from the most recent fiscal and interim financial statements (discussion of items such as leverage, liquidity, and cash flow) when the primary reason for the write-up relates to the borrower's financial condition or operating performance. Cost of goods sold, nonrecurring expenses, dividends, or other items indicating deterioration in the credit quality may also be highlighted. Any stated value of the borrower's encumbered assets should be set off against specific debt to arrive at the unprotected balance, if applicable. In addition, the examiner should identify encumbered assets that are pledged elsewhere.
5. *A concise description of any management action taken or planned to address the weakness in the asset.* The action plan should focus on a concise description of management's workout or action plan to improve the credit's collectibility or to liquidate the debt. Review of the bank's documented workout plan should give an examiner a clear idea of past efforts to improve the prospect of collectibility and management's current efforts and future strategy. The plan should clearly state the bank's goals and corresponding timetable as they appear at that point, including items such as the degree of repayment envisioned and the proceeds anticipated from the sale of the collateral. Based on this information, the examiner should succinctly summarize in the write-up the bank's collection efforts to date and its ongoing plans to address the situation.

Optional Information for Write-ups

At the examiner's discretion, other information may be included in loan write-ups. For example the examiner may want to include current financial information on the borrower, cosigners, and guarantors. The additional information may consist of discussions regarding current balance sheets and operating statements. If discussed, the examiner should indicate whether the financial statements have been audited, reviewed, compiled, or prepared by the borrower, and whether they are fiscal or interim statements. If the statements are audited, the examiner should indicate the type of opinion expressed—unqualified, qualified, disclaimer, or adverse—and whether the auditor is a certified public accountant. If the opinion is qualified, note the reason(s) given by the auditor.

When the examiner includes comments regarding the borrower's financial condition, the comments should always highlight credit weaknesses in a manner that supports the risk assessment. It is important that sufficient detail is provided to identify unfavorable factors. A trend analysis or details of balance-sheet, income-statement, or cash-flow items can be included. The examiner may also include comments when special mention or classified credits may exhibit favorable as well as unfavorable financial characteristics. Both types of pertinent factors may be included in the write-up as long as they are placed in the proper perspective to demonstrate the credit's inherent weaknesses.

INTRODUCTION

The allowance for loan and lease losses (ALLL), often referred to as the loan-loss reserve by the banking industry, is presented on the balance sheet as a contra-asset account that reduces the amount of the loan portfolio reported on the balance sheet. The purpose of the ALLL is to absorb estimated credit losses within a bank's portfolio of loans and leases, including all binding commitments to lend. Estimated credit losses are anticipated losses that are reasonably expected to occur but whose amounts or obligors cannot be specifically identified.

All insured depository institutions, except for federally insured branches and agencies of foreign banks, must maintain an allowance that is sufficient to absorb all estimated credit losses contained in the bank's loan and lease portfolio. To ensure that its allowance is maintained at an adequate level, a bank must determine the amount of its estimated credit losses at least quarterly or more frequently, if warranted, by evaluating the collectibility of its loan and lease portfolio, including any accrued and unpaid interest. If the amount of the ALLL is inadequate to absorb the level of estimated credit losses, the bank must make a provision for loan and lease losses. This provision appears as an expense item on the bank's income statement and decreases the net income for that period. The ALLL must always have a credit balance and may not be increased by transfers from undivided profits or any segregation thereof. Once a loan or lease loss becomes identifiable, that is, when available information confirms that a specific loan or lease, or portions thereof, is uncollectible, it is to be promptly charged off against the ALLL. Under no circumstances can loan or lease losses be charged directly to undivided profits and capital reserves. Any recoveries on loans or leases previously charged off must be credited back to the ALLL.

To illustrate these concepts, assume that Bank A has a loan and lease portfolio totaling $100 million at the end of year 1 and an ALLL of $1.25 million; thus, its net carrying amount for the loan portfolio on the balance sheet is $98.75 million. Based on its most recent analysis, Bank A has determined that an ALLL of $1.5 million is necessary to cover its estimated credit losses as of the end of the fourth quarter. Therefore, in the fourth quarter of year 1, Bank A should record a "provision for loan and lease losses" for $250,000, debiting this expense and crediting the ALLL for this amount. Assume further that during the first quarter of year 2, Bank A identifies $750,000 in uncollectible loans. It must charge off this amount against the ALLL by debiting the ALLL and crediting the individual loans for $750,000. Also assume that in the same first quarter of year 2, Bank A receives $100,000 in cash recoveries on previously charged off loans. These recoveries must be credited to the ALLL in that quarter. Thus, in the first quarter of year 2, Bank A's ALLL, which began the year at $1.5 million, will have been reduced to $850,000 ($1,500,000 – $750,000 + $100,000 = $850,000). However, management must also perform its quarterly analysis of the adequacy of the ALLL. Assuming this analysis indicates that an ALLL of $1.2 million is necessary to absorb estimated credit losses that cannot be currently identified, Bank A must make a provision for loan and lease losses of $350,000 to bring its ALLL up to the required amount by the end of the first quarter of year 2.

While the overall responsibility for maintaining the ALLL at an adequate level rests with the bank's senior management and board of directors, the adequacy of the ALLL and management's analysis of it are subject to examiner review. The examiner should make every effort to fully understand a bank's methods for determining the adequacy of its ALLL and should take these methods into account when making a final determination of the adequacy of the ALLL for examination purposes. It is appropriate for the examiner to confer with bank management and any outside accountant or auditor that has advised management on its ALLL-review policies or practices.

After completing the examination review of the ALLL, the examiner-in-charge may conclude that the allowance for loan and lease losses is less than adequate. The examiner-in-charge, in rare cases, may also conclude that management has significantly overprovided for the ALLL, thus misstating the bank's financial condition and results of operations. If there is a significant error in either direction, the examiner should discuss these findings with bank management, include appropriate comments in the examination report, and, if the ALLL is inadequate, direct the bank to restore it to an adequate level.

OVERVIEW OF THE 1993 INTERAGENCY POLICY STATEMENT

The primary document that governs the determination of the adequacy of the ALLL is the interagency Policy Statement on the Allowance for Loan and Lease Losses, issued December 21, 1993. This policy statement, included as an appendix to this section, provides institutions and examiners with guidance on the management policies, internal systems, and approaches for estimating adequate loan-loss reserves. The examiner is responsible for ascertaining that the bank under examination is in compliance with the interagency policy statement.

The policy imposes certain responsibilities on examiners to determine (1) the effectiveness of each bank's internal credit-review procedures, (2) the adequacy of its ALLL-evaluation techniques, and (3) ultimately, whether its ALLL is sufficient both in terms of the accounting principles used and in the broader context of the safety and soundness of the institution. In applying the terms of the interagency policy statement during individual bank examinations, the examiner must take into account the variations in size, character, and complexity of operation and the different levels of management sophistication among state member banks. The principles of the policy statement should always be applied consistently with these factors. Consequently, the ways that individual banks comply with the policy statement will vary greatly from institution to institution. As a general rule, examiners can expect smaller institutions with less diverse operations offering traditional lending products to have much simpler and more abbreviated lending policies and less sophisticated loan-review processes than larger and more complex banks. Thus, when determining compliance with the policy statement, the examiner should pay particular attention and give special weight to management's record of success in properly managing the credit function and in identifying problem assets promptly.

Finally, in an attempt to bring consistency to the subjective process of judging credit risk, potential future loan losses, and the adequacy of the ALLL, the policy statement established a uniform standard for judging whether the level of a bank's ALLL is reasonable. The examiner should check the reasonableness of management's ALLL methodology by comparing the reported ALLL (after deducting all identified losses) against the sum of 50 percent of the loans the examiner has classified as doubtful, plus 15 percent of the loans the examiner has classified as substandard, plus an additional amount for unclassified assets. The final amount of this calculation should not be considered a floor or a safe-harbor level for a bank's ALLL. Rather, the examiner should use this amount as a general guide, taking into account the bank's individual circumstances. Examiners should also exercise considerable judgment when evaluating the estimated reserves attributed to the unclassified loan portfolio, keeping in mind the overall management of the loan portfolio, the bank's historical losses on nonclassified loans (if available), concentrations of credit, the strength of the local economy, or any other issue deemed appropriate.

Verification During Examinations of State Member Banks

The examiner's responsibility to determine the adequacy of a bank's ALLL is one of the most important functions of any examination. The examiner must not only verify that the balance of the ALLL as of the examination date is adequate to absorb estimated credit losses that may become specifically identifiable in the future, he or she must also ascertain that the ALLL and related information have been correctly reported in the bank's call report and that management is in compliance with the interagency policy statement and has adequate systems in place to ensure continued compliance.

To carry out this responsibility, the examiner will consider all relevant information (1) developed during current and prior examinations, particularly the results of the examiner's loan review and the level, trend, and type of assets classified during the examination; (2) presented in the Uniform Bank Performance Reports, such as trends and peer data; (3) gleaned from correspondence files and other sources; and (4) developed by the bank as part of its internal credit-review process, internal management information systems, and formal analysis of the adequacy of its ALLL. Other information to be considered by the examiner may include—

- the current level and trend of delinquencies;
- listings of aged past-due loans, loans on which interest is not being collected in accordance with the terms of the loans, and loans whose terms have been modified by reducing or deferring the interest or principal payments;
- excessive loan renewals and extensions;
- the practice of habitual or excessive granting of exceptions to the bank's established underwriting standards;
- the results of discussions with bank officers and employees and the examiner's assessment of their level of competence;
- general or local economic conditions that might have a bearing on the collectibility of loans, such as pronounced business recessions, the closing of an important plant, weather or market factors affecting agriculture, widespread labor strikes, or international trade barriers; or
- all available outside information of comparable nature on banks of similar loan-portfolio size, composition, and quality.

The examiner should remember that loan and lease losses, whether actual or estimated, may vary greatly even among banks with loan portfolios of similar size, composition, and quality. Accordingly, information from peer-group banks should be used only as general guidance and never as the sole determinant of the adequacy of the ALLL.

The examiner will also ascertain that all identifiable losses have been charged off in a timely manner, meaning immediately after a loan has been identified as a loss. For secured loans, it may not be possible to precisely identify the loss until the collateral is liquidated. However, an attempt to estimate the loss should be made based on available information about the value of the collateral. If the collateral is sold shortly after it was received in a foreclosure or repossession, the bank shall substitute the value received at the sale for the fair value estimated at the time of foreclosure or repossession and adjust the loss charged against the ALLL. If an asset received in a foreclosure or repossession is held for longer than a short period of time, any additional losses in value and any gain or loss from the sale or disposition of the asset are not to be reported as a loan or lease loss or recovery, and they shall not be debited or credited to the ALLL. Examiners will need to use their judgment when evaluating whether the gain or loss from the sale of the asset occurred within a short period of time. Additional declines in value and the gain or loss from the sale or disposition shall be treated as other noninterest income or expense in accordance with the call report instructions. When a loan is charged off, all applicable accrued interest should be recognized as loss. Interest that has been accrued year-to-date should be charged against current income, and interest accrued in the prior calendar year should be charged to the ALLL. For discounted loans, the unearned portion of the loan balance should be charged against the unearned discount account.

The banking agencies have developed expanded supervisory guidance for subprime lending that includes analysis and documentation standards for the ALLL. See section 2133.1 and SR-01-4.

FEDERAL BANKING AGENCIES AND SEC COMMITMENT AND REAFFIRMATION LETTERS

In November 1998, the federal banking agencies and the Securities and Exchange Commission (SEC) announced an agreement to work together to promote sound accounting and disclosure practices, while also maintaining allowances at appropriate levels. An interagency letter to financial institutions from the federal banking agencies and the SEC was released March 10, 1999, which reaffirmed the agencies' commitment to support credible financial statements and meaningful disclosures, consistent with generally accepted accounting principles (GAAP). The letter indicates that the agencies will issue additional guidance on appropriate methodologies, supporting documentation, and enhanced disclosures regarding the allowance, and it confirms that the agencies will encourage accounting-standard setters to provide additional guidance related to the ALLL. Additionally, the letter concludes that the SEC and the banking regulators will generally focus on enhancing ALLL practices going forward. After the March 10, 1999, letter was issued, the SEC and the federal banking agencies formed a joint working group to oversee the interagency project to develop enhanced guidance on internal documentation and public disclosures about the allowance.

On May 21, 1999, the Federal Reserve Board issued SR-99-13, which reemphasized the need for conservative reserving practices, provided background information that described the March 10 initiatives, and provided background information on emerging points of agreement between the banking agencies and the SEC. As discussed in this SR-letter, banks may reserve conservatively at the higher end of the range of estimated losses when those levels are management's best estimate. Furthermore, unallocated reserves are acceptable under GAAP, and allowance estimates can reflect a margin for imprecision. The SR-letter provides a broader interpretation of an article published by the Financial Accounting Standards Board (FASB) on the ALLL, based on discussions with senior FASB staff. The FASB article addresses the interaction between the two primary accounting standards on the ALLL, FASB Statements No. 5 and 114 (FAS 5 and FAS 114). It clarifies that an allowance calculated under FAS 5 may be required for loans that are not identified as being impaired under FAS 114. The article also specifies that reserve calculations for specific impaired loans under FAS 114 should incorporate evaluation of environmental factors (such as industry, geographic, economic, and political factors). Thus, reserves calculated under FAS 5 should not be required for loans that are determined to be impaired under FAS 114.

On July 12, 1999, the federal banking agencies and the SEC issued an interagency letter to financial institutions (see SR-99-22) to reaffirm the principles outlined in the May 21, 1999, SR-letter. In addition, the letter indicated the SEC does not have a policy of seeking reductions in financial institutions' loan-loss-allowance levels and will consult with the banking agencies as it considers whether to take a significant action regarding an institution's ALLL accounting practices.

APPENDIX—1993 INTERAGENCY POLICY STATEMENT

Nature and Purpose of the ALLL

Federally insured depository institutions (''institutions'') must maintain an ALLL at a level that is adequate to absorb estimated credit losses associated with the loan and lease portfolio, including all binding commitments to lend.[1] To the extent not provided for in a separate liability account, the ALLL should also be sufficient to absorb estimated credit losses associated with off-balance-sheet credit instruments such as standby letters of credit.[2]

For purposes of this policy statement, the term ''estimated credit losses'' means an estimate of the current amount of the loan and lease portfolio (net of unearned income) that is not likely to be collected; that is, net charge-offs that are likely to be realized for a loan or pool of loans given facts and circumstances as of the evaluation date. These estimated credit losses should meet the criteria for accrual of a loss contingency (i.e., a provision to the ALLL) set forth in generally accepted accounting principles (GAAP). When available information confirms specific loans and leases, or portions thereof, to be uncollectible, these amounts should be promptly charged off against the ALLL.

Estimates of credit losses should reflect consideration of all significant factors that affect the collectibility of the portfolio as of the evaluation date. For individually analyzed loans, these estimates should reflect consideration of the facts and circumstances that affect the repayment of such loans as of the evaluation date. For pools of loans, estimated credit losses should reflect consideration of the institution's historical net charge-off rate on pools of similar loans, adjusted for changes in trends, conditions, and other relevant factors that affect repayment of the loans in these pools as of the evaluation date. Methodologies for the determination of the historical net charge-off rate on a pool of loans can range from a simple average of an institution's net charge-off experience over a relevant period of years—coupled with appropriate adjustments as noted above for factors that affect repayment—to more complex techniques, such as migration analysis.

As discussed more fully below, for analytical

1. In the case of binding commitments to lend and off-balance-sheet credit instruments, such losses represent the amount of loans and leases that will likely not be collected (given facts and circumstances as of the evaluation date) and, thus, will be charged off. For purposes of this policy statement, the loan and lease portfolio, binding commitments to lend, and off-balance-sheet credit commitments are referred to as ''loans,'' ''loans and leases,'' the ''loan and lease portfolio,'' or the ''portfolio.''

2. Recourse liability accounts (that arise from recourse obligations for any transfers of loans that are reported as sales for regulatory reporting purposes) should be reported as liabilities that are separate and distinct from the ALLL.

purposes, an institution may attribute portions of the ALLL to individual loans or groups of loans. However, the ALLL is available to absorb all credit losses that arise from the loan and lease portfolio and is not to be segregated for, or allocated to, any particular loan or group of loans.

Responsibility of the Board of Directors and Management

Adequate ALLL Level

It is the responsibility of the board of directors and management of each institution to maintain the ALLL at an adequate level.[3] For purposes of the Reports of Condition and Income (call report) and the Thrift Financial Report (TFR), an adequate ALLL should be no less than the sum of the following items *given facts and circumstances as of the evaluation date* (after deduction of all portions of the portfolio classified loss):

- for loans and leases classified substandard or doubtful, whether analyzed and provided for individually or as part of pools, all estimated credit losses over the remaining effective lives of these loans
- for components of the loan and lease portfolio that are not classified, all estimated credit losses over the upcoming 12 months[4]
- amounts for estimated losses from transfer risk on international loans

Furthermore, when determining the appropriate level for the ALLL, management's analysis should be conservative so that the overall ALLL appropriately reflects a margin for the imprecision inherent in most estimates of expected credit losses. This additional margin for imprecision might be incorporated into the ALLL through the amounts attributed for analytical purposes to individual loans or groups of loans or in a portion of the ALLL that is not attributed to specific components of the loan portfolio.[5]

The adequacy of the ALLL should be evaluated as of the end of each quarter, or more frequently if warranted, and appropriate provisions made to maintain the ALLL at an adequate level as of each call report or Thrift Financial Report date. This evaluation will be subject to review by examiners.

Related Responsibilities

In carrying out their responsibility for maintaining an adequate ALLL, the board of directors and management are expected to—

- ensure that the institution has an effective loan-review system and controls (which include an effective credit-grading system) that identify, monitor, and address asset-quality problems in an accurate and timely manner (to be effective, the institution's loan-review system and controls must be responsive to changes in

3. When Financial Accounting Standards Board (FASB) Statement No. 114, "Accounting by Creditors for Impairment of a Loan," becomes effective, an "allowance for losses" must be calculated on a present-value basis when a loan is impaired. FASB Statement No. 114 states that it "does *not* address how a creditor should assess the *overall adequacy* of the allowance for credit losses" (emphasis added), and that, in addition to the allowance for credit losses calculated under FASB Statement No. 114, a creditor should continue to recognize an ALLL necessary to comply with FASB Statement No. 5, "Accounting for Contingencies." Furthermore, the guidance in FASB Statement No. 114 only applies to a subset of the loan and lease portfolio as the term is used in this policy statement (e.g., the FASB standard does *not* apply to leases, binding commitments to lend, and large groups of smaller-balance homogeneous loans that are collectively evaluated for impairment).

In contrast, this policy statement provides guidance on assessing the *overall adequacy* of the ALLL. At a later date, the federal bank and thrift regulatory agencies may issue further guidance on the application of FASB Statement No. 114 in the ALLL-evaluation process.

4. In certain circumstances, subject to examiner review, a net charge-off horizon of less than one year from the balance-sheet date may be employed for components of the portfolio that have not been classified. For institutions with conservative charge-off policies, a charge-off horizon of less than one year might be appropriate for pools of loans that are neither classified nor subject to greater than normal credit risk and that have well-documented and highly predictable cash flows and loss rates, such as pools of certain smaller consumer installment or credit card loans. On the other hand, a net charge-off horizon of more than one year for loans that have not been classified might be appropriate until an institution's loan-review function and credit-grading system results in accurate and timely assessments of the portfolio. In such situations, an institution should expeditiously correct deficiencies in its loan-review function and credit-grading system.

5. As discussed later in this policy statement, institutions are encouraged to segment their loan and lease portfolios into as many components as practical when analyzing the adequacy of the ALLL. Therefore, institutions are encouraged to reflect the margin for imprecision in amounts attributable for analytical purposes to these components of the portfolio, to the extent possible.

internal and external factors affecting the level of credit risk in the portfolio);
- ensure the prompt charge-off of loans, or portions of loans, that available information confirms to be uncollectible; and
- ensure that the institution's process for determining an adequate level for the ALLL is based on a comprehensive, adequately documented, and consistently applied analysis of the institution's loan and lease portfolio that considers all significant factors that affect the collectibility of the portfolio and supports the range of credit losses estimated by this process.

As discussed more fully in attachment 1, it is essential that institutions maintain effective loan-review systems, although smaller institutions would not be expected to maintain separate loan-review departments. An effective loan-review system should work to ensure the accuracy of internal credit-grading systems and, thus, the quality of the information used to assess the adequacy of the ALLL. The complexity and scope of the institution's ALLL evaluation process, loan-review system, and other relevant controls should be appropriate in view of the size of the institution and the nature of its lending activities, and provide for sufficient flexibility to accommodate changes in the factors that affect the collectibility of the portfolio.

Analysis of the Loan and Lease Portfolio

In determining the appropriate level of the ALLL, the institution should rely primarily on an analysis of the various components of its portfolio, including all significant credits on an individual basis. When analyzing the adequacy of the ALLL, institutions should segment their loan and lease portfolios into as many components as practical. Each component would normally have similar characteristics, such as risk classification, past-due status, type of loan, industry, or collateral. A depository institution may, for example, analyze the following components of its portfolio and provide for them in the ALLL:

- all significant credits on an individual basis that are classified doubtful (or the institution's equivalent)
- all other significant credits reviewed individually (If no allocation can be determined for such credits on an individual basis, they should be provided for as part of an appropriate pool below.)
- all other loans and leases that are not included by examiners or by the institution's credit-grading system in the population of loans reviewed individually, but are delinquent or are classified or designated special-mention (e.g., pools of smaller delinquent, special-mention, and classified commercial and industrial loans; real estate loans; consumer loans; and lease-financing receivables)
- homogeneous loans that have not been reviewed individually or are not delinquent, classified, or designated as special-mention (e.g., pools of direct consumer loans, indirect consumer loans, credit card loans, home equity lines of credit, and residential real estate mortgages)
- all other loans that have not been considered or provided for elsewhere (e.g., pools of commercial and industrial loans that have not been reviewed, classified, or designated special-mention; standby letters of credit; and other off-balance-sheet commitments to lend)

In addition to estimated credit losses, the losses that arise from the transfer risk associated with an institution's cross-border lending activities require special consideration. Over and above any minimum amount that is required by the Interagency Country Exposure Review Committee to be provided in the Allocated Transfer Risk Reserve (or charged against the ALLL), the institution must determine that the ALLL is adequate to absorb all estimated losses from transfer risk associated with its cross-border lending exposure. (See attachment 2 for factors to consider.)

Factors to Consider in the Estimation of Credit Losses

As previously mentioned, estimates of credit losses should reflect consideration of all significant factors that affect the collectibility of the portfolio as of the evaluation date. While historical loss experience provides a reasonable starting point for the institution's analysis, historical losses, or even recent trends in losses, are not, by themselves, a sufficient basis to determine the appropriate level for the ALLL. Management should also consider any factors that are likely to cause estimated credit losses associated with the institution's current portfolio to differ from historical loss experience, including, but not limited to—

- changes in lending policies and procedures, including underwriting standards and collection, charge-off, and recovery practices;
- changes in national and local economic and business conditions and developments, including the condition of various market segments;[6]
- changes in the nature and volume of the portfolio;
- changes in the experience, ability, and depth of lending management and staff;
- changes in the trend of the volume and severity of past-due and classified loans, and trends in the volume of nonaccrual loans, troubled-debt restructurings, and other loan modifications;
- changes in the quality of the institution's loan-review system and the degree of oversight by the institution's board of directors;
- the existence and effect of any concentrations of credit and changes in the level of such concentrations; and
- the effect of external factors such as competition and legal and regulatory requirements on the level of estimated credit losses in the institution's current portfolio.

Institutions are also encouraged to use ratio analysis as a supplemental check or tool for evaluating the overall reasonableness of the ALLL. Ratio analysis can be useful in identifying divergent trends (compared with the institution's peer group and its own historical practices) in the relationship of the ALLL to classified and nonclassified loans and leases, to past-due and nonaccrual loans and leases, to total loans and binding commitments, and to

6. Credit-loss and recovery experience may vary significantly depending upon the business cycle. For example, an overreliance on recent credit-loss experience during a period of economic growth will not result in realistic estimates of credit losses during a period of economic downturn.

historical gross and net charge-offs. However, while such comparisons can be helpful as a supplemental check of the reasonableness of management's assumptions and analyses, they are not, by themselves, a sufficient basis for determining the adequacy of the ALLL. In particular, such comparisons do not obviate the need for a comprehensive analysis of the loan and lease portfolio and the factors affecting its collectibility.

Examiner Responsibilities

Examiners will assess the asset quality of an institution's loan and lease portfolio and the adequacy of the ALLL. In the review and classification of the loan and lease portfolio, examiners should consider all significant factors that affect the collectibility of the portfolio, including the value of any collateral. In reviewing the adequacy of the ALLL, examiners will—

- consider the quality of the institution's loan-review system and management in identifying, monitoring, and addressing asset-quality problems (this will include a review of the institution's credit-grading system and loan-review function);[7]
- evaluate the ALLL process evaluation that management has followed to arrive at an overall estimate of the ALLL, and the related assumptions made by management, in order to ensure that the institution's historical loss experience and all significant factors that affect the collectibility of the portfolio (including changes in the quality of the institution's loan-review function and other factors previously discussed) have been appropriately considered;
- review the overall level of the ALLL and the range of credit losses estimated by management for reasonableness in view of the factors discussed in the prior sections of this policy statement;
- perform a quantitative analysis (e.g., using the types of ratio analysis previously discussed) as a check of the reasonableness of the ALLL; and
- review the adequacy of the documentation that has been maintained by management to support the adequacy of the ALLL.

After analyzing an institution's policies, practices, and historical credit-loss experience, the examiner should further check the reasonableness of management's ALLL methodology by comparing the reported ALLL (after the deduction of all loans, or portions thereof, classified as loss) against the sum of the following amounts:

- 50 percent of the portfolio that is classified doubtful
- 15 percent of the portfolio that is classified substandard
- for the portions of the portfolio that have not been classified (including those loans designated special-mention), estimated credit losses over the upcoming 12 months given facts and circumstances as of the evaluation date (based on the institution's average annual rate of net charge-offs experienced over the previous two or three years on similar loans, adjusted for current conditions and trends)[8]

This amount is neither a floor nor a safe-harbor level for an institution's ALLL. However, examiners will view a shortfall relative to this amount as indicating a need to more closely review management's analysis to determine whether it is reasonable and supported by the weight of reliable evidence and that all relevant factors have been appropriately considered.[9]

7. The review of an institution's loan-review system (including credit-grading) by an examiner will usually include tests involving a sample of the institution's loans. If differences noted between examiner credit grades and those of the institution's loan-review system indicate problems with the loan-review system, especially where the credit grades assigned by the institution are more liberal than those assigned by the examiner, the institution would be expected to make appropriate adjustments to the assignment of its credit grades to the loan and lease portfolio and to its estimate of the ALLL. Furthermore, the institution would be expected to improve its loan-review system. (Attachment 1 discusses effective loan-review systems.)

8. In cases where the institution has an insufficient basis for determining this amount, the examiner may use the industry-average net charge-off rate for nonclassified loans and leases.

9. The weights of 50 percent and 15 percent for doubtful and substandard loans, respectively, are estimates of the industry's average-loss experience over time on similarly classified credits. Because they represent the average-industry experience, these weights do not take into account idiosyncratic factors that may be important for estimating expected credit losses for a particular institution, such as the composition of its portfolio; the quality of underwriting, collection, and loan-review systems; and current economic conditions and trends. *Nor do these weights incorporate any additional margin to reflect the imprecision inherent in estimates of expected credit losses.* Due to such institution-specific factors, including an institution's historical loss experience adjusted for current conditions and trends, in many cases an ALLL exceeding the sum of (a), (b), and (c) above might still

In assessing the adequacy of the ALLL, it is important to recognize that the related process, methodology, and underlying assumptions require a substantial degree of judgment. Even when an institution maintains sound loan administration and collection procedures and effective internal systems and controls, the estimation of credit losses will not be precise due to the wide range of factors that must be considered. Further, the ability to estimate credit losses on specific loans and categories of loans improves over time as substantive information accumulates regarding the factors affecting repayment prospects. Therefore, examiners will generally accept management's estimates in their assessment of the adequacy of the ALLL when management has (1) maintained effective systems and controls for identifying, monitoring, and addressing asset-quality problems in a timely manner; (2) analyzed all significant factors that affect the collectibility of the portfolio in a reasonable manner; and (3) established an acceptable ALLL evaluation process that meets the objectives for an adequate ALLL.

After the completion of all aspects of the ALLL review described in this section, if the examiner does not concur that the reported ALLL level is adequate or if the ALLL evaluation process is deficient or based on the results of an unreliable loan-review system, recommendations for correcting these problems, including any examiner concerns regarding an appropriate level of the ALLL, should be noted in the report of examination.

ALLL Level Reflected in Regulatory Reports

The agencies believe that an ALLL established in accordance with this policy statement will fall within the range of acceptable estimates developed in accordance with GAAP. When an institution's reported ALLL does not meet the objectives for an adequate ALLL, the institution will be required to increase its provision for loan- and lease-losses expense sufficiently to restore the level of the ALLL reported on its call report or TFR to an adequate level as of the evaluation date.

be inadequate, while in other cases, the weight of evidence might indicate that an ALLL less than this amount is adequate. In all circumstances, for purposes of the call report or Thrift Financial Report, the reported ALLL should meet the standard for an adequate ALLL set forth in the subsection "Responsibility of the Board of Directors and Management."

Attachment 1 to Policy Statement—Loan-Review Systems

The nature of loan-review systems may vary based on an institution's size, complexity, and management practices. For example, a loan-review system may include components of a traditional loan-review function that is independent of the lending function, or it may place some reliance on loan officers. In addition, the use of the term "loan-review system" can refer to various responsibilities assigned to credit administration, loan administration, problem-loan workout, or other areas of an institution. These responsibilities may range from administering the internal problem-loan reporting process to maintaining the integrity of the credit-grading process (e.g., ensuring that changes are made in credit grades as needed) and coordinating the information necessary to assess the adequacy of the allowance for loan and lease losses (ALLL). Regardless of the structure of the loan-review system in an institution, at a minimum, an effective loan-review system should have the following objectives:

- to promptly identify loans having potential credit weaknesses and appropriately classify loans with well-defined credit weaknesses that jeopardize repayment so that timely action can be taken and credit losses can be minimized
- to project relevant trends that affect the collectibility of the portfolio and isolate potential problem areas
- to provide essential information to determine the adequacy of the ALLL
- to assess the adequacy of and adherence to internal credit policies and loan administration procedures and to monitor compliance with relevant laws and regulations
- to evaluate the activities of lending personnel
- to provide senior management and the board of directors with an objective and timely assessment of the overall quality of the loan portfolio
- to provide management with accurate and timely information related to credit quality that can be used for financial and regulatory reporting purposes

Credit-Grading Systems

The foundation for any loan-review system is accurate and timely credit grading, which involves an assessment of credit quality and leads to the identification of problem loans. An effective credit-grading system provides important information on the collectibility of the portfolio for use in the determination of an adequate level for the ALLL.

Regardless of the particular type of loan-review system employed, an effective credit-grading framework generally places primary reliance on loan officers to identify emerging loan problems. However, given the importance and subjective nature of credit grading, a loan officer's judgment regarding the assignment of a particular credit grade to a loan may be subject to review by (1) peers, superiors, or loan committee(s); (2) an independent, qualified part-time or full-time person(s); (3) an internal department staffed with credit-review specialists; or (4) outside credit-review consultants. A credit-grading review that is independent of the lending function is the preferred approach because it typically provides a more conservative and realistic assessment of credit quality. Because accurate and timely credit grading is a critical component of an effective loan-review system, each institution should ensure that its loan-review system includes the following attributes:

- a formal credit-grading system that can be reconciled with the framework used by the federal regulatory agencies[10]
- an identification or grouping of loans that warrant the special attention of management
- documentation supporting the reason(s) why a particular loan merits special attention
- a mechanism for direct, periodic, and timely reporting to senior management and the board of directors on the status of loans identified as meriting special attention and the action(s) taken by management
- appropriate documentation of the institution's credit-loss experience for various components of its loan and lease portfolio[11]

An institution should maintain a written description of its credit-grading system, including a discussion of the factors used to assign appropriate credit grades to loans. Loan credit grades should reflect the risk of credit losses.

In addition, the loan-review program should be in writing and reviewed and approved at least annually by the board of directors to evidence their support of and commitment to the system.

Loan-Review-System Elements

The following discussion refers to the primary activities comprising a loan-review system that were previously addressed, ranging from the credit-administration function to the independent internal loan-review function. An institution's written policy and documentation for its loan-review system should address the following elements:

- qualifications of loan-review personnel
- independence of loan-review personnel
- frequency of reviews
- scope of reviews
- depth of reviews
- review of findings and follow-up
- workpaper and report distribution, including distribution of reports to senior management and the board of directors

Qualifications of loan-review personnel. Persons involved in the loan review function should be qualified based on level of education, experience, and extent of formal credit training and should be knowledgeable in both sound lending practices and the institution's lending guidelines for the types of loans offered by the institution. In addition, these persons should be knowledgeable of relevant laws and regulations affecting lending activities.

Independence of loan-review personnel. An effective loan-review system utilizes both the initial identification of emerging problem loans

10. An institution may have a credit-grading system that differs from the credit-grading framework used by the federal banking agencies. However, each institution that maintains a credit-grading system that differs from the agencies' framework should maintain documentation that translates its credit-grading system into the pass/special mention/substandard/doubtful/loss credit-grading framework used by the federal regulatory agencies. This documentation should be sufficient to enable examiners to reconcile the totals for the various credit grades under the institution's system to the agencies' categories listed above.

11. Institutions are encouraged to maintain records of net credit-loss experience for credits in each of the following categories: items not classified or designated as special-mention, special-mention, substandard, doubtful, and loss.

by loan officers and the credit review of loans by individuals independent of the credit-approval decisions. An important element of an effective system is to place responsibility on loan officers for continuous portfolio analysis and prompt identification and reporting of problem loans. Because of their frequent contact with borrowers, loan officers can usually identify potential problems before they become apparent to others. However, institutions should be careful to avoid overreliance upon loan officers for identification of problem loans. Institutions should ensure that loans are also reviewed by individuals that do not have control over the loans they review and are not part of, or influenced by anyone associated with, the loan-approval process.

While larger institutions typically establish a separate department staffed with credit-review specialists, cost and volume considerations may not justify such a system in smaller institutions. In many smaller institutions, an independent committee of outside directors may fill this role. Whether or not the institution has an independent loan-review department, the loan-review function should report *directly* to the board of directors or a committee thereof (though senior management may be responsible for appropriate administrative functions so long as they do not compromise the independence of the loan-review function).

Frequency of reviews. Optimally, the loan-review function can be used to provide useful continual feedback on the effectiveness of the lending process in order to identify any emerging problems. For example, the frequency of review of significant credits could be at least annually, upon renewal, or more frequently when internal or external factors indicate a potential for deteriorating credit quality in a particular type of loan or pool of loans. A system of ongoing or periodic portfolio reviews is particularly important to the ALLL determination process, which is dependent on the accurate and timely identification of problem loans.

Scope of reviews. The review should cover all loans that are significant. Also, the review typically includes, in addition to all loans over a predetermined size, a sample of smaller loans; past-due, nonaccrual, renewed, and restructured loans; loans previously classified or designated as special-mention by the institution or by its examiners; insider loans; and concentrations and other loans affected by common repayment factors. The percentage of the portfolio selected for review should provide reasonable assurance that the results of the review have identified the major problems in the portfolio and reflect its quality as a whole. Management should document that the scope of its reviews continues to identify major problems in the portfolio and reflect the portfolio's quality as a whole. The scope of loan reviews should be approved by the institution's board of directors on an annual basis or when any significant changes to the scope of reviews are made.

Depth of reviews. These reviews should analyze a number of important aspects of selected loans, including—

- credit quality,
- sufficiency of credit and collateral documentation,
- proper lien perfection,
- proper approval by the loan officer and loan committee(s),
- adherence to any loan-agreement covenants, and
- compliance with internal policies and procedures and laws and regulations.

Furthermore, these reviews should consider the appropriateness and timeliness of the identification of problem loans by loan officers.

Review of findings and follow-up. Findings should be reviewed with appropriate loan officers, department managers, and members of senior management, and any existing or planned corrective action should be elicited for all noted deficiencies and identified weaknesses, including the timeframes for correction. All noted deficiencies and identified weaknesses that remain unresolved beyond the assigned timeframes for correction should be promptly reported to senior management and the board of directors.

Workpaper and report distribution. A list of loans reviewed, the date of the review, and documentation (including summary analyses) to substantiate assigned classifications or designations of loans as special-mention should be prepared on all loans reviewed. A report that summarizes the results of the loan review should be submitted to the board of directors on at least a quarterly basis.[12] In addition to reporting current credit-quality findings, comparative trends can be presented to the board of directors that identify significant changes in the overall quality of the portfolio. Findings should also address the adequacy of and adherence to internal policies, practices and procedures, and compliance with laws and regulations so that any noted deficiencies can be remedied in a timely manner.

Attachment 2 to Policy Statement—International Transfer Risk Considerations

With respect to international transfer risk, an institution should support its determination of the adequacy of its allowance for loan and lease losses by performing an analysis of the transfer risk, commensurate with the size and composition of the institution's exposure to each country. Such analyses should take into consideration the following factors, as appropriate:

- the institution's loan-portfolio mix for each country (e.g., types of borrowers, loan maturities, collateral, guarantees, special credit facilities, and other distinguishing factors)
- the institution's business strategy and its debt-management plans for each country
- each country's balance-of-payments position
- each country's level of international reserves
- each country's established payment-performance record and its future debt-servicing prospects
- each country's sociopolitical situation and its effect on the adoption or implementation of economic reforms, in particular those affecting debt-servicing capacity
- each country's current standing with multilateral and official creditors
- the status of each country's relationships with bank creditors
- the most recent evaluations distributed by the Interagency Country Exposure Review Committee (ICERC) of the federal banking agencies

Issued jointly by the Board of Governors of the Federal Reserve System, the Federal Insurance Corporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision.

12. The board of directors should be informed more frequently than quarterly when material adverse trends are noted.

Allowance for Loan and Lease Losses
Examination Objectives
Effective date November 1995

Section 2070.2

1. To determine if the policies, practices, procedures and internal controls regarding loan and lease losses and the allowance for loan and lease losses are adequate.
2. To determine if bank officers and employees are operating in conformance with the established guidelines.
3. To determine the scope and adequacy of the audit function.
4. To determine compliance with laws and regulations.
5. To initiate corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws or regulations have been noted.

1. If selected for implementation, complete or update the Allowance for Loan and Lease Losses section of the Internal Control Questionnaire. To do so, obtain a description of the methods and procedures employed by management to determine the adequacy of the bank's allowance for loan and lease losses and the supporting records maintained.
2. Based on the evaluation of internal controls and the work performed by internal/external auditors, determine the scope of the examination.
3. Test for compliance with policies, practices, procedures and internal controls in conjunction with performing the remaining examination procedures and obtain a listing of any audit deficiencies noted in the latest review done by internal/external auditors from the examiner assigned "Internal Control," and determine if appropriate corrections have been made.
4. Obtain or prepare an analysis of the allowance for loan and lease losses (valuation reserve) and the related deferred tax and capital accounts (in prior years referred to as the deferred tax and contingency portions of the reserve) for the period from the last examination date to the current one. Agree beginning and ending balances to the general ledger and review the appropriateness of changes in those accounts.
5. Obtain from the appropriate examiner a list of problem loans as of the examination date, that is, loans which are or may become less than 100 percent collectible, possess more than the normal degree of credit risk, are past due, or require more than normal management supervision.
6. Obtain from the appropriate examiner a detailed list of classified loans identified in the various loan departments.
7. Determine whether the reserve for possible loan losses has been adjusted through the most recent quarter and, if not, suggest that management make such adjustment.
8. If, in the opinion of management, significant changes in the collectibility of loans have occurred since the allowance was last adjusted, suggest that management adjust the allowance through examination date.
9. Evaluate management's determination of the amount necessary to adequately provide for estimated loan losses as of the examination date by considering the following:
   a. known probable losses as determined by a review of the lists of loans obtained in steps 5 and 6 and other pertinent information
   b. information included in the Uniform Bank Performance Report including—
      - historical losses as a percentage of loans outstanding and other relevant factors; and
      - comparison of the allowance ratios of banks of similar loan portfolio size and composition
   c. other procedures necessary in the circumstances
10. Review the following items with appropriate management personnel, or prepare a memo to other examining personnel, for their use in reviewing with management:
    a. internal control exceptions and deficiencies in or noncompliance with written policies, practices, and procedures
    b. uncorrected audit deficiencies
    c. inadequate allowance for possible loan and lease losses, if any
11. Request that management make appropriate adjustments to the allowance for loan and lease losses.
    a. Determine the materiality of the change and the need to file amended financial reports.
    b. Provide information to the examiner reviewing regulatory reports, if appropriate.
12. Prepare comments for the examination report regarding the allowance for loan and lease losses, and include any deficiencies reviewed with management and any remedial actions recommended.
13. Update the workpapers with any information that will facilitate future examinations.

Review the bank's internal controls, policies, practices and procedures relating to the allowance for loan and lease losses (valuation reserve) and the determination of its adequacy. The bank's system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used and other pertinent information. Items marked with an asterisk require substantiation by observation or testing.

POLICIES

1. Has the board of directors, consistent with its duties and responsibilities, adopted written policies which:
   a. Establish criteria for determining when a loan is to be charged-off?
   b. Establish procedures for charging off loans?
   c. Establish procedures for periodically reviewing and documenting the adequacy of the valuation portion of the allowance?
   d. Define collection efforts to be undertaken after a loan is charged-off?

LOAN CHARGE-OFFS

*2. Is the preparation and posting of any subsidiary records of loans charged-off performed or reviewed by persons who do not also:
   a. Issue official checks and drafts?
   b. Handle cash?

*3. Are all loans charged-off reviewed and approved by the board of directors as evidenced by the minutes of board meetings?

*4. Are notes for loans charged-off maintained under dual custody?

5. Are collection efforts continued for loans charged-off until the potential for recovery is exhausted?

6. Are periodic progress reports prepared and reviewed by appropriate management personnel for all loans charged-off for which collection efforts are continuing?

7. Are adequate procedures in effect relative to recoveries?

OTHER

*8. Does management review the adequacy of the valuation portion of the allowance and make necessary adjustments prior to preparing public financial statements (at a minimum, on a quarterly basis)?

9. Does management's review encompass and give adequate consideration to:
   a. Past loan loss experience and other pertinent historical data?
   b. Assessment of the effectiveness of lending policies and procedures?
   c. Identification, on an individual loan basis, of significant potential weaknesses within the current loan portfolio and an estimate of related amount of loss?
   d. Changes in the character of the loan portfolio?
   e. Current economic conditions?
   f. Amount of past-due loans on which interest is not being collected in accordance with the terms of the loans, and loans whose terms have been modified by reducing interest rates or deferring interest?
   g. Other information appropriate to the circumstances (if so, explain briefly)?

10. Does management retain documentation of their review?

11. Is accrued interest on loans charged-off also charged-off against the allowance account or reversed against interest income, as appropriate?

CONCLUSION

12. Is the foregoing information considered an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.

13. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

OVERVIEW

A supplemental interagency Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions[1] was issued by the Federal Financial Institutions Examination Council (FFIEC) on July 2, 2001.[2] The policy statement clarifies the agencies' expectations for documentation that supports the ALLL methodology. Additionally, the statement emphasizes the need for appropriate ALLL policies and procedures, which should include an effective loan-review system. The guidance also provides examples of appropriate supporting documentation, as well as illustrations on how to implement this guidance. The policy statement, by its terms, applies only to depository institutions insured by the Federal Deposit Insurance Corporation. Examiners should apply the policy during the examination of state member banks and their subsidiaries. (See SR-01-17.)

The guidance requires that a financial institution's ALLL methodology be in accordance with generally accepted accounting principles (GAAP) and all outstanding supervisory guidance. An ALLL methodology should be systematic, consistently applied, and auditable. The methodology should be validated periodically and modified to incorporate new events or findings, as needed. The guidance specifies that management, under the direction of the board of directors, should implement appropriate procedures and controls to ensure compliance with the institution's ALLL policies and procedures. Institution management should (1) segment the portfolio to evaluate credit risks; (2) select loss rates that best reflect the probable loss; and (3) be responsive to changes in the organization, the economy, or the lending environment by changing the methodology, when appropriate. Furthermore, supporting information should be included on summary schedules, whenever feasible. Under this policy, institutions with less complex loan products or portfolios, such as community banks, may use a more streamlined approach to implement this guidance.

1. See 66 *Fed. Reg.* 35629–35639 (July 6, 2001).
2. The guidance was developed in consultation with Securities and Exchange Commission staff, who are issuing parallel guidance in the form of Staff Accounting Bulletin No. 102.

The policy statement is consistent with the Federal Reserve's long-standing policy to promote strong internal controls over an institution's ALLL process. It supplements and does not affect or modify the guidance in the interagency policy statement on the ALLL issued in December 1993. (See SR-93-70.) In this regard, the new policy statement recognizes that determining an appropriate allowance involves a high degree of management judgment and is inevitably imprecise. Accordingly, an institution may determine that the amount of loss falls within a range. In accordance with GAAP, an institution should record its best estimate within the range of credit losses.

The policy statement is provided below. Some wording has been slightly modified for this manual, as indicated by asterisks or text enclosed in brackets. Some footnotes have also been renumbered.

2001 POLICY STATEMENT ON ALLL METHODOLOGIES AND DOCUMENTATION

Boards of directors of banks * * * are responsible for ensuring that their institutions have controls in place to consistently determine the allowance for loan and lease losses (ALLL) in accordance with the institutions' stated policies and procedures, generally accepted accounting principles (GAAP), and ALLL supervisory guidance.[3] To fulfill this responsibility, boards of directors instruct management to develop and maintain an appropriate, systematic, and consistently applied process to determine the amounts of the ALLL and provisions for loan losses. Management should create and implement suitable policies and procedures to communicate the ALLL process internally to all applicable personnel. Regardless of who develops and implements these policies, procedures, and underlying controls, the board of directors should assure themselves that the policies specifically address

3. [The actual policy statement includes a bibliography] that lists applicable ALLL GAAP guidance, interagency statements, and other reference materials that may assist in understanding and implementing an ALLL in accordance with GAAP. See [the appendix] for additional information on applying GAAP to determine the ALLL.

the institution's unique goals, systems, risk profile, personnel, and other resources before approving them. Additionally, by creating an environment that encourages personnel to follow these policies and procedures, management improves procedural discipline and compliance.

The determination of the amounts of the ALLL and provisions for loan and lease losses should be based on management's current judgments about the credit quality of the loan portfolio, and should consider all known relevant internal and external factors that affect loan collectibility as of the reporting date. The amounts reported each period for the provision for loan and lease losses and the ALLL should be reviewed and approved by the board of directors. To ensure the methodology remains appropriate for the institution, the board of directors should have the methodology periodically validated and, if appropriate, revised. Further, the audit committee[4] should oversee and monitor the internal controls over the ALLL-determination process.[5]

The [Federal Reserve and other] banking agencies[6] have long-standing examination policies that call for examiners to review an institution's lending and loan-review functions and recommend improvements, if needed. Additionally, in 1995 and 1996, the banking agencies adopted interagency guidelines establishing standards for safety and soundness, pursuant to section 39 of the Federal Deposit Insurance Act (FDI Act).[7] The interagency asset-quality guidelines and [this guidance will assist] an institution in estimating and establishing a sufficient ALLL supported by adequate documentation, as required under the FDI Act. Additionally, the guidelines require operational and managerial standards that are appropriate for an institution's size and the nature and scope of its activities.

4. All institutions are encouraged to establish audit committees; however, at small institutions without audit committees, the board of directors retains this responsibility.

5. Institutions and their auditors should refer to Statement on Auditing Standards No. 61, "Communication with Audit Committees" (as amended by Statement on Auditing Standards No. 90, "Audit Committee Communications"), which requires certain discussions between the auditor and the audit committee. These discussions should include items, such as accounting policies and estimates, judgments, and uncertainties that have a significant impact on the accounting information included in the financial statements.

6. The [other] banking agencies are the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision.

7. Institutions should refer to the guidelines *** for state member banks, appendix D to part 208***.

For financial-reporting purposes, including regulatory reporting, the provision for loan and lease losses and the ALLL must be determined in accordance with GAAP. GAAP requires that allowances be well documented, with clear explanations of the supporting analyses and rationale.[8] This [2001] policy statement describes but does not increase the documentation requirements already existing within GAAP. Failure to maintain, analyze, or support an adequate ALLL in accordance with GAAP and supervisory guidance is generally an unsafe and unsound banking practice.[9]

This guidance [the 2001 policy statement] applies equally to all institutions, regardless of the size. However, institutions with less complex lending activities and products may find it more efficient to combine a number of procedures (e.g., information gathering, documentation, and internal-approval processes) while continuing to ensure the institution has a consistent and appropriate methodology. Thus, much of the supporting documentation required for an institution with more complex products or portfolios may be combined into fewer supporting documents in an institution with less complex products or portfolios. For example, simplified documentation can include spreadsheets, checklists, and other summary documents that many institutions currently use. Illustrations A and C provide specific examples of how less complex institutions may determine and document portions of their loan-loss allowance.

Documentation Standards

Appropriate written supporting documentation for the loan-loss provision and allowance facili-

8. The documentation guidance within this [2001] policy statement is predominantly based upon the GAAP guidance from Financial Accounting Standards Board (FASB) Statement No. 5 and No. 114 (FAS 5 and FAS 114, respectively); Emerging Issues Task Force Topic No. D-80 (EITF Topic D-80 and attachments), "Application of FASB Statements No. 5 and No. 114 to a Loan Portfolio" (which includes the *Viewpoints* article—an article issued in 1999 by FASB staff providing guidance on certain issues regarding the ALLL, particularly on the application of FAS 5 and FAS 114 and how these statements interrelate); Chapter 7, "Credit Losses," the American Institute of Certified Public Accountants' (AICPA) Audit and Accounting Guide, *Banks and Savings Institutions*, 2000 edition (AICPA Audit Guide); and the Securities and Exchange Commission's (SEC) Financial Reporting Release No. 28 (FRR 28).

9. Failure to maintain adequate supporting documentation does not relieve an institution of its obligation to record an appropriate ALLL.

tates review of the ALLL process and reported amounts, builds discipline and consistency into the ALLL-determination process, and improves the process for estimating loan and lease losses by helping to ensure that all relevant factors are appropriately considered in the ALLL analysis. An institution should document the relationship between the findings of its detailed review of the loan portfolio and the amount of the ALLL and the provision for loan and lease losses reported in each period.[10]

At a minimum, institutions should maintain written supporting documentation for the following decisions, strategies, and processes:

- policies and procedures—
  - — over the systems and controls that maintain an appropriate ALLL and
  - — over the ALLL methodology
- loan-grading system or process
- summary or consolidation of the ALLL balance
- validation of the ALLL methodology
- periodic adjustments to the ALLL process

Policies and Procedures

Financial institutions utilize a wide range of policies, procedures, and control systems in their ALLL process. Sound policies should be appropriately tailored to the size and complexity of the institution and its loan portfolio.

In order for an institution's ALLL methodology to be effective, the institution's written policies and procedures for the systems and controls that maintain an appropriate ALLL should address but not be limited to—

- the roles and responsibilities of the institution's departments and personnel (including the lending function, credit review, financial reporting, internal audit, senior management, audit committee, board of directors, and others, as applicable) who determine, or review, as applicable, the ALLL to be reported in the financial statements;
- the institution's accounting policies for loans, [leases, and their loan losses], including the policies for charge-offs and recoveries and for estimating the fair value of collateral, where applicable;
- the description of the institution's systematic methodology, which should be consistent with the institution's accounting policies for determining its ALLL;[11] and
- the system of internal controls used to ensure that the ALLL process is maintained in accordance with GAAP and supervisory guidance.

An internal-control system for the ALLL-estimation process should—

- include measures to provide assurance regarding the reliability and integrity of information and compliance with laws, regulations, and internal policies and procedures;
- reasonably assure that the institution's financial statements (including regulatory reports) are prepared in accordance with GAAP and ALLL supervisory guidance;[12] and
- include a well-defined loan-review process containing—
  - — an effective loan-grading system that is consistently applied, identifies differing risk characteristics and loan-quality problems accurately and in a timely manner, and prompts appropriate administrative actions;
  - — sufficient internal controls to ensure that all relevant loan-review information is appropriately considered in estimating losses. This includes maintaining appropriate reports, details of reviews performed, and identification of personnel involved; and
  - — clear formal communication and coordination between an institution's credit-administration function, financial-reporting group, management, board of directors,

10. This position is fully described in the SEC's FRR 28, in which the SEC indicates that the books and records of public companies engaged in lending activities should include documentation of the rationale supporting each period's determination that the ALLL and provision amounts reported were adequate.

11. Further explanation is presented in the "Methodology" section that appears below.

12. In addition to the supporting documentation requirements for financial institutions, as described in interagency asset-quality guidelines, public companies are required to comply with the books and records provisions of the Securities Exchange Act of 1934 (Exchange Act). Under sections 13(b)(2)–(7) of the Exchange Act, registrants must make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of assets of the registrant. Registrants also must maintain internal accounting controls that are sufficient to provide reasonable assurances that, among other things, transactions are recorded as necessary to permit the preparation of financial statements in conformity with GAAP. See also SEC Staff Accounting Bulletin No. 99, *Materiality.*

and others who are involved in the ALLL-determination or -review process, as applicable (e.g., written policies and procedures, management reports, audit programs, and committee minutes).

Methodology

An ALLL methodology is a system that an institution designs and implements to reasonably estimate loan and lease losses as of the financial statement date. It is critical that ALLL methodologies incorporate management's current judgments about the credit quality of the loan portfolio through a disciplined and consistently applied process.

An institution's ALLL methodology is influenced by institution-specific factors, such as an institution's size, organizational structure, business environment and strategy, management style, loan-portfolio characteristics, loan-administration procedures, and management information systems. However, there are certain common elements an institution should incorporate in its ALLL methodology. A summary of common elements is provided in [the appendix].[13]

Documentation of ALLL Methodology in Written Policies and Procedures

An institution's written policies and procedures should describe the primary elements of the institution's ALLL methodology, including portfolio segmentation and impairment measurement. In order for an institution's ALLL methodology to be effective, the institution's written policies and procedures should describe the methodology—

- for segmenting the portfolio:
  - — how the segmentation process is performed (i.e., by loan type, industry, risk rates, etc.),
  - — when a loan-grading system is used to segment the portfolio:
    - the definitions of each loan grade,
    - a reconciliation of the internal loan grades to supervisory loan grades, and
    - the delineation of responsibilities for the loan-grading system.
- for determining and measuring impairment under FAS 114:
  - — the methods used to identify loans to be analyzed individually;
  - — for individually reviewed loans that are impaired, how the amount of any impairment is determined and measured, including—
    - procedures describing the impairment-measurement techniques available and
    - steps performed to determine which technique is most appropriate in a given situation.
  - — the methods used to determine whether and how loans individually evaluated under FAS 114, but not considered to be individually impaired, should be grouped with other loans that share common characteristics for impairment evaluation under FAS 5.
- for determining and measuring impairment under FAS 5—
  - — how loans with similar characteristics are grouped to be evaluated for loan collectibility (such as loan type, past-due status, and risk);
  - — how loss rates are determined (e.g., historical loss rates adjusted for environmental factors or migration analysis) and what factors are considered when establishing appropriate time frames over which to evaluate loss experience; and
  - — descriptions of qualitative factors (e.g., industry, geographical, economic, and political factors) that may affect loss rates or other loss measurements.

The supporting documents for the ALLL may be integrated in an institution's credit files, loan-review reports or worksheets, board of directors' and committee meeting minutes, computer reports, or other appropriate documents and files.

ALLL Under FAS 114

An institution's ALLL methodology related to FAS 114 loans begins with the use of its normal loan-review procedures to identify whether a loan is impaired as defined by the accounting standard. Institutions should document—

- the method and process for identifying loans to be evaluated under FAS 114 and

13. Also, refer to paragraph 7.05 of the AICPA Audit Guide.

- the analysis that resulted in an impairment decision for each loan and the determination of the impairment-measurement method to be used (i.e., present value of expected future cash flows, fair value of collateral less costs to sell, or the loan's observable market price).

Once an institution has determined which of the three available measurement methods to use for an impaired loan under FAS 114, it should maintain supporting documentation as follows:

- When using the present-value-of-expected-future-cash-flows method—
  - — the amount and timing of cash flows,
  - — the effective interest rate used to discount the cash flows, and
  - — the basis for the determination of cash flows, including consideration of current environmental factors and other information reflecting past events and current conditions.
- When using the fair-value-of-collateral method—
  - — how fair value was determined, including the use of appraisals, valuation assumptions, and calculations,
  - — the supporting rationale for adjustments to appraised values, if any,
  - — the determination of costs to sell, if applicable, and
  - — appraisal quality, and the expertise and independence of the appraiser.
- When using the observable-market-price-of-a-loan method—
  - — the amount, source, and date of the observable market price.

Illustration A describes a practice used by a small financial institution to document its FAS 114 measurement of impairment using a comprehensive worksheet.[14] [Examples 1 and 2 provide examples of applying and documenting impairment-measurement methods under FAS 114. Some loans that are evauluated individually for impairment under FAS 114 may be fully collateralized and therefore require no ALLL. Example 3 presents an institution whose loan portfolio includes fully collateralized loans. It describes the documentation maintained by that institution to support its conclusion that no ALLL was needed for those loans.]

14. The [referenced] illustrations are presented to assist institutions in evaluating how to implement the guidance provided in this document. The methods described in the illustrations may not be suitable for all institutions and are not considered required processes or actions. For additional descriptions of key aspects of ALLL guidance, a series of [numbered examples is provided. These examples were included in appendix A of the policy statement as questions and answers. The wording of the examples has been slightly modified for this format.]

Illustration A
Documenting an ALLL Under FAS 114

Comprehensive worksheet for the impairment-measurement process

A small institution utilizes a comprehensive worksheet for each loan being reviewed individually under FAS 114. Each worksheet includes a description of why the loan was selected for individual review, the impairment-measurement technique used, the measurement calculation, a comparison to the current loan balance, and the amount of the ALLL for that loan. The rationale for the impairment-measurement technique used (e.g., present value of expected future cash flows, observable market price of the loan, fair value of the collateral) is also described on the worksheet.

Example 1: ALLL Under FAS 114—Measuring and Documenting Impairment

Facts. Approximately one-third of Institution A's commercial loan portfolio consists of large-balance, nonhomogeneous loans. Due to their large individual balances, these loans meet the criteria under Institution A's policies and procedures for individual review for impairment under FAS 114. Upon review of the large-balance loans, Institution A determines that certain of the loans are impaired as defined by FAS 114.

Analysis. For the commercial loans reviewed under FAS 114 that are individually impaired, Institution A should measure and document the impairment on those loans. For those loans that are reviewed individually under FAS 114 and considered individually impaired, Institution A must use one of the methods for measuring impairment that is specified by FAS 114 (that is, the present value of expected future cash flows, the loan's observable market price, or the fair value of collateral).

An impairment-measurement method other than the methods allowed by FAS 114 cannot be used. For the loans considered individually impaired under FAS 114, under the circumstances described above, it would not be appropriate for Institution A to choose a measurement method not prescribed by FAS 114. For example, it would not be appropriate to measure loan impairment by applying a loss rate to each loan based on the average historical loss percentage for all of its commercial loans for the past five years.

Institution A should maintain, as sufficient, objective evidence, written documentation to support its measurement of loan impairment under FAS 114. If it uses the present value of expected future cash flows to measure impairment of a loan, it should document (1) the amount and timing of cash flows, (2) the effective interest rate used to discount the cash flows, and (3) the basis for the determination of cash flows, including consideration of current environmental factors[15] and other information reflecting past events and current conditions. If Institution A uses the fair value of collateral to measure impairment, it should document (1) how it determined the fair value, including the use of appraisals, valuation assumptions and calculations; (2) the supporting rationale for adjustments to appraised values, if any, and the determination of costs to sell, if applicable; (3) appraisal quality; and (4) the expertise and independence of the appraiser. Similarly, Institution A should document the amount, source, and date of the observable market price of a loan, if that method of measuring loan impairment is used.

Example 2: ALLL Under FAS 114—Measuring Impairment for a Collateral-Dependent Loan

Facts. Institution B has a $10 million loan outstanding to Company X that is secured by real estate, which Institution B individually evaluates under FAS 114 due to the loan's size. Company X is delinquent in its loan payments under the terms of the loan agreement. Accordingly, Institution B determines that its loan to Company X is impaired, as defined by FAS 114. Because the loan is collateral dependent, Institution B measures impairment of the loan based on the fair value of the collateral. Institution B determines that the most recent valuation of the collateral was performed by an appraiser 18 months ago and, at that time, the estimated value of the collateral (fair value less costs to sell) was $12 million.

Institution B believes that certain of the assumptions that were used to value the collateral 18 months ago do not reflect current market conditions and, therefore, the appraiser's valuation does not approximate current fair value of the collateral. Several buildings, which are comparable to the real estate collateral, were recently completed in the area, increasing vacancy rates, decreasing lease rates, and attracting several tenants away from the borrower. Accordingly, credit-review personnel at Institution B adjust certain of the valuation assumptions to better reflect the current market conditions as they relate to the loan's collateral.[16] After adjusting the collateral-valuation assumptions, the credit-review department determines that the current estimated fair value of the collateral, less costs to sell, is $8 million. Given that the recorded investment in the loan is $10 million, Institution B concludes that the loan is impaired by $2 million and records an allowance for loan losses of $2 million.

Analysis. Institution B should maintain documentation to support its determination of the allowance for loan losses of $2 million for the loan to Company X. It should document that it measured impairment of the loan to Company X by using the fair value of the loan's collateral, less costs to sell, which it estimated to be $8 million. This documentation should include (1) the institution's rationale and basis for the $8 million valuation, including the revised valuation assumptions it used; (2) the valuation calculation; and (3) the determination of costs to sell, if applicable. Because Institution B arrived at the valuation of $8 million by modifying an earlier appraisal, it should document its rationale and basis for the changes it made to the valuation assumptions that resulted in the collateral value declining from $12 million 18

15. Question 16 in Exhibit D-80A of EITF Topic D-80 and [its] attachments indicates that environmental factors include existing industry, geographical, economic, and political factors.

16. When reviewing collateral-dependent loans, Institution B may often find it more appropriate to obtain an updated appraisal to estimate the effect of current market conditions on the appraised value instead of internally estimating an adjustment.

months ago to $8 million in the current period.[17]

Example 3: ALLL Under FAS 114—Fully Collateralized Loans

Facts. Institution C has $10 million in loans that are fully collateralized by highly rated debt securities with readily determinable market values. The loan agreement for each of these loans requires the borrower to provide qualifying collateral sufficient to maintain a loan-to-value ratio with sufficient margin to absorb volatility in the securities' market prices. Institution C's collateral department has physical control of the debt securities through safekeeping arrangements. In addition, Institution C perfected its security interest in the collateral when the funds were originally distributed. On a quarterly basis, Institution C's credit-administration function determines the market value of the collateral for each loan using two independent market quotes and compares the collateral value to the loan carrying value. If there are any collateral deficiencies, Institution C notifies the borrower and requests that the borrower immediately remedy the deficiency. Due in part to its efficient operation, Institution C has historically not incurred any material losses on these loans. Institution C believes these loans are fully collateralized and therefore does not maintain any ALLL balance for these loans.

Analysis. To adequately support its determination that no allowance is needed for this group of loans, Institution C must maintain the following documentation:

- The management summary of the ALLL must include documentation indicating that, in accordance with the institution's ALLL policy, (1) Institution C has verified the collateral protection on these loans, (2) no probable loss has been incurred, and (3) no ALLL is necessary.
- The documentation in Institution C's loan files must include (1) the two independent market quotes obtained each quarter for each loan's collateral amount, (2) the documents evidencing the perfection of the security interest in the collateral and other relevant supporting documents, and (3) Institution C's ALLL policy, including guidance for determining when a loan is considered "fully collateralized," which would not require an ALLL. Institution C's policy should require the following factors to be considered and fully documented:
  - — volatility of the market value of the collateral
  - — recency and reliability of the appraisal or other valuation
  - — recency of the institution's or third party's inspection of the collateral
  - — historical losses on similar loans
  - — confidence in the institution's lien or security position including appropriate—
    - type of security perfection (e.g., physical possession of collateral or secured filing);
    - filing of security perfection (i.e., correct documents and with the appropriate officials);
    - relationship to other liens; and
    - other factors as appropriate for the loan type.

17. In accordance with the FFIEC's *Federal Register* notice, Implementation Issues Arising from FASB No. 114, "Accounting by Creditors for Impairment of a Loan," published February 10, 1995 (60 *Fed. Reg.* 7966, February 10, 1995), impaired, collateral-dependent loans must be reported at the fair value of collateral, less costs to sell, in regulatory reports. This treatment is to be applied to all collateral-dependent loans, regardless of type of collateral.

ALLL Under FAS 5

Segmenting the Portfolio

For loans evaluated on a group basis under FAS 5, management should segment the loan portfolio by identifying risk characteristics that are common to groups of loans. Institutions typically decide how to segment their loan portfolios based on many factors, which vary with their business strategies as well as their information system capabilities. Smaller institutions that are involved in less complex activities often segment the portfolio into broad loan categories. This method of segmenting the portfolio is likely to be appropriate in only small institutions offering a narrow range of loan products. Larger institutions typically offer a more diverse and complex mix of loan products. Such institutions may start by segmenting the portfolio into major loan types but typically have more detailed information available that allows them to further segregate the portfolio into product-line segments based on the risk characteristics of each portfolio segment. Regardless of the segmentation method used, an institution should maintain documentation to support its conclusion that the loans in each segment have similar attributes or characteristics.

As economic and other business conditions change, institutions often modify their business strategies, which may result in adjustments to the way in which they segment their loan portfolio for purposes of estimating loan losses. Illustration B presents an example in which an institution refined its segmentation method to more effectively consider risk factors and maintains documentation to support this change.

Illustration B

Documenting Segmenting Practices

Documenting a refinement in a segmentation method

An institution with a significant portfolio of consumer loans performed a review of its ALLL methodology. The institution had determined its ALLL based upon historical loss rates in the overall consumer portfolio. The ALLL methodology was validated by comparing actual loss rates (charge-offs) for the past two years to the estimated loss rates. During this process, the institution decided to evaluate loss rates on an individual-product basis (e.g., auto loans, unsecured loans, or home equity loans). This analysis disclosed significant differences in the loss rates on different products. With this additional information, the methodology was amended in the current period to segment the portfolio by product, resulting in a better estimation of the loan losses associated with the portfolio. To support this change in segmentation practice, the credit-review committee records contain the analysis that was used as a basis for the change and the written report describing the need for the change.

Institutions use a variety of documents to support the segmentation of their portfolios. Some of these documents include—

- loan trial balances by categories and types of loans,
- management reports about the mix of loans in the portfolio,
- delinquency and nonaccrual reports, and
- a summary presentation of the results of an internal or external loan-grading review.

Reports generated to assess the profitability of a loan-product line may be useful in identifying areas in which to further segment the portfolio.

Estimating Loss on Groups of Loans

Based on the segmentation of the loan portfolio, an institution should estimate the FAS 5 portion of its ALLL. For those segments that require an ALLL, [18] the institution should estimate the loan and lease losses, on at least a quarterly basis, based upon its ongoing loan-review process and analysis of loan performance. The institution should follow a systematic and consistently applied approach to select the most appropriate loss-measurement methods and support its conclusions and rationale with written documentation. Regardless of the methods used to measure losses, an institution should demonstrate and document that the loss-measurement methods used to estimate the ALLL for each segment are determined in accordance with GAAP as of the financial statement date.[19]

One method of estimating loan losses for groups of loans is through the application of loss rates to the groups' aggregate loan balances. Such loss rates typically reflect the institution's historical loan-loss experience for each group of loans, adjusted for relevant environmental factors (e.g., industry, geographical, economic, and political factors) over a defined period of time. If an institution does not have loss experience of its own, it may be appropriate to reference the loss experience of other institutions, provided that the institution demonstrates that the attributes of the loans in its portfolio segment are similar to those of the loans included in the portfolio of the institution providing the loss experience.[20] Institutions should maintain supporting docu-

18. An example of a loan segment that does not generally require an ALLL is loans that are fully secured by deposits maintained at the lending institution.

19. Refer to paragraph 8(b) of FAS 5***.

20. Refer to paragraph 23 of FAS 5.

mentation for the technique used to develop their loss rates, including the period of time over which the losses were incurred. If a range of loss is determined, institutions should maintain documentation to support the identified range and the rationale used for determining which estimate is the best estimate within the range of loan losses. An example of how a small institution performs a comprehensive historical loss analysis is provided as the first item in Illustration C.

Before employing a loss-estimation model, an institution should evaluate and modify, as needed, the model's assumptions to ensure that the resulting loss estimate is consistent with GAAP. In order to demonstrate consistency with GAAP, institutions that use loss-estimation models typically document the evaluation, the conclusions regarding the appropriateness of estimating loan losses with a model or other loss-estimation tool, and the support for adjustments to the model or its results.

In developing loss measurements, institutions should consider the impact of current environmental factors and then document which factors were used in the analysis and how those factors affected the loss measurements. Factors that should be considered in developing loss measurements include the following:[21]

- levels of and trends in delinquencies and impaired loans
- levels of and trends in charge-offs and recoveries
- trends in volume and terms of loans
- effects of any changes in risk-selection and underwriting standards, and other changes in lending policies, procedures, and practices
- experience, ability, and depth of lending management and other relevant staff
- national and local economic trends and conditions
- industry conditions
- effects of changes in credit concentrations

For any adjustment of loss measurements for environmental factors, the institution should maintain sufficient, objective evidence to support the amount of the adjustment and to explain why the adjustment is necessary to reflect current information, events, circumstances, and conditions in the loss measurements.

The second item in illustration C provides an example of how an institution adjusts its commercial real estate historical loss rates for changes in local economic conditions. Example 4 provides an example of maintaining supporting documentation for adjustments to portfolio-segment loss rates for an environmental factor related to an economic downturn in the borrower's primary industry. Example 5 describes one institution's process for determining and documenting an ALLL for loans that are not individually impaired but have characteristics indicating there are loan losses on a group basis.

21. Refer to paragraph 7.13 in the AICPA Audit Guide.

Illustration C

Documenting the Setting of Loss Rates

Comprehensive loss analysis in a small institution

A small institution determines its loss rates based on loss rates over a three-year historical period. The analysis is conducted by type of loan and is further segmented by originating branch office. The analysis considers charge-offs and recoveries in determining the loss rate. The institution also considers the loss rates for each loan grade and compares them to historical losses on similarly rated loans in arriving at the historical loss factor. The institution maintains supporting documentation for its loss-factor analysis, including historical losses by type of loan, originating branch office, and loan grade for the three-year period.

Adjustment of loss rates for changes in local economic conditions

An institution develops a factor to adjust loss rates for its assessment of the impact of changes in the local economy. For example, when analyzing the loss rate on commercial real estate loans, the assessment identifies changes in recent commercial building occupancy rates. The institution generally finds the occupancy statistics to be a good indicator of probable losses on these types of loans. The institution maintains documentation that summarizes the relationship between current occupancy rates and its loss experience.

Example 4: ALLL Under FAS 5—Adjusting Loss Rates

Facts. Institution D's lending area includes a metropolitan area that is financially dependent upon the profitability of a number of manufacturing businesses. These businesses use highly specialized equipment and significant quantities of rare metals in the manufacturing process. Due to increased low-cost foreign competition, several of the parts suppliers servicing these manufacturing firms declared bankruptcy. The foreign suppliers have subsequently increased prices, and the manufacturing firms have suffered from increased equipment maintenance costs and smaller profit margins. Additionally, the cost of the rare metals used in the manufacturing process increased and has now stabilized at double last year's price. Due to these events, the manufacturing businesses are experiencing financial difficulties and have recently announced downsizing plans.

Although Institution D has yet to confirm an increase in its loss experience as a result of these events, management knows that it lends to a significant number of businesses and individuals whose repayment ability depends upon the long-term viability of the manufacturing businesses. Institution D's management has identified particular segments of its commercial and consumer customer bases that include borrowers highly dependent upon sales or salary from the manufacturing businesses. Institution D's management performs an analysis of the affected portfolio segments to adjust its historical loss rates used to determine the ALLL. In this particular case, Institution D has experienced similar business and lending conditions in the past that it can compare to current conditions.

Analysis. Institution D should document its support for the loss-rate adjustments that result from considering these manufacturing firms' financial downturns. It should document its identification of the particular segments of its commercial and consumer loan portfolio for which it is probable that the manufacturing business' financial downturn has resulted in loan losses. In addition, it should document its analysis that resulted in the adjustments to the loss rates for the affected portfolio segments. As part of its documentation, Institution D should maintain copies of the documents supporting the analysis, including relevant newspaper articles, economic reports, economic data, and notes from discussions with individual borrowers.

Since Institution D has had similar situations in the past, its supporting documentation should also include an analysis of how the current conditions compare to its previous loss experiences in similar circumstances. As part of its effective ALLL methodology, a summary should be created of the amount and rationale for the adjustment factor, which management presents to the audit committee and board for their review and approval prior to the issuance of the financial statements.

Example 5: ALLL Under FAS 5—Estimating Losses on Loans Individually Reviewed for Impairment but Not Considered Individually Impaired

Facts. Institution E has outstanding loans of $2 million to Company Y and $1 million to Company Z, both of which are paying as agreed upon in the loan documents. The institution's ALLL policy specifies that all loans greater than $750,000 must be individually reviewed for impairment under FAS 114. Company Y's financial statements reflect a strong net worth, good profits, and ongoing ability to meet debt-service requirements. In contrast, recent information indicates Company Z's profitability is declining and its cash flow is tight. Accordingly, this loan is rated substandard under the institution's loan-grading system. Despite its concern, management believes Company Z will resolve its problems and determines that neither loan is individually impaired as defined by FAS 114.

Institution E segments its loan portfolio to estimate loan losses under FAS 5. Two of its loan portfolio segments are Segment 1 and Segment 2. The loan to Company Y has risk characteristics similar to the loans included in Segment 1, and the loan to Company Z has risk characteristics similar to the loans included in Segment 2.[22]

In its determination of the ALLL under FAS 5, Institution E includes its loans to Company Y

22. These groups of loans do not include any loans that have been individually reviewed for impairment under FAS 114 and determined to be impaired as defined by FAS 114.

and Company Z in the groups of loans with similar characteristics (i.e., Segment 1 for Company Y's loan and Segment 2 for Company Z's loan). Management's analyses of Segment 1 and Segment 2 indicate that it is probable that each segment includes some losses, even though the losses cannot be identified to one or more specific loans. Management estimates that the use of its historical loss rates for these two segments, with adjustments for changes in environmental factors, provides a reasonable estimate of the institution's probable loan losses in these segments.

Analysis. Institution E should adequately document an ALLL under FAS 5 for these loans that were individually reviewed for impairment but are not considered individually impaired. As part of its effective ALLL methodology, Institution E documents the decision to include its loans to Company Y and Company Z in its determination of its ALLL under FAS 5. It should also document the specific characteristics of the loans that were the basis for grouping these loans with other loans in Segment 1 and Segment 2, respectively. Institution E maintains documentation to support its method of estimating loan losses for Segment 1 and Segment 2, including the average loss rate used, the analysis of historical losses by loan type and by internal risk rating, and support for any adjustments to its historical loss rates. The institution also maintains copies of the economic and other reports that provided source data.

Consolidating the Loss Estimates

To verify that ALLL balances are presented fairly in accordance with GAAP and are auditable, management should prepare a document that summarizes the amount to be reported in the financial statements for the ALLL. The board of directors should review and approve this summary.

Common elements in such summaries include—

- the estimate of the probable loss or range of loss incurred for each category evaluated (e.g., individually evaluated impaired loans, homogeneous pools, and other groups of loans that are collectively evaluated for impairment);
- the aggregate probable loss estimated using the institution's methodology;
- a summary of the current ALLL balance;
- the amount, if any, by which the ALLL is to be adjusted;[23] and
- depending on the level of detail that supports the ALLL analysis, detailed subschedules of loss estimates that reconcile to the summary schedule.

Illustration D describes how an institution documents its estimated ALLL by adding comprehensive explanations to its summary schedule.

Generally, an institution's review and approval process for the ALLL relies upon the data provided in these consolidated summaries. There may be instances in which individuals or committees that review the ALLL methodology and resulting allowance balance identify adjustments that need to be made to the loss estimates to provide a better estimate of loan losses. These changes may be due to information not known at the time of the initial loss estimate (e.g., information that surfaces after determining and adjusting, as necessary, historical loss rates, or a recent decline in the marketability of property after conducting a FAS 114 valuation based upon the fair value of collateral). It is important that these adjustments are consistent with GAAP and are reviewed and approved by appropriate personnel. Additionally, the summary should provide each subsequent reviewer with an understanding of the support behind these adjustments. Therefore, management should document the nature of any adjustments and the underlying rationale for making the changes. This documentation should be provided to those making the final determination of the ALLL amount. Example 6 addresses the documentation of the final amount of the ALLL.

23. Subsequent to adjustments, there should be no material differences between the consolidated loss estimate, as determined by the methodology, and the final ALLL balance reported in the financial statements.

Illustration D
Summarizing Loss Estimates

Descriptive comments added to the consolidated ALLL summary schedule

To simplify the supporting documentation process and to eliminate redundancy, an institution adds detailed supporting information to its summary schedule. For example, this institution's board of directors receives, within the body of the ALLL summary schedule, a brief description of the institution's policy for selecting loans for evaluation under FAS 114. Additionally, the institution identifies which FAS 114 impairment-measurement method was used for each individually reviewed impaired loan. Other items on the schedule include a brief description of the loss factors for each segment of the loan portfolio, the basis for adjustments to loss rates, and explanations of changes in ALLL amounts from period to period, including cross-references to more detailed supporting documents.

Example 6: Consolidating the Loss Estimates—Documenting the Reported ALLL

Facts. Institution F determines its ALLL using an established systematic process. At the end of each period, the accounting department prepares a summary schedule that includes the amount of each of the components of the ALLL, as well as the total ALLL amount, for review by senior management, the credit committee, and, ultimately, the board of directors. Members of senior management and the credit committee meet to discuss the ALLL. During these discussions, they identify changes that are required by GAAP to be made to certain of the ALLL estimates. As a result of the adjustments made by senior management, the total amount of the ALLL changes. However, senior management (or its designee) does not update the ALLL summary schedule to reflect the adjustments or reasons for the adjustments. When performing their audit of the financial statements, the independent accountants are provided with the original ALLL summary schedule that was reviewed by senior management and the credit committee, as well as a verbal explanation of the changes made by senior management and the credit committee when they met to discuss the loan-loss allowance.

Analysis. Institution F's documentation practices supporting the balance of its loan-loss allowance, as reported in its financial statements, are not in compliance with existing documentation guidance. An institution must maintain supporting documentation for the loan-loss allowance amount reported in its financial statements. As illustrated above, there may be instances in which ALLL reviewers identify adjustments that need to be made to the loan-loss estimates. The nature of the adjustments, how they were measured or determined, and the underlying rationale for making the changes to the ALLL balance should be documented. Appropriate documentation of the adjustments should be provided to the board of directors (or its designee) for review of the final ALLL amount to be reported in the financial statements. For institutions subject to external audit, this documentation should also be made available to the independent accountants. If changes frequently occur during management or credit committee reviews of the ALLL, management may find it appropriate to analyze the reasons for the frequent changes and to reassess the methodology the institution uses.

Validating the ALLL Methodology

An institution's ALLL methodology is considered valid when it accurately estimates the amount of loss contained in the portfolio. Thus, the institution's methodology should include procedures that adjust loss-estimation methods to reduce differences between estimated losses and actual subsequent charge-offs, as necessary.

To verify that the ALLL methodology is valid and conforms to GAAP and supervisory guidance, an institution's directors should establish internal-control policies, appropriate for the size of the institution and the type and complexity of its loan products. These policies should include procedures for a review, by a party who is independent of the ALLL-estimation process, of the ALLL methodology and its application in order to confirm its effectiveness.

In practice, financial institutions employ numerous procedures when validating the reasonableness of their ALLL methodology and determining whether there may be deficiencies in their overall methodology or loan-grading process. Examples are—

- a review of trends in loan volume, delinquencies, restructurings, and concentrations;
- a review of previous charge-off and recovery history, including an evaluation of the timeliness of the entries to record both the charge-offs and the recoveries;
- a review by a party that is independent of the ALLL-estimation process (this often involves the independent party reviewing, on a test basis, source documents and underlying assumptions to determine that the established methodology develops reasonable loss estimates); and
- an evaluation of the appraisal process of the underlying collateral. (This may be accomplished by periodically comparing the appraised value to the actual sales price on selected properties sold.)

Supporting Documentation for the Validation Process

Management usually supports the validation process with the workpapers from the ALLL-review function. Additional documentation often includes the summary findings of the independent reviewer. The institution's board of directors, or its designee, reviews the findings and acknowledges its review in its meeting minutes. If the methodology is changed based upon the findings of the validation process, documentation that describes and supports the changes should be maintained.

Appendix—Application of GAAP

[This appendix was designated appendix B in the policy statement.] An ALLL recorded pursuant to GAAP is an institution's best estimate of the probable amount of loans and lease-financing receivables that it will be unable to collect based on current information and events.[24] A creditor should record an ALLL when the criteria for accrual of a loss contingency as set forth in GAAP have been met. Estimating the amount of an ALLL involves a high degree of management judgment and is inevitably imprecise. Accordingly, an institution may determine that the amount of loss falls within a range. An institution should record its best estimate within the range of loan losses.[25]

Under GAAP, Statement of Financial Accounting Standards No. 5, ''Accounting for Contingencies'' (FAS 5), provides the basic guidance for recognition of a loss contingency, such as the collectibility of loans (receivables), when it is probable that a loss has been incurred and the amount can be reasonably estimated. Statement of Financial Accounting Standards No. 114, ''Accounting by Creditors for Impairment of a Loan'' (FAS 114) provides more specific guidance about the measurement and disclosure of impairment for certain types of loans.[26] Specifically, FAS 114 applies to loans that are identified for evaluation on an individual basis. Loans are considered impaired when, based on current information and events, it is probable that the creditor will be unable to collect all interest and principal payments due according to the contractual terms of the loan agreement.

For individually impaired loans, FAS 114 provides guidance on the acceptable methods to measure impairment. Specifically, FAS 114 states that when a loan is impaired, a creditor should measure impairment based on the present value of expected future principal and interest cash flows discounted at the loan's effective interest rate, except that as a practical expedient, a creditor may measure impairment based on a loan's observable market price or the fair value of collateral, if the loan is collateral dependent. When developing the estimate of expected future cash flows for a loan, an institution should

24. This appendix provides guidance on the ALLL and does not address allowances for credit losses for off-balance-sheet instruments (e.g., loan commitments, guarantees, and standby letters of credit). Institutions should record liabilities for these exposures in accordance with GAAP. Further guidance on this topic is presented in the American Institute of Certified Public Accountants' Audit and Accounting Guide, *Banks and Savings Institutions,* 2000 edition (AICPA Audit Guide). Additionally, this appendix does not address allowances or accounting for assets or portions of assets sold with recourse, which is described in Statement of Financial Accounting Standards No. 140, ''Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities—a Replacement of FASB Statement No. 125'' (FAS 140).

25. Refer to FASB Interpretation No. 14, ''Reasonable Estimation of the Amount of a Loss,'' and Emerging Issues Task Force Topic No. D-80, ''Application of FASB Statements No. 5 and No. 114 to a Loan Portfolio'' (EITF Topic D-80).

26. EITF Topic D-80 includes additional guidance on the requirements of FAS 5 and FAS 114 and how they relate to each other.***

consider all available information reflecting past events and current conditions, including the effect of existing environmental factors. The following illustration provides an example of an institution estimating a loan's impairment when the loan has been partially charged off.

Illustration

Interaction of FAS 114 with an Adversely Classified Loan, Partial Charge-Off, and the Overall ALLL

An institution determined that a collateral-dependent loan, which it identified for evaluation, was impaired. In accordance with FAS 114, the institution established an ALLL for the amount that the recorded investment in the loan exceeded the fair value of the underlying collateral, less costs to sell.

Consistent with relevant regulatory guidance, the institution classified as ''Loss,'' the portion of the recorded investment deemed to be the confirmed loss and classified the remaining recorded investment as ''Substandard.'' For this loan, the amount classified ''Loss'' was less than the impairment amount (as determined under FAS 114). The institution charged off the ''Loss'' portion of the loan. After the charge-off, the portion of the ALLL related to this ''Substandard'' loan (1) reflects an appropriate measure of impairment under FAS 114, and (2) is included in the aggregate FAS 114 ALLL for all loans that were identified for evaluation and individually considered impaired. The aggregate FAS 114 ALLL is included in the institution's overall ALLL.

Large groups of smaller-balance homogeneous loans that are collectively evaluated for impairment are not included in the scope of FAS 114.[27] Such groups of loans may include, but are not limited to, credit card, residential mortgage, and consumer installment loans. FAS 5 addresses the accounting for impairment of these loans. Also, FAS 5 provides the accounting guidance for impairment of loans that are not identified for evaluation on an individual basis and loans that are individually evaluated but are not individually considered impaired. Institutions should ensure that they do not layer their loan-loss allowances. Layering is the inappropriate practice of recording in the ALLL more than one amount for the same probable loan loss. Layering can happen when an institution includes a loan in one segment, determines its best estimate of loss for that loan either individually or on a group basis (after taking into account all appropriate environmental factors, conditions, and events), and then includes the loan in another group, which receives an additional ALLL amount.[28]

While different institutions may use different methods, there are certain common elements that should be included in any loan-loss allowance methodology. Generally, an institution's methodology should—

- include a detailed analysis of the loan portfolio, performed on a regular basis;
- consider all loans (whether on an individual or group basis);
- identify loans to be evaluated for impairment on an individual basis under FAS 114 and segment the remainder of the portfolio into groups of loans with similar risk characteristics for evaluation and analysis under FAS 5;
- consider all known relevant internal and external factors that may affect loan collectibility;
- be applied consistently but, when appropriate, be modified for new factors affecting collectibility;
- consider the particular risks inherent in different kinds of lending;
- consider current collateral values (less costs to sell), where applicable;
- require that analyses, estimates, reviews, and other ALLL methodology functions be performed by competent and well-trained personnel;
- be based on current and reliable data;

27. In addition, FAS 114 does not apply to loans measured at fair value or at the lower of cost or fair value, leases, or debt securities.

28. According to the Federal Financial Institutions Examination Council's *Federal Register* notice, Implementation Issues Arising from FASB Statement No. 114, ''Accounting by Creditors for Impairment of a Loan,'' published February 10, 1995, institution-specific issues should be reviewed when estimating loan losses under FAS 114. This analysis should be conducted as part of the evaluation of each individual loan reviewed under FAS 114 to avoid potential ALLL layering.

- be well documented, in writing, with clear explanations of the supporting analyses and rationale; and
- include a systematic and logical method to consolidate the loss estimates and ensure the ALLL balance is recorded in accordance with GAAP.[29]

A systematic methodology that is properly designed and implemented should result in an institution's best estimate of the ALLL. Accordingly, institutions should adjust their ALLL balance, either upward or downward, in each period for differences between the results of the systematic determination process and the unadjusted ALLL balance in the general ledger.[30]

29. Refer to paragraph 7.05 of the AICPA Audit Guide.

30. Institutions should refer to the guidance on materiality in SEC Staff Accounting Bulletin No. 99, *Materiality*.

ALLL Methodologies and Documentation
Examination Objectives
Effective date November 2002

Section 2072.2

1. To evaluate internal controls over the loan-loss estimation process by evaluating the ALLL written policy and the process used to create and maintain the policy, loan-grading systems, and other associated internal controls over credit risk.
2. To determine the existence of an ALLL balance and review the summary schedule supporting it.
3. To analyze and review the evaluation for Statement of Financial Accounting Standards No. 114 (FAS 114) (for individually listed loans).
4. To analyze and review the evaluation for Statement of Financial Accounting Standards No. 5 (FAS 5) (for groups of loans).
5. To determine if the bank has adequately developed a range of loss and a margin for imprecision.
6. To determine that the ALLL reflects estimated credit losses for specifically identified loans (or groups of loans) and any estimated *probable* credit losses inherent in the remainder of the loan portfolio at the balance-sheet date.
7. To analyze and review the ALLL-documentation support.
8. To determine the adequacy of the bank's process to evaluate the ALLL methodology and to adjust the methodology, as needed.

1. Determine if the board of directors has developed and maintained an appropriate, systematic, and consistently applied process to determine the amounts of the ALLL and provision for loan losses, or if it has instructed management to do so. Determine if the ALLL policies specifically address the bank's goals, risk profile, personnel, and other resources.
2. Determine if the board of directors has approved the written ALLL policy.
3. Determine if the bank's loan-loss estimate, in accordance with its methodology, is consistent with generally accepted accounting principles and supervisory guidance. Additionally, ensure that the bank's loan-loss estimate is materially consistent with the reported balance of the bank's ALLL account.
4. Determine if the ALLL methodology is periodically validated by an independent party and, if appropriate, revised.
5. Ascertain whether the audit committee is overseeing and monitoring the internal controls over the ALLL-documentation process.
6. Ascertain that the bank maintains adequate written documentation of its ALLL, including clear explanations of the supporting analyses and rationale. The documentation should consist of—
   - policies and procedures over the systems and controls that maintain an appropriate ALLL and over the ALLL methodology,
   - the loan-grading system or process,
   - a summary or consolidation (including losses) of the ALLL balance,
   - a validation of the ALLL methodology, and
   - periodic adjustments to the ALLL process.
7. Determine if the amount reported for the ALLL for each period and the provisions for loan and leases losses are reviewed and approved by the board of directors.

INTRODUCTION

The term ''commercial and industrial loan'' is commonly used to designate loans to a corporation, commercial enterprise, or joint venture that are not ordinarily maintained in either the real estate or consumer installment loan portfolios. Generally, commercial loans are the largest asset concentration of a state member bank, offer the most complexity, and require the greatest commitment from bank management to monitor and control risks. Proper management of these assets requires a clearly articulated credit-policy that imposes discipline and sound loan administration. Since lenders are subject to pressures related to productivity and competition, they may be tempted to relax prudent credit-underwriting standards to remain competitive in the marketplace, thus increasing the potential for risk. Examiners need to understand the unique characteristics of the varying types of commercial and industrial loans, as well as how to properly analyze their quality.

Commercial loans are extended on a secured or unsecured basis with a wide range of purposes, terms, and maturities. While the types of commercial and industrial loans can vary widely depending on the purpose of loans made and market characteristics where the bank operates, most commercial and industrial loans will primarily be made in the form of a seasonal or working-capital loan, term business loan, or loan to an individual for a business purpose. This section will provide examiners with a fundamental understanding of secured and unsecured transactions, loan evaluation and coverage techniques, the key principles for assessing credit quality, minimum documentation standards for loan line sheets, and basic bankruptcy law, as well as an overview of sections 23A and 23B of the Federal Reserve Act and tie-in arrangements. Other sections of this manual discuss more specific types of lending.

PRIMARY TYPES OF COMMERCIAL AND INDUSTRIAL LOANS

Seasonal or Working-Capital Loans

Seasonal or working-capital loans provide a business with short-term financing for inventory, receivables, the purchase of supplies, or other operating needs during the business cycle. These types of loans are often appropriate for businesses that experience seasonal or short-term peaks in current assets and current liabilities, such as a retailer who relies heavily on a holiday season for sales or a manufacturing company that specializes in summer clothing. These types of loans are often structured in the form of an advised line of credit or a revolving credit. An advised revocable line of credit is a revocable commitment by the bank to lend funds up to a specified period of time, usually one year. Lines of credit are generally reviewed annually by the bank, do not have a fixed repayment schedule, and may not require fees or compensating balances. In the case of unadvised lines of credit, the bank has more control over advances and may terminate the facility at any time, depending on state law or legal precedents. A revolving credit is valid for a stated period of time and does not have a fixed repayment schedule, but usually it has a required fee. The lender has less control over a revolving credit since there is an embedded guarantee to make advances within the prescribed limits of the loan agreement. The borrower may receive periodic advances under the line of credit or the revolving credit. Repayment of the loans is generally accomplished through conversion or turnover of short-term assets. Interest payments on seasonal loans are usually paid throughout the term of the loan, such as monthly or quarterly.

Seasonal or working-capital loans are intended to be repaid through the cash flow derived from converting the financed assets to cash. The structure of the loans can vary, but they should be closely tied to the timing of the conversion of the financed assets. In most cases, seasonal or working-capital facilities are renewable at maturity, are for a one-year term, and include a clean-up requirement for a period sometime during the low point or contraction phase of the business cycle. The clean-up period is a specified period (usually 30 days) during the term of the loan in which the borrower is required to pay off the loan. While this requirement is becoming less common, it provides the bank with proof that the borrower is not dependent on the lender for permanent financing. It is important to note, however, that an expanding business may not be able to clean up its facility since it may be increasing its current assets.

Analysis of Seasonal and Working-Capital Loans

The analysis of a seasonal loan is best accomplished by a monthly or quarterly review of a company's balance sheet and income statements to identify the peak and contraction phases of the business cycle. The lender should know when the peak and contraction phases are, and the loan should be structured accordingly. The lender's primary objective is to determine whether the advances are being used for the intended purposes (inventories or payables) and not for the acquisition of fixed assets or payments on other debts. Repayments on the facility should also be consistent with the conversion of assets. If the borrower has other loan facilities at the bank, all credit facilities should be reviewed at the same time to ensure that the activity with the seasonal or working-capital facility is not linked to other loans in the bank. Projections of sources and uses of funds are also a valuable tool for reviewing a seasonal or working-capital line of credit and determining the sales cycle.

Quarterly balance-sheet and income statements are very helpful when a comparison is made with the original projections. Other helpful information can be obtained from a review of an aging of accounts receivable for delinquencies and concentrations, a current list of inventory, an accounts-payable aging, and accruals made during the quarter. This information can be compared with the outstanding balance of the facility to ensure that the loan is not overextended and that the collateral margins are consistent with borrowing-base parameters. A borrowing base is the amount the lender is willing to advance against a dollar value of pledged collateral; for example, a bank will only lend up to a predetermined specified percentage of total outstanding receivables less all past-due accounts more than a certain number of days delinquent. A borrowing-base certificate should be compiled at least monthly or more often during peak activity in the facility. When reviewing seasonal loans, examiners should remember that a bank relies heavily on inventory as collateral in the beginning of a company's business cycle and on receivables toward the end of the business cycle. However, in traditional working-capital loans, greater emphasis is usually placed on accounts receivable as collateral throughout the loan's tenure.

Normally, a bank is secured by a perfected blanket security interest on accounts receivable, inventory, and equipment and on the proceeds from the turnover of these assets. Well-capitalized companies with a good history of seasonal payout or cleanup may be exceptions. An annual lien search, however, would be prudent under this type of lending relationship to detect any purchase-money security interest that may have occurred during the business cycle.

The following are potential problems associated with working-capital and seasonal loans:

- *Working-capital advances used for funding losses.* A business uses advances from a revolving line of credit to fund business losses, including the funding of wages, business expenses, debt service, or any other cost not specifically associated with the intended purpose of the facility.
- *Working-capital advances funding long-term assets.* A business will use working-capital funds to purchase capital assets that are normally associated with term business loans.
- *Trade creditors not paid out at end of business cycle.* While the bank may be paid out, some trade creditors may not get full repayment. This can cause a strained relationship as unpaid trade creditors may be less willing to provide financing or offer favorable credit terms in the future. In turn, the business will become more reliant on the bank to support funding needs that were previously financed by trade creditors.
- *Overextension of collateral.* The business does not have the collateral to support the extension of credit, causing an out-of-borrowing-base situation. Examiners should review borrowing-base certificates to verify that coverage meets the prescribed limitations established by the bank's credit policy for the specific asset being financed.
- *Value of inventory declines.* If a business does not pay back the bank after inventory is converted to cash or accounts receivable, the value of the inventory declines. Other causes of inventory devaluation include obsolescence; a general economic downturn; or, in the case of a commodity, market volatility. Declines in inventory value will commonly put a working-capital facility in an out-of-borrowing-base situation and require the excess debt to be amortized and repaid through future profits of the business.

- *Collectibility of accounts receivable declines.* The increasingly past-due status of accounts receivable or deteriorating credit quality of account customers both result in the noncollection of receivables. This can also cause an out-of-borrowing-base situation for the lending institution.
- *Working-capital advances used to fund long-term capital.* Funds may be inappropriately used to repurchase company stock, pay off subordinated debt holders, or even pay dividends on capital stock.

These situations may cause a loan balance to be remaining at the end of the business cycle. If this should occur, the bank generally has one of three options: (1) Require the unpaid balance to be amortized. This option is, however, dependent on the ability of the business to repay the debt through future profits. (2) Request the borrower to find another lender or require an infusion of capital by the borrower. This is not always a feasible option because of the probable weakened financial condition of the business and ownership under these circumstances. (3) Liquidate the collateral. Foreclosing on the collateral should only be executed when it becomes obvious that the business can no longer function as a going concern. The problem with this option is that once the bank discovers that the business is no longer a viable concern, realizing the full value of the collateral is in jeopardy. The need to resort to any of these options may prompt criticism of the credit.

Term Business Loans

Term business loans are generally granted at a fixed or variable rate of interest, have a maturity in excess of one year, and are intended to provide an organization with the funds needed to acquire long-term assets, such as physical plants and equipment, or finance the residual balance on lines of credit or long-term working capital. Term loans are repaid through the business's cash flow, according to a fixed-amortization schedule, which can vary based on the cash-flow expectations of the underlying asset financed or the anticipated profitability or cash flow of the business. Term business loans involve greater risk than short-term advances because of the length of time the credit is extended. As a result of this greater risk, term loans are often secured. Loan interest may be payable monthly, quarterly, semiannually, or annually.

In most cases, the terms of these loans are detailed in formal loan agreements with affirmative and negative covenants that place certain conditions on the borrower throughout the term of the loan. Generally, loan agreements substantially enhance a borrower/banker relationship because they encourage and promote more frequent communication between the parties. In affirmative covenants, the borrower pledges to fulfill certain requirements, such as maintain adequate insurance coverage, make timely loan repayments, or ensure the financial stability of the business. Negative or restrictive covenants prohibit or require the borrower to refrain from certain practices, such as selling or transferring assets, defaulting, falling below a minimum debt coverage ratio, exceeding a maximum debt-to-equity ratio, or taking any action that may diminish the value of collateral or impair the collectibility of the loan. Covenants should not be written so restrictively that the borrower is constantly in default over trivial issues; however, violations should be dealt with immediately to give credibility to the agreement. Violations of these covenants can often result in acceleration of the debt maturity. A formal loan agreement is most often associated with longer-term loans. If a formal agreement does not exist, the term loans should be written with shorter maturities and balloon payments to allow more frequent review by bank management.

Analysis of Term Business Loans

While a seasonal or working-capital loan analysis emphasizes the balance sheet, the analysis of term loans will focus on both the balance sheet and the income statement. Because a term loan is repaid from excess cash flow, the long-term viability of the business is critical in determining the overall quality of the credit. In evaluating long-term earnings, the examiner must develop a fundamental understanding of the company's industry and competitive position in the marketplace. Most of the analysis will be conducted based on the historical performance of the business and its history of making payments on its debt. Any historical record of inconsistencies or inability to perform on existing debt should prompt an in-depth review to determine the ability of the borrower to meet the loan's contractual agreements. One of the most critical determinations that should be made when evaluating term debt is whether the term of the debt exceeds the useful life of the underlying asset being financed.

While cash flow of the business is the primary source of repayment for a term loan, a secondary source would be the sale of the underlying collateral. Often, if circumstances warrant a collateral sale, the bank may face steep discounts and significant expenses related to the sale. Examiners should carefully consider these issues when evaluating the underlying value of collateral under a liquidation scenario.

The following are potential problems associated with term business loans:

- The term of the loan is not consistent with the useful life of collateral.
- Cash flow from operations does not allow for adequate debt amortization, a fundamental problem that can only be solved by improved performance.
- The gross margin of the business is narrowing, which requires the business to sell more product to produce the same gross profit. Higher sales volume could require more cash for expansion of current assets, leaving less cash for debt amortization. This situation is a common by-product of increased competition.
- Sales are lower than expected. In the face of lower sales, management is unable or unwilling to cut overhead expenses, straining cash flow and resulting in diminished debt-servicing ability.
- Fixed assets that are financed by term loans become obsolete before the loans are retired, likely causing the value of underlying collateral to deteriorate.
- The business's excess cash is spent on higher salaries or other unnecessary expenses.
- The payments on term debt have put a strain on cash flow, and the business is unable to adequately operate or allow natural expansion.
- The balance sheet of the business is weakening. The overall financial condition of the business is deteriorating because of poor performance or unforeseen occurrences in the industry.

Shared National Credits

The Federal Reserve System participates in a program for the uniform review of shared national credits (SNCs). An SNC is defined as any loan or commitment in an original amount of $20 million or more that is (1) shared at its inception by two or more supervised institutions under a formal loan agreement and (2) sold in part to one or more supervised institutions with the purchasing bank assuming its pro rata share of the credit risk. Loans sold to affiliate banks of the same holding company are not part of the SNC program. If the outstanding balance or commitment of an SNC credit falls below $20 million after its inception, and it is not criticized, the credit will not be reviewed at the next review date. Therefore, the examiner should conduct an individual review of the credit at the bank under examination. However, if the former SNC facility fell below the threshold through a charge-off, and was classified or specially mentioned at the most recent SNC review, the credit relationship would continue to be reviewed under the SNC program until such time that the balance falls below $10 million. The Federal Deposit Insurance Corporation (FDIC), the state agencies, and the Office of the Comptroller of the Currency (OCC) also participate in this program. The Federal Reserve carries out the examination of SNCs at the lead or agent banks that are state member banks, state-chartered foreign branches, and credit-extending nonbank subsidiaries of domestic and foreign organizations. The FDIC is primarily responsible for any SNC credits at state nonmember banks, and the OCC supervises the review of those SNCs in which the lead bank is a national bank or an OCC-chartered foreign branch.

SNCs should not be analyzed or reviewed during the examination of the individual participating bank. If the examiner is uncertain whether the credit was reviewed under the SNC program, the respective Reserve Bank coordinator should be contacted. If credits eligible for the program are found but have not been reviewed (other than new SNCs since the time of the last SNC program review), the examiner should submit a memorandum detailing those credits to the respective Reserve Bank coordinator to be forwarded to the SNC coordinator at the Federal Reserve Bank of New York.

SECURED AND UNSECURED TRANSACTIONS

This subsection is intended to be a general reference for an examiner's review of a credit file to determine whether the bank's collateral position is properly documented. Examiners should be aware that secured transactions encompass an extensive body of law that is rather technical in nature. The following discussion contains general information for examiners on the basic laws that govern a bank's security interest in property and on the documentation that needs to be in a loan file to properly document a perfected security interest in a borrower's assets.

Secured Transactions

Most secured transactions in personal property and fixtures are governed by article 9 of the Uniform Commercial Code (UCC). The UCC has been adopted by all 50 states, the District of Columbia, and the Virgin Islands. Timing differences as well as filing locations differ from state to state. Failure to file a financing statement in a timely manner or in the proper location will compromise a lender's security interest in the collateral.

Article 9 of the UCC applies to any transaction that is intended to create a security interest in personal property. Mortgage transactions are not covered, marine mortgages are filed with the Coast Guard, and aircraft liens are filed with the Federal Aviation Administration. A ‘‘security interest’’ is defined in the UCC as ‘‘an interest in personal property or fixtures which secures payment or performance of an obligation.’’ A secured transaction requires that there be an *agreement* between the parties indicating the parties' intention to create a security interest for the benefit of the creditor or secured party. This agreement is commonly referred to as a security agreement.

Article 9 of the UCC refers to two different concepts related to security interests: attachment and perfection. Attachment is the point in time at which the security interest is created and becomes enforceable against the debtor. Perfection refers to the steps that must be taken in order for the security interest to be enforceable against third parties who have claims against collateral.

Attachment of Security Interest

The three requirements for the creation of a security interest are stated in UCC section 9-203(1). Once the following requirements are met, the security interest attaches:

- The collateral is in the possession of the secured party pursuant to agreement, or the debtor has signed a security agreement that contains a description of the collateral and, when the security interest covers crops now growing or to be grown or timber to be cut, a description of the land concerned.
- Value has been given to the debtor.
- The debtor has rights in the collateral.

Thus, unless the collateral is in the possession of the secured party, there must be a written security agreement that describes the collateral. The description does not have to be very specific or detailed—‘‘any description of personal property . . . is sufficient whether or not it is specific if it reasonably identifies what is described’’ (see section 9-110). The agreement must also be signed by the debtor. The creditor may sign it, but its failure to do so does not affect the agreement's enforceability against the debtor.

‘‘Giving value’’ is any consideration that supports a contract. Value can be given by a direct loan, a commitment to grant a loan in the future, the release of an existing security interest, or the sale of goods on contract.

While the debtor must have ‘‘rights’’ in the collateral, he or she does not necessarily have to have title to the property. For example, the debtor may be the beneficiary of a trust (the trustee has title of trust assets) or may lease the collateral. The debtor, in such cases, has rights in the collateral, but does not hold the title to the collateral. The secured party, however, only obtains the debtor's limited interest in the collateral on default if the debtor does not have full title to the collateral.

Perfection of Security Interest in Property

Perfection represents the legal process by which a bank secures an interest in property. Perfection provides the bank assurance that it has an interest in the collateral. The category of collateral will dictate the method of perfection to be used. The most common methods of perfection are (1) automatic perfection when the security interest attaches (such as in the case of purchase-money security interests applicable to consumer goods other than vehicles); (2) perfection by possession; (3) the filing of a financing statement in one or more public filing offices (The financing statement is good for five years, and the lender must file for a continuation within the six-month period before expiration of the original statement.) and (4) compliance with a state certificate of title law or central filing under a state statute other than the UCC, such as registration of vehicles.

The most common method of perfecting a security interest is public filing. Public filing serves as a constructive notice to the rest of the world that the bank claims a security interest in certain property of the debtor described in both the security agreement and the financing statement. Public filing is accomplished by filing a financing statement (UCC-1) in a public office, usually the county recorder or secretary of state. The system of filing required by the UCC provides for a notice filing whereby potential creditors can determine the existence of any outstanding liens against the debtor's property.

The form of the financing statement and where to file it varies from state to state. While the filing of a nonstandard form will generally be accepted, the failure to file in the proper public office can jeopardize the priority of the lender's security interest. The UCC provides three alternative filing systems:

- *Alternative System One.* Liens on minerals, timber to be cut, and fixtures are filed in the county land records. All other liens are filed in the office of the secretary of state.
- *Alternative System Two.* The majority of states have adopted this version. It is the same as system one, except liens on consumer goods, farm equipment, and farm products are filed in the county where the debtor resides or in the county where the collateral is located if it is owned by a nonresident.
- *Alternative System Three.* In a minority of states, filings made with the secretary of state must also be filed in the county of the borrower's business (or residence if there is no place of business in that state). Otherwise, the requirement in these states is the same as system two.

As each state may select any of the above three alternatives or a modified version of them, it is important that the examiner ascertain the filing requirements of the state(s) where the bank's customer operates. Most importantly, it is the location of the borrower, not the bank, that determines where the financing statement must be filed.

Evaluation of Security Interest in Property

Key items to look for in evaluating a security interest in property include the following:

- *Security agreement.* There should be a proper security agreement, signed and dated by the borrower, that identifies the appropriate collateral to be secured. It should include a description of the collateral and its location in sufficient detail so the lender can identify it, and should assign to the lender the right to sell or dispose of the collateral if the borrower is unable to pay the obligation.
- *Collateral possession.* If the institution has taken possession of the collateral to perfect its security interest, management of the institution should have an adequate record-keeping system and proper dual control over the property.
- *Financing statement.* If the institution has filed a financing statement with the state or local authority to perfect its security interest in the collateral, in general, it should contain the following information:
  —names of the secured party and debtor
  —the debtor's signature
  —the debtor's mailing address
  —the address of the secured party from which information about the security interest may be obtained
  —the types of the collateral and description of the collateral (Substantial compliance with the requirements of UCC section 9-402 is sufficient if errors are only minor and not seriously misleading. Some states require the debtor's tax ID number on the financing statement.)
- *Amendments.* Not all amendments require the borrower's signature, and banks may file an amendment for the following reasons:
  —borrower's change of address
  —creditor's change of address
  —borrower's name change
  —creditor's name change
  —correction of an inaccurate collateral description
  —addition of a trade name for the borrower that was subsequently adopted

- *Where to file a financing statement.* In general, financing statements filed in good faith or financing statements not filed in all of the required places are effective with respect to any collateral covered by the financing statement against any person with knowledge of the statement's contents. If a local filing is required, the office of the recorder in the county of the debtor's residence is the place to file. If state filing is required, the office of the secretary of state is the place to file.
- *Duration of effectiveness of a financing statement.* Generally, effectiveness lapses five years after filing date. If a continuation statement is filed within six months before the lapse, effectiveness is extended five years after the last date on which the filing was effective. Succeeding continuation statements may be filed to further extend the period of effectiveness.

Perfection of Security Interest in Real Estate

As previously mentioned, real estate is expressly excluded from coverage under the UCC. A separate body of state law covers such interests. However, for a real estate mortgage to be enforceable, the mortgage must be recorded in the county where the real estate covered by the mortgage is located.

Real estate mortgage or deed of trust. When obtaining a valid lien on real estate, only one document is used, the mortgage or deed of trust. The difference between a mortgage and a deed of trust varies from state to state; however, the primary difference relates to the process of foreclosure. A mortgage generally requires a judicial foreclosure, whereas, in some states, a foreclosure on a deed of trust may not. Nearly all matters affecting the title to the real estate, including the ownership thereof, are recorded in the recorder's office.

When determining the enforceability of a real estate mortgage or deed of trust, the examiner should be aware of the following requirements:

- The mortgage must be in writing.
- To be recordable, the mortgage must be acknowledged. There are different forms of acknowledgments for various situations depending on whether individuals, corporations, partnerships, or other entities are executing the mortgage. Make sure that the form of the acknowledgment used is in accordance with the type of individual or entity executing the mortgage.
- If a corporation is the mortgagor, its articles of incorporation or bylaws often will specifically state which officers have authority to sign an instrument affecting real estate. In these instances, the designated officer should be required to sign. If the corporation has a seal, that also must be affixed. If the corporation does not have a seal, this fact must be shown in the acknowledgment.
- As soon as possible after the mortgage is executed, it should be recorded in the office of the recorder for each county in which the property described in the mortgage is located. In most cases, the borrower signs an affidavit that indicates, in part, that he or she will not attempt to encumber the property while the lender is waiting for the mortgage to be recorded. In smaller community banks, common practice may be not to advance any of the money under the loan until the mortgage has been recorded and the later search completed. In larger banks or cities, however, this practice is often not practical.
- If the mortgagor is married, the spouse must join in the execution of the mortgage to subject his or her interest to the lien of the mortgage. If the mortgagor is single, the mortgage should indicate that no spouse exists who might have a dower interest or homestead interest in the property.
- If the mortgagor is a partnership, it must be determined whether the title is in the name of the partnership or in the names of the individual partners. If the title is in the names of the individual partners, their spouses should join in executing the mortgage. If the title is in the name of the partnership, those partners who are required to sign under the partnership agreement should sign.

Unsecured Transactions

Unsecured transactions are granted based on the borrower's financial capacity, credit history, earnings potential, and liquidity. Assignment of the borrower's collateral is not required, and repayment is based on the terms and conditions of the loan agreement. While unsecured loans often represent the bank's strongest borrowers, the unsecured loan portfolio can represent its most significant risk. One of the primary concerns related to unsecured credit is that if the borrower's financial condition deteriorates, the lender's options to work out of the lending relationship deteriorate as well. In general, if a credit is unsecured, the file should contain reliable and current financial information that is sufficient to indicate that the borrower has the capacity and can be reasonably expected to repay the debt.

Problem Loans

The following are key signals of an emerging problem loan:

- *Outdated or inaccurate financial information on the borrower.* The borrower is unwilling to provide the financial institution with a current, complete, and accurate financial statement at least annually. Management should also be requesting a personal tax return (and all related schedules) on the borrower. While borrowers will usually present their personal financial statements in the most favorable light, their income tax return provides a more conservative picture.
- *The crisis borrower.* The borrower needed the money yesterday, so the bank advanced unsecured credit.
- *No specific terms for repayment.* The unsecured loan has no structure for repayment, and it is commonly renewed or extended at maturity.
- *Undefined source of repayment.* These types of loans are often repaid through excess cash flow of the borrower, sale of an asset(s), or loan proceeds from another financial institution. These repayment sources are often not identified and are unpredictable.

LOAN-SAMPLING AND COVERAGE REQUIREMENTS

A thorough review of a bank's commercial loan portfolio is one of the most important elements of a bank examination. Credit reviews are an examiner's primary means for evaluating the effectiveness of internal loan-review and credit-grading systems, determining that credit is being extended in compliance with internal policies and credit standards, and evaluating the adequacy of the allowance for loan and lease losses. Credit reviews also help the examiner to ascertain a bank's compliance with applicable laws and regulations, judge the safety and soundness of the bank's lending and credit-administration functions, and, most important, evaluate directly the quality of the bank's loan portfolio. Since examiners need to make the most efficient use of their time during their on-site review of the loan portfolio, it is not practical to review every loan in the bank's loan portfolio. Instead, examiners must select for review a sample of loans[1] that is sufficient in size and scope to enable them to reach reliable conclusions about the bank's overall lending function. At a minimum, examiners should include in their sample a group of loans referred to as the "core group,"[2] as described below.

SR-02-19 describes an alternative to the traditional statistical sampling procedures (see SR-94-13) found in this section. (See also section 2082.1.) The alternative statistical sampling procedures of SR-02-19 may only be used for reviewing loans at certain community banks—those rated CAMELS composite and asset quality 1 or 2 with assets of less than $1 billion. The statistical sampling approach is not recommended for use at de novo banks and other banks with unusually high or low capital ratios. If the statistical sampling procedures of SR-02-19 are *not* used, the minimum loan-review coverage is still 40 percent of the core group of loans.

Core Group

Commercial and industrial loans and commercial real estate loans subject to examiner review should include the following:

- All problem loans, including loans that have been previously classified or specially mentioned by the respective Reserve Bank or state banking department during the most recent

1. For the purposes of this section, the term "loans" includes all sources of credit exposure arising from loans and leases. This exposure includes guarantees, letters of credit, and other loan commitments.

2. If the examiner decides it is practical, the requirements and fundamental guidance set forth in this section can be applied to all types of commercial and industrial loans, as well as to commercial real estate loans or any other type of loan made by the bank.

examinations, loans that are past due as of the date of examination, loans that are on non-accrual status, loans that have been designated as impaired according to the guidelines set forth in Statement No. 114 of the Financial Accounting Standards Board, loans that are considered renegotiated or restructured debt, and loans that are included on the bank's most recent internal watch list.

- All large loans, defined as loans or aggregations of loans to the same or related borrowers that exceed a dollar cutoff level established by the examiner-in-charge. This cutoff will typically be equal to about 1 percent of a bank's

equity capital, but a higher or lower percentage may be warranted depending on the circumstances of the bank being examined.
- Insider loans, as defined by the Board's Regulation O (12 CFR 215).

This core group of loans (problem loans, special-mention loans, insider loans, and large loans) should represent a substantial portion of the dollar volume of a bank's total commercial and industrial loans and commercial real estate loans. Nevertheless, in the majority of cases, the examiner should select additional loans from the remaining portfolio to be reasonably assured of making an accurate and comprehensive assessment of the condition of the bank's overall loan portfolio and lending activities.[3]

In determining the size and nature of additional loans to be reviewed, the examiner should consider the coverage ratio of the core group of loans.[4] If the core group of loans reviewed constitutes a substantial portion of the total dollar volume of loans (at least 40 to 50 percent), then sufficient additional loans should be reviewed to raise the coverage ratio another 10 percent. If, on the other hand, the coverage ratio of the core group of loans reviewed is lower, primarily because the bank has fewer large loans, then a greater number and higher dollar volume of loans outside the core group should be reviewed. For example, if the coverage of the core group of loans amounts to only 20 to 30 percent, then the loans reviewed in the remaining portfolio should raise the coverage ratio to a minimum of 40 to 50 percent. Loan coverage at the lower end of this range (40 percent) would be appropriate only if the bank—

- is in satisfactory condition,
- has strong asset quality,
- is well-managed, and
- has effective internal risk controls and underwriting standards.

Furthermore, the examiner should not have identified any other matters of significant concern during the examination. In other words, coverage of the core group of loans could be 40 percent only for a bank that received a composite CAMELS rating of 1 or 2 and an asset-quality rating of 1 on its last examination, provided the findings of the current review of the core group of loans appears consistent with these ratings. For banks that have high overall ratings (CAMELS 1 and 2) but a coverage ratio for its core group of loans that is significantly below 40 percent, additional loans should be selected to bring the coverage ratio for all loans reviewed to a minimum 40 percent.

Banking organizations with less than satisfactory composite supervisory ratings or other significant areas of supervisory concern should have loan coverage ratios of at least 55 to 60 percent to fully determine the financial condition of the organization. Any divergence from these guidelines should be fully documented in the confidential section of the examination report.

The examiner should use his or her conclusions from the review of the core group of loans to determine the extent to which additional loans should be selected for review, as these loans will provide the most up-to-date indications of the general condition of the bank's loan portfolio and the adequacy of the bank's credit-administration practices. For example, if the review of the core group of loans reveals that an undue proportion of a bank's problem assets are concentrated in a particular type of loan or if a portion of the portfolio is growing rapidly, the additional loans to be reviewed should be selected from that group.

In determining the extent of additional loans to be reviewed, the effectiveness of the bank's internal credit-review and -grading system should also be considered. If, for example, the examiner's review of the core group of loans provides essentially the same results as those from these systems, then the number and dollar size of the remaining sample reviewed can be kept relatively low (unless the review of the remaining sample raises questions about the integrity of the system with respect to the remaining portfolio).

In addition to the coverage ratio of the core group of loans, an examiner should take into

3. One approach to selecting the additional sample of loans to be reviewed is to lower the cutoff level of larger loans subject to review. Alternatively, other methods (including random sampling or selecting recent loans or specific loan types) may be used to select the sample when these methods appear more suited to the bank's circumstances.

4. A loan-review-coverage ratio should be calculated by dividing the dollar volume of commercial and industrial loans and commercial real estate loans reviewed during the examination by a bank's total dollar volume of such credits. For the purposes of this calculation, loans are defined as all sources of credit exposure arising from loans and leases, including guarantees, letters of credit, and other loan commitments. Credit exposures arising from trading and derivatives activities are not generally included in this coverage ratio.

account other factors, including the overall condition of the bank at its last examination and, most importantly, that examination's findings on the quality of the loan portfolio and the adequacy of loan-administration activities (that is, the accuracy of internal loan-rating systems, the appropriateness of underwriting standards, the adequacy of documentation in files, the adequacy of management information and internal control systems, and the adequacy of loan-loss reserves). Other important factors are the ability and experience of the lending officers and personnel managing the lending function, any changes in asset quality or lending policies since the last examination, and significant concentrations identified in the preliminary review of the loan portfolio. Regardless of the total coverage of the core-group review and the additional sample of loans, the examiner must select a sufficient number, volume, and variety of loans to accurately judge the condition of the bank's entire loan and lease portfolio and the effectiveness of its credit-administration policies and practices.

Commercial Loan Sampling Techniques

Sampling techniques are a valid and efficient method for reviewing the commercial loan portfolios at banks during on-site examinations. Sampling enables the examiner to draw conclusions regarding the condition of the entire loan portfolio by reviewing only a selected portion. These techniques make more efficient use of examination resources and allow examiners to devote more of their time and efforts to other areas of the examination.

Generally, a judgmental sampling technique is used for reviewing commercial loans. This technique enables examiners to evaluate the portfolio by reviewing a desired percentage of all the loans over a preselected cutoff amount. In addition to the judgmental sampling approach, statistical sampling techniques can also be valid methods for evaluating loan portfolios. Two statistical sampling techniques that may be selectively implemented during on-site examinations are attributes sampling and proportional sampling. Attributes sampling is especially well-suited for large banks that have formal loan review programs; proportional sampling may be better suited for smaller or regional banks without internal loan-review programs.

In statistical sampling, the examiner uses the concepts of probability to apply sampling techniques to the design, selection, and evaluation of loan samples. Statistical sampling eliminates (or at least minimizes) potential selection biases because each item in the sample-loan population must have an equal or otherwise determinable probability of being included in the examined portion. This probability provides the examiner with a quantitative, controllable measure of risk.

Generally, statistical sampling techniques may be implemented only in those banks (1) that were found to be in financially sound condition, (2) that were without any undue loan portfolio problems at the latest examination, and (3) where it was determined that the systems and controls were appropriate for implementing such techniques. Moreover, if during an examination, the examiner determines that the statistical sampling results are unsatisfactory, the traditional judgmental sampling technique should be implemented.

The two recommended statistical sampling techniques are described below:

- *Attributes Sampling.* The objective of attributes sampling is to determine from a sample, within specified reliability limits, the validity of the bank's internal loan-review program. The reliability limits are determined by the examiner, who formulates a hypothesis about the bank's loan-review program when evaluating its policies, practices, and procedures for loan extensions. The population to be sampled consists of all loans between certain dollar parameters, except for loans reviewed under the shared national credit program and loans to identified problem industries (the latter are reviewed separately during the examination). The lower dollar parameter is an amount that the examiner deems sufficient to achieve the desired coverage of the loan portfolio and is selected in much the same manner as a cutoff line is chosen in judgmental sampling. The upper dollar parameter is an amount over which all loans must be reviewed because of the significant effect each could have on the bank's capital. Loans are selected from the sample population by using a random digit table.

  When the selected loans are reviewed, the examiner compares his or her grading with those of the bank's loan-review program. An "error" generally exists if the examiner's grading of a particular loan is significantly more severe than the bank's grading. If the error rate in the sample is beyond the pre-established reliability limits the examiner is able to accept, all loans over the cutoff amount should be reviewed. If the examiner is satisfied with the sample results, the bank's internal grading will be accepted for all criticized loans that have not been independently reviewed within the sample population. Even when the bank's internal grading is deemed acceptable by the examiner, any loans reviewed and found to be in error will be appropriately classified in the report.

- *Proportional Sampling.* The procedures for proportional sampling are similar to those followed for attributes sampling. The objective of this sampling technique is to determine whether bank management can identify all the criticizable loans in the portfolio. The examiner formulates a hypothesis about the quality of the examined bank's loan administration, based on an analysis of loan policies, practices, and procedures for loan extensions. In proportional sampling, every loan in the sample population is given an equal chance of selection in proportion to its size, so the larger the loan, the more likely it will be selected for review. Examiners grade the loans in the sample and compare these gradings with the bank's problem-loan list.

  As in attributes sampling, the examiner specifies the desired precision of the sample, that is, that the true error rate in the bank's problem-loan list should be within a certain range of values. A statistical error occurs whenever the examiner criticizes a loan that is not criticized by the bank. If the error rate is higher than expected, the examiner will review all loans over a cutoff line, which is determined using the same criteria as line selection in judgmental sampling. If the sample results indicate an error rate within expectations, then the examiner will accept the bank's problem-loan list as a reliable list of the nonpass loans in the population from which the sample was taken. The examiner will then review and grade each loan on the problem-loan list over the cutoff amount.

For detailed procedures on how to implement both attributes and proportional sampling, examiners should contact either Reserve Bank supervision staff or Federal Reserve Board supervision staff.

REVIEWING CREDIT QUALITY

Importance of Cash Flow

Evaluating cash flow is the single most important element in determining whether a business has the ability to repay debt. Two principal methods of calculating the cash flow available in a business to service debt are presented in this subsection. The results of these methods should be used to determine the adequacy of cash flow in each credit evaluated at an institution. The accrual conversion method is the preferred method because it is the most reliable. The second and less reliable method is the supplemental or traditional cash-flow analysis; however, the information needed for this analysis is usually more obtainable and easier to calculate. The traditional method can be used when circumstances warrant, for example, when the borrower's financial statements are not sufficiently detailed for the information requested in the accrual conversion analysis or when historical information is inadequate.

Analysis and Limitations of Cash Flow

Cash-flow analysis uses the income statement and balance sheet to determine a borrower's operational cash flow. Careful analysis of all investment and financing (borrowing) activities must be made for an accurate assessment of cash flow. In reality, examiners face time constraints that often prevent them from performing the complex mathematical calculations involved in sophisticated cash-flow analysis. Therefore, the cash-flow methods presented below were designed to be reasonable and practical for examiner use. *However, examiners should be careful of conclusions reached using the traditional cash-flow analysis, without consideration to balance-sheet changes or other activities that affect cash flow. The traditional cash-flow analysis does not recognize growth in accounts receivable or inventory, a slow-down in accounts payable, capital expenditures, or additional borrowings.* If the credit file contains a CPA-prepared statement of cash flow or a statement prepared using the accrual conversion method, the examiner should concentrate efforts on reviewing and analyzing these statements rather than on preparing a traditional cash-flow statement.

One critical issue to remember is that deficit cash flow does not always mean that the borrower is encountering serious financial difficulties. In some cases, deficit cash flow is caused by a business's experiencing significant growth, and there is a pronounced need for external financing to accommodate this growth and eliminate the deficit cash-flow position. In this case, an adequate working-capital facility may not be in place to accommodate the need for additional inventory. A comprehensive analysis of changes in the balance sheet from period to period should be made before the loan is criticized.[5]

Components of the Accrual Conversion Method of Cash Flow

Category	*Basis for Amount*
Sales:	Dollar amount of sales in period
+/–change in A/R, INV., A/P:	Represents the absolute difference of the current period from the corresponding period of the previous year in accounts receivable, inventory, and accounts payable.
Formula:	(a) An increase in any current asset is a use of cash and is subtracted from the calculation. Conversely, a decrease in any current asset is a source of cash and is added to the calculation. (b) An increase in any current liability is a source of cash and is added to the calculation. Conversely, a decrease in any current liability is a use of cash and is subtracted from the calculation.
SGA:	Subtract selling, general, and administrative expenses.
Interest Expense:	Add interest expense to the calculation if SGA "expense" includes interest expense.
Excess (Deficit) Cash Flow:	Represents cash available before debt service.

5. Examiners should make sure that they are using financial data from consistent periods, that is, year-to-date financial information. Mixing annual financial data with interim financial information can cause misinterpretation of cash flow for a given business cycle or annual period.

Calculation of Supplemental/Traditional Cash Flow

Net Income:	Amount of net income reported on most recent annual income statement before taxes.
Interest Expense:	Add the total amount of interest expense for the period.
Depreciation/ Amortization:	Add all noncash depreciation and principal amortization on outstanding debt.
Cash Flow before Debt Service:	Indicates net Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA). Amortization should include both principal and interest payments required on debt.
Debt Service:	Subtract scheduled principal and interest payments.
Capital Expenditures:	Subtract all capital expenditures for the period.
EQUALS— Excess (Deficit) Cash Flow:	Total amount of excess or deficit cash flow for the period after debt service.
Coverage Ratio:	Cash flow before debt service divided by debt service (principal and interest).

Importance of Financial Analysis

While cash-flow analysis is critical in reviewing whether a borrower has the ability to repay individual debt, a review of the borrower's other financial statements can offer information about other sources of repayment, as well as the borrower's overall financial condition and future prospects. The availability of historical balance-sheet and income information, which allow declining trends to be identified, is critical. Also, it may be appropriate to compare the borrower's financial ratios with the average for the industry overall. Much of the financial information that examiners will review will not be audited; therefore, considerable understanding of general accounting principles is necessary to competently review an unaudited financial statement. The bank should obtain at least annual financial statements from a borrower.

When reviewing a credit file of a borrowing customer of a bank, the following financial information should be available for review: income statement, balance sheet, reconciliation of equity, cash-flow statements, and applicable notes to financial statements. The components for a financial review can be segregated into three areas: operations management, asset management, and liability management. Operations management is derived from the income statement and can be used to assess company sales, cost control, and profitability. Asset management involves the analysis of the quality and liquidity of assets, as well as the asset mix. Liability management covers the analysis of the company's record of matching liabilities to the asset conversion cycle, such as long-term assets being funded by long-term liabilities.

In studying the above forms of management, various ratios will help the examiner form an informed and educated conclusion about the quality of the credit being reviewed. The ratios can be divided into four main categories:

- *Profitability ratios.* These ratios measure management's efficiency in achieving a given level of sales revenue and profits, as well as management's ability to control expenses and generate return on investment. Examples of these ratios include gross margin, operating profit margin, net profit margin, profit to sales ratio, profit to total assets ratio, and direct cost and expense ratios.
- *Efficiency ratios.* These ratios, which measure management's ability to manage and control assets, include sales to assets, inventory days on hand, accounts receivable days on hand, accounts payable days on hand, sales to net fixed assets, return on assets, and return on equity.
- *Leverage ratios.* These ratios compare the funds supplied by business owners with the financing supplied by creditors, and measure debt capacity and ability to meet obligations. These ratios may include debt to assets, debt to net worth, debt to tangible net worth, and interest coverage.
- *Liquidity ratios.* Include ratios such as the current ratio and quick ratio, which measure the borrower's ability to meet current obligations.

Common "Red Flags"

The symptoms listed below are included to provide an understanding of the common problems or weaknesses examiners encounter in their review of financial information. While one symptom may not justify criticizing a loan, when symptoms are considered in the aggregate, they may help the examiner detect near-term trouble. This list is only a sampling of "red flags" that should prompt further review; examiners should also be able to identify issues that may require further investigation from their cursory review of a borrower's financial statement.

- *A slowdown in the receivables collection period.* This symptom often reveals that the borrower has become more liberal in establishing credit policies, has softened collection practices, or is encountering an increase in uncollected accounts.
- *Noticeably rising inventory levels in both dollar amount and percentage of total assets.* Increases in inventory levels are usually supported by trade suppliers, and financing these increases can be extremely risky, particularly if turnover ratios are declining. The increase in inventory levels or lower turnover ratios may also be related to the borrower's natural reluctance to liquidate excessive or obsolete goods at a reduced price. Many businesses are willing to sacrifice liquidity to maintain profit margins.
- *Slowdown in inventory turnover.* This symptom may indicate overbuying or some other imbalance in the company's purchasing policies, and it may indicate that inventory is slow-moving. If the inventory is undervalued, the actual turnover is even slower than the calculated results.
- *Existence of heavy liens on assets.* Evidence of second and third mortgage holders is a sign of greater-than-average risk. The cost of junior

money is high. Most borrowers are reluctant to use this source of funds unless conventional sources are unavailable.

- *Concentrations of noncurrent assets other than fixed assets.* A company may put funds into affiliates or subsidiaries for which the bank may not have a ready source of information on operations.
- *High levels of intangible assets.* Intangible assets, which shrink or vanish much more quickly than hard assets, usually have very uncertain values in the marketplace. In some cases, however, intangible assets such as patents or trademarks have significant value and should be given considerable credit.
- *Substantial increases in long-term debt.* This symptom causes increasing dependence on cash flow and long-term profits to support debt repayment.
- *A major gap between gross and net sales.* This gap represents a rising level of returns and allowances, which could indicate lower quality or inferior product lines. Customer dissatisfaction can seriously affect future profitability.
- *Rising cost percentages.* These percentages can indicate the business's inability or unwillingness to pass higher costs to the customer or its inability to control overhead expenses.
- *A rising level of total assets in relation to sales.* If a company does more business, it will take more current assets in the form of inventory, receivables, and fixed assets. Examiners should be concerned when assets are increasing faster than sales growth.
- *Significant changes in the balance-sheet structure.* These changes may not be the customary changes mentioned previously, but they are represented by marked changes spread across many balance-sheet items and may not be consistent with changes in the marketplace, profits or sales, product lines, or the general nature of the business.

REQUIRED MINIMUM DOCUMENTATION STANDARDS FOR LOAN LINE SHEETS

Certain minimum documentation must appear on all line examination sheets to leave an acceptable audit trail and to support the classification of designated loans. Currently, much of this information is often placed on the line ticket automatically by using computer-based loan-review systems. However, the disposition of the loan and the reasons for that disposition are the most crucial entries on the line ticket. Examiners must document their entries and decide how much of the documentation is required to support the loan-review decision. That decision and a summary of the reasons a loan is passed, listed for special mention, or adversely classified should be provided (preferably in bullet form) on the loan line ticket. Beyond that, the documentation will vary depending on the complexity and profile of the credit. The examiner may provide more detailed information on the collateral, cash flow, and repayment history. This additional information is not mandatory if the rationale for the disposition of the credit is otherwise clear.

The extension of credit line sheets and workpapers should document loan discussion comments, identify the examiner who reviewed the credit, and identify the officer(s) with whom the credit was discussed. Line sheets should also include the examiner's conclusion on the specific credit and the reasons for that conclusion.

As part of a review of examination and supervisory policies and procedures and to promote consistency, the items described below have been implemented as required minimum documentation standards for loan line sheets. These standards recognize a transactional approach in examinations and reflect the efficiencies inherent in a risk-focused approach to examinations. The amount of information that should be documented or included as part of a line sheet may vary depending on the type, complexity, and materiality of the credit. However, all line sheets should include the following information to satisfy the required minimum documentation standards, as set forth by SR-99-25 (''Minimum Documentation Standards for Loan Line Sheets,'' September 29, 1999). The first seven items are frequently provided through computer-based loan-review systems.

- *Name and location of borrower.* Document the name of the individual or company responsible for repayment of the debt.
- *Notation if the borrower is an insider or a related interest of an insider.* If the borrower is an insider or a related interest of the insider as defined by Regulation O, reflect this association on the line sheet.
- *Business or occupation.* Briefly describe the legal entity and the type of business in which the company is engaged, according to the

following definitions:

- *Corporation.* A business organization that is owned by shareholders who have no inherent right to manage the business. The organization is generally managed by a board of directors that is elected by the shareholders. The file should contain the borrowing resolution indicating which officers from the corporation are authorized to sign on its behalf. Indicate if the corporation is closely held.
- *Partnership.* A business organization, specifically, an association of two or more persons to carry on as co-owners of a business for profit. Indicate if it is a general partnership (GP) or limited partnership (LP). If GP, each partner is fully liable for the firm's debts and actions. If LP, at least one general partner is fully liable, but there will also be a number of partners whose liability is limited to that enumerated by the partnership agreement. Indicate each partner's proportionate interest (such as 25 or 50 percent).
- *Proprietorship.* A form of business organization that is owned and operated by an individual. If the borrower is an individual, include his or her primary occupation.

• *Loan terms.* Include the following loan information[6]:
  - date of origination (note subsequent renewals and/or extensions)
  - repayment terms (for example, maturity, periodic payments, revolving)
  - maturity (restructured loans should be noted as such)
  - interest rate (fixed or variable) (If variable, state the basis (index) upon which the interest rate is determined.)
  - originated amount of the loan

• *Purpose of loan.* Note the purpose of each credit facility.

• *Repayment source.* Indicate the primary and secondary sources of repayment for each credit facility.

• *Collateral summary and value.* Describe collateral and assess the value of the collateral in which the bank maintains a perfected security interest. Values should be supported by some type of document, such as a recent financial statement, formal appraisal, management estimate, or any publication that maintains a current market value of collateral. At a minimum, the collateral assessment should include the following information:
  - collateral value
  - basis for valuation
  - date of valuation
  - control of collateral
  - current lien status

• *Loan officer assigned to the credit and the internal rating of the credit.* Note the name of the loan officer responsible for the loan. Also document the bank's internal risk-rating. The date of the most recent update of the rating should also be noted. Particular attention should be given to the consistency between the loan classification at the current examination and the assessment provided by the bank's internal loan-review department. Significant disparities should be noted in the asset-quality assessment.

• *Total commitment and total outstanding balances.* Indicate the total amount of the bank's legal commitment or line of credit available to the borrower. Note the total outstanding debt to the borrower as of the date of examination.

• *Examination date.* Indicate the as-of date of the examination.

• *Past-due or nonaccrual status.* Indicate the past-due status (current, nonaccrual, and days past due).

• *Amounts previously classified.* Note the loan amount and how the loan was previously classified at the most recent examination (Federal Reserve Bank or state).

• *Loan disposition (pass, special mention, or adverse classification).* Note the credit amount and how the credit is being classified, such as pass, special mention, substandard, doubtful, or loss.

• *Rationale for examiner's conclusions (preferably in bullet form).* Indicate the reasons for passing the credit or extending it for criticism, which should be consistent with the classification descriptions noted in ''Classification of Credits,'' section 2060.1.

• *Name or initials of the examiner reviewing the credit.* Indicate the name or initials of the examiner who reviewed and assigned the classification to the credit.

• *Any significant comments by, or commitments from, management.* Clearly and specifically indicate relevant comments (including man-

6. If the loan is a shared national credit (SNC), this should be noted on the line sheet. A copy of the SNC write-up should be attached to the line sheet, and it is not necessary to provide any additional data.

agement's disagreement with the disposition of the loan, if applicable) that may be considered when determining whether or not to criticize the credit. Comments can include officer's comments noted in the credit file, information derived from discussions with management, questions the examiner may have about the borrower, or any other item deemed appropriate. If management plans to get out of the credit relationship, a workout strategy should be included in this section. Comments should be included as to why management disagrees with any loan classification or how any loan was classified.
- *Any noted documentation exceptions or loan-administration policy or procedural weaknesses, and any contravention of law, regulation, or policy.* Indicate any documentation exception or violation of law, regulation, or policy that would be appropriate to include as part of the report of examination. The examiner may include any technical exception noted from the credit file that would inhibit the ability of the loan officer or the examiner to make an informed and/or competent judgment about the quality of the credit relationship.

When needed, loan line sheets should briefly note that information is not available or that certain information is not reliable due to deficient loan-administration systems and processes, particularly with respect to loan and collateral documentation and collateral values. If such deficiencies are material, a listing of the exceptions should be noted in the examination report. In addition, the effect of these loan-administration weaknesses should be discussed and factored into the risk-management rating.

Optional Information for Loan Line Sheets

In addition to the above information, additional items should be listed when needed to describe the terms of the credit and/or the disposition accorded to it by the examiners, for example, guarantors, amount of any specific reserve, or amounts previously charged off, as described below:

- *Related debt/tie-ins.* The name, total debt outstanding, and type of borrowings (such as real estate, commercial, installment debt) of the related party might be indicated.
- *Guarantor(s).* If a guarantor exists, the name, amount of the guaranty, and date the guaranty was signed can be noted. A summary and an assessment of data supporting a guaranty may also be included, along with current financial information from the guarantor(s) which the bank should obtain at least annually. Tax returns and supporting schedules, income statements, and other pertinent information on the guarantor(s) may be appropriate under certain circumstances. If a troubled credit, indicate whether the guarantor has exhibited any willingness to financially support the credit.
- *Summary of financial data.* The following information may be appropriate, based on the type and complexity of the loan:
  - — key balance-sheet information (current ratio, D/E ratio)
  - — key income items (EBITDA—earnings before income taxes, depreciation, and amortization; net income; profit margin)
  - — cash-flow coverage (debt-service coverage, interest coverage)
  - — source of financial data (company-prepared balance sheet, audited financial statement)
- *Dates and amounts of previous charge-offs.*
- *Specific reserves.* The examiner may indicate whether an amount (allocated reserve) was specifically set aside to absorb any loss from the credit. When evaluating the overall adequacy of the loan-loss reserve, subtract the aggregate of allocated reserves from the total reserve balance, and subtract the aggregate amount of loans for which allocated reserves exist from the total loan balance.
- *The name of the loan officer who may have offered the most pertinent discussion items that affected the classification decision.*

BANKRUPTCY LAW AND COMMERCIAL LOANS

This section provides examiners with an overview of the United States Bankruptcy Code (the code) chapters that affect commercial and industrial loans. Bankruptcy law is a significant body of law; it would be difficult in this manual to discuss all the issues necessary for comprehensive understanding of the code. This subsection will focus on basic issues that an examiner needs to be familiar with relative to three principal sections of the code: chapters 7, 11, and 13.

Creditors of a Bankrupt Business

A creditor in bankruptcy is anyone with a claim against a bankrupt business, even if a formal claim is not filed in the bankruptcy case. In bankruptcy court, a claim is defined very broadly. A claim may include a right to payment from a bankrupt business, a promise to perform work, or a right to a disputed payment from the debtor that is contingent on some other event. The two basic types of creditors are secured and unsecured. Secured creditors are those with perfected security interest in specific property, such as equipment, accounts receivable, or any other asset pledged as collateral on a loan. Unsecured creditors are generally trade creditors and others who have not taken a specific interest in property supplied to the bankrupt debtor.

Voluntary Versus Involuntary Bankruptcy

When a debtor files a bankruptcy petition, it is described as a voluntary bankruptcy filing. The individual or organization does not have to be insolvent to file a voluntary case. Creditors may also file a bankruptcy petition, in which case the proceeding is known as an involuntary bankruptcy. This form of petition can occur in chapters 7 and 11 bankruptcy cases, and the debtor generally must be insolvent. To be deemed insolvent, the debtor must be unable to pay debts as they mature. However, the code does limit who an involuntary action can be sought against.

Chapter 7—Liquidation Bankruptcy

A chapter 7 action may be filed by virtually any person or business organization that is eligible to file bankruptcy. Chapter 7 bankruptcy can be filed by a sole proprietorship, partnership, corporation, joint stock company, or any other business organization. Restrictions apply to only a few highly regulated businesses, such as railroads, insurance companies, banks, municipalities, and other financial institutions. This chapter is often referred to as ‘‘straight liquidation,’’ or the orderly liquidation of all assets of the entity. Generally, a debtor in a chapter 7 bankruptcy case is released from obligations to pay all dischargeable prebankruptcy debts in exchange for surrendering all nonexempt assets to a bankruptcy trustee. The trustee liquidates all assets and distributes the net proceeds on a pro rata basis against the allowed claims of unsecured creditors. Secured creditor claims are generally satisfied by possession or sale of the debtor’s assets. Depending on the circumstances, a secured creditor may receive the collateral, the proceeds from the sale of the collateral, or a reaffirmation of the debt from the debtor. The reaffirmed debts are generally secured by property that the debtor can exempt from the bankruptcy estate, such as a home or vehicle. The amount of the reaffirmation is limited to the value of the asset at the time of the bankruptcy filing. Some characteristics of a chapter 7 bankruptcy are described below:

- A trustee is appointed in all chapter 7 bankruptcies and acts as an administrator of the bankruptcy estate. The bankruptcy estate that is established when the petition is filed becomes the legal owner of the property. The trustee acts to protect the interest of all parties affected by the bankruptcy.

- The trustee has control of all nonexempt assets of the bankrupt debtor.
- The trustee is required to liquidate the estate quickly without jeopardizing the interests of the affected parties.
- The proceeds from the sale pay trustee's fees and other creditors. Trustee fees are determined according to the amount disbursed to the creditors and are a priority claim.
- A chapter 7 bankruptcy is typically completed in 90 days, depending on the time needed to liquidate collateral. Some chapter 7 bankruptcies take years to complete.
- The court may allow the trustee to continue to operate a business, if this is consistent with the orderly liquidation of the estate.

Chapter 11—Reorganization

Most major or large businesses filing bankruptcy file a chapter 11 reorganization. As in chapter 7, virtually any business can file a chapter 11 reorganization. There are specialized chapter 11 reorganization procedures for certain businesses such as railroads, and chapter 11 is not available to stockbrokers, commodity brokers, or a municipality. The basic concept behind chapter 11 is that a business gets temporary relief or a reprieve from paying all debts owed to creditors. This temporary relief gives the business time to reorganize, reschedule its debts (at least partially), and successfully emerge from bankruptcy as a viable business. The basic assumption underlying a chapter 11 bankruptcy is that the value of the enterprise as a going concern will usually exceed the liquidation value of its assets.

Reorganization Plan

Generally, the debtor has an exclusive 120-day period to prepare and file a reorganization plan. If the debtor's plan has not been confirmed within 180 days of the bankruptcy filing, a creditor may file a plan. A plan can provide for any treatment of creditor claims and equity interest, as long as it meets the requirements set out in the code. For example, a plan must designate substantially similar creditor claims and equity interest into classes and provide for equal treatment of such class members. A plan must also identify those classes with impaired claims and their proposed treatment. Finally, a method of implementation must be provided. Although plans do not have to be filed by a deadline, the bankruptcy judge will generally place a deadline on the debtor or creditor authorized to prepare the plan.

Some characteristics of a chapter 11 bankruptcy are described below.

- The bankrupt debtor usually controls the business during the bankruptcy proceedings. This arrangement is referred to as "debtor in possession."
- The business continues to operate while in bankruptcy.
- The debtor is charged with the duty of developing a reorganization plan within the first 120 days of the filing. After this period expires, the court may grant this authority to a creditors' committee.
- Once the plan is approved by the bankruptcy court, the debtor's payment of debts is generally limited to the schedule and amounts that are detailed in the reorganization plan.
- A chapter 11 proceeding can be complex and lengthy, depending on the number of creditors, amount of the debts, amount of the assets, and other factors that complicate the proceedings.

Chapter 13—Wage-Earner Bankruptcy

A chapter 13 bankruptcy is available to any individual whose income is sufficiently stable and regular to enable him or her to make payments under the plan. As long as the individual has regular wages or takes a regular draw from his or her business, the individual may qualify under chapter 13 of the code. Under chapter 13, an individual or married couple can pay their debts over time without selling their property. As a protection to creditors, the money paid to a creditor must equal or exceed the amount that the creditor would get in a liquidation or chapter 7 bankruptcy. Chapter 13 may be used for a business bankruptcy, but only if the business is a proprietorship. In most cases, the business needs to be fairly small to qualify.

Some characteristics of a chapter 13 bankruptcy are described below:

- In most cases, only an individual can file a chapter 13 bankruptcy.
- Secured debt may not exceed $350,000.
- Unsecured debt may not exceed $100,000.
- The debtor must propose a good-faith plan to repay as many debts as possible from available income.
- A debtor makes regular payments to a trustee, who disburses the funds to creditors under the terms of the plan.
- The trustee does not control the debtor's assets.
- A chapter 13 bankruptcy may include the debts of a sole proprietorship. The business may continue to operate during the bankruptcy.
- After all payments are made under the plan, general discharge is granted.

SECTIONS 23A AND 23B OF THE FEDERAL RESERVE ACT

As a result of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), the application of sections 23A and 23B of the Federal Reserve Act was expanded to all federally insured commercial and thrift depository institutions. The passage of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) affected section 23A by allowing the appropriate federal regulator to revoke the ''sister bank'' exemption for all financial institutions that are ''significantly undercapitalized'' or those that are ''undercapitalized'' and fail to submit and implement capital-restoration plans. In addition, FDICIA prohibits critically undercapitalized banks from engaging in covered transactions that are defined in section 23A without prior written approval from the FDIC. Section 23B was added to the Federal Reserve Act on August 10, 1987, through the Competitive Equality Banking Act of 1987. This new section essentially codified additional limitations regarding transactions banks have with their nonbank affiliates. Previously, these transactions had been governed only by Federal Reserve policy or interpretation. The intent of this subsection is to provide examiners with general guidance on how to identify potential violations of these sections of the Federal Reserve Act as it pertains to the commercial-lending function. (Specific guidance and definitions can be obtained from part 1 of the *Federal Reserve Regulatory Service*.)

Section 23A

Section 23A of the Federal Reserve Act was designed to prevent misuse of a bank's resources stemming from non-arm's-length transactions with affiliates. Examiners will first need to determine if the institution and counterparty involved in a transaction are affiliates. Once this relationship is determined, the examiner will need to decide if the transaction is included in the statute as a ''covered transaction.'' Generally, covered transactions within the lending function of the institution would include any loan or extension of credit to an affiliate as defined by section 23A. Any transaction by a bank with any person is deemed to be a transaction with an affiliate to the extent that the affiliate benefited from the transaction. A key element of section 23A is that covered transactions between a bank and its affiliate must be on terms and conditions consistent with safe and sound banking practices.

Once the examiner has determined that the counterparty is an affiliate and that the transaction is a covered transaction, there are quantitative limitations that apply. Section 23A limits the covered transaction between a bank and its affiliate to no more than 10 percent of the bank's capital and surplus (defined as capital stock, surplus, retained earnings, and reserves for loan losses). In addition, an institution and its subsidiaries may only engage in a covered transaction with an affiliate if, in the case of all affiliates, the aggregate amount of the covered transactions of the institution and its subsidiaries will not exceed 20 percent of the capital stock and surplus of the institution.

When the transaction involves an extension of credit to a defined affiliate, certain collateral requirements must also be met. Generally, extensions of credit require certain collateral margins that are tied to the type of collateral. For example, extensions of credit that are secured by U.S. Treasury securities or its agencies require a collateral margin of 100 percent of the transaction amount, whereas collateral consisting of stock, leases, or other real or personal property requires a margin of 130 percent. Some collateral, such as the obligations of an affiliate, is not eligible. Certain exemptions to collateral requirements were included to permit transactions that posed little risk to the bank and to prevent undue hardship among the affiliated organizations in carrying out customary transactions with related entities. These exemptions include various transactions that are related to sister-bank relationships, correspondent relationships, uncollected items, or loans to affiliates secured by riskless collateral.

Section 23B

With respect to affiliates, section 23B defines affiliates in the same manner as section 23A, except that all banks are excluded from section 23B as affiliates. The principal requirements of section 23B state that any transaction between a bank and a defined affiliate under the act must be (1) on terms and under circumstances, including credit standards, that are substantially the same, or at least as favorable to the bank or its subsidiary, as those prevailing at the time for comparable transactions with or involving other nonaffiliated companies, or (2) in the absence of comparable transactions, on terms and under circumstances, including credit standards, that in good faith would be offered or would apply to nonaffiliated companies. In short, the terms and conditions of an extension of credit to an affiliate under section 23B should be no more favorable than those that would be extended to any other borrowing customer of the bank. For covered transactions, all transactions that are covered under section 23A are covered under section 23B; however, section 23B expanded the list to include other transactions such as the sale of securities or the receipt of money or services from an affiliate.

The focus of section 23B is different from that of section 23A. Section 23A contains quantitative and collateral restrictions to protect the bank; section 23B focuses on whether transactions with nonbank affiliates are arm's length and not injurious to the bank. Occasionally, an extension of credit, by definition, is granted to an affiliate of a federally insured bank or thrift institution, so examiners are reminded that it is likely that sections 23A and 23B will be implicated. Essentially, examiners need to keep one basic principal in mind: If money flows from the bank to an affiliate other than through a dividend, the transaction is probably a covered transaction and would be enforceable under sections 23A and 23B.

TIE-IN ARRANGEMENTS

Section 106(b) of the Bank Holding Company Act Amendments of 1970 prohibits banks from directly tying products or services offered by the bank or any of its affiliates. In the typical tie-in arrangement, whether or not credit is extended or a service is provided (or the amount charged for the credit or service) depends upon the customer's obtaining some additional product or service from the bank or its affiliate or providing some additional product or service to the bank or its affiliate. The intent of section 106(b) was to affirm the principles of fair competition by eliminating the use of tie-in arrangements that suppress competition. Specifically, the section prevents banks from using their marketing power over certain products, specifically credit, to gain an unfair competitive advantage. There are two exceptions to the anti-tying restrictions. The bank may vary the consideration charged for a traditional bank product on the condition or requirement that a customer also obtain a traditional bank product from an affiliate. This exception is a limited extension of the traditional bank product exception provided in section 106. The second exception applies to securities brokerage services (only those activities authorized under section 225.28(b)(7) of Regulation Y). A bank may vary the consideration charged for securities brokerage services on the condition that a customer also obtain a traditional bank product from that bank or its affiliate.

On April 19, 1995, the Board issued a final rule on the anti-tying provisions of section 106 of the 1970 Bank Holding Company Act Amendments. The rule establishes a ''combined-balance discount'' safe harbor for a banking organization offering varieties of services to its customers and wishing to offer them discounts based on the customers' overall relationship with the bank or its holding company and subsidiaries. The amendment, effective May 26, 1995, provides that a bank holding company or any bank or nonbank subsidiary thereof may weight products as it sees fit in connection with its evaluation of combined-balance discount arrangements, so long as deposits receive an equal or higher weight than other products. The new rule expanded the Board's recent exemption to a large regional banking organization to all banking organizations tying traditional services, such as checking accounts and nontraditional banking products like brokerage services. It permits banks to market products more efficiently and compete more effectively with their nonbanking competitors who currently offer combined-balance discount arrangements.

Examiners should be aware that the principal motive of section 106(b) is to eliminate any potential for ''arm twisting'' customers into buying some other product to get the product they desire. Examiners should focus on potentially illegal tie-in arrangements by reviewing (1) the banking organization's internal controls and procedures and its written policies and procedures in this area; (2) the training provided to the organization's staff; (3) pertinent extensions of credit to borrowers whose credit facilities or services may be susceptible to improper tie-in arrangements imposed by the bank or company in violation of section 106(b) or the Board's regulations; and (4) where applicable, the firewalls that have been established between banks and their holding companies and nonbank affiliates, including section 20 subsidiaries.

1. To determine if lending policies, practices, procedures, and internal controls for commercial and industrial loans are adequate.
2. To determine if bank officers are operating in conformance with the established guidelines.
3. To evaluate the portfolio for credit quality, performance, collectibility, and collateral sufficiency.
4. To determine the scope and adequacy of the audit function.
5. To determine compliance with applicable laws and regulations.
6. To initiate corrective action when policies, practices, procedures, objectives, or internal controls are deficient or when violations of laws or regulations have been noted.

1. If selected for implementation, complete or update the commercial loan section of the internal control questionnaire.
2. On the basis of the evaluation of internal controls and the work performed by internal or external auditors, determine the scope of the examination.
3. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examination procedures. Also obtain a listing of any deficiencies noted in the latest review done by internal or external auditors, and determine if corrections have been accomplished.
4. Obtain a trial balance of the customer liability records.
   a. Agree or reconcile balances to department controls and the general ledger.
   b. Review reconciling items for reasonableness.
5. Using an appropriate technique, select borrowers for examination. Prepare credit line cards.
6. Obtain the following information from the bank or other examination areas, if applicable:
   a. past-due loans
   b. loans in a nonaccrual status
   c. loans on which interest is not being collected in accordance with the terms of the loan (Particular attention should be given to loans that have been renewed with interest being rolled into principal.)
   d. loans whose terms have been modified by a reduction of interest-rate or principal payment, by a deferral of interest or principal, or by other restructuring of repayment terms
   e. loans transferred, either in whole or in part, to another lending institution as a result of a sale, participation, or asset swap since the previous examination
   f. loans acquired from another lending institution as a result of a purchase, participation, or asset swap since the previous examination
   g. loan commitments and other contingent liabilities
   h. loans secured by stock of other depository institutions
   i. extensions of credit to employees, officers, directors, and principal shareholders and their interests, specifying which officers are considered executive officers
   j. extensions of credit to executive officers, directors, and principal shareholders and their interests of correspondent banks
   k. a list of correspondent banks
   l. miscellaneous loan-debit and credit-suspense accounts
   m. Shared National Credits
   n. loans considered ‘‘problem loans’’ by management
   o. specific guidelines in the lending policy
   p. each officer’s current lending authority
   q. any useful information resulting from the review of the minutes of the loan and discount committee or any similar committee
   r. reports furnished to the loan and discount committee or any similar committee
   s. reports furnished to the board of directors
   t. loans classified during the previous examination
   u. the extent and nature of loans serviced
7. Review the information received, and perform the following procedures.
   a. *Loans transferred, either in whole or in part, to or from another lending institution as a result of a participation, sale or purchase, or asset swap.*
      - Participations only:
        — Test participation certificates and records, and determine that the parties share in the risks and contractual payments on a pro rata basis.
        — Determine that the bank exercises similar controls and procedures over loans serviced for others as for loans in its own portfolio.
        — Determine that the bank, as lead or agent in a credit, exercises similar controls and procedures over syndications and participations sold as for loans in its own portfolio.
      - Procedures pertaining to all transfers:
        — Investigate any situations in which loans were transferred immediately before the date of examination to determine if any were trans-

ferred to avoid possible criticism during the examination.

— Determine whether any of the loans transferred were either nonperforming at the time of transfer or classified at the previous examination.
— Determine that the consideration received for low-quality loans transferred from the bank to an affiliate is properly reflected on the bank's books and is equal to the fair market value of the transferred loans. (While fair market value may be difficult to determine, it should at a minimum reflect both the rate of return being earned on such loans as well as an appropriate risk premium.) Section 23A of the Federal Reserve Act generally prohibits a state member bank from purchasing a low-quality asset.
— Determine that low-quality loans transferred to the parent holding company or a nonbank affiliate are properly reflected at fair market value on the books of both the bank and its affiliate.
— If low-quality loans were transferred to or from another lending institution for which the Federal Reserve is not the primary regulator, prepare a memorandum to be submitted to Reserve Bank supervisory personnel. The Reserve Bank will then inform the local office of the primary federal regulator of the other institution involved in the transfer. The memorandum should include the following information, as applicable:
  (1) name of originating institution
  (2) name of receiving institution
  (3) type of transfer (i.e., participation, purchase or sale, swap)
  (4) date of transfer
  (5) total number of loans transferred
  (6) total dollar amount of loans transferred
  (7) status of the loans when transferred (e.g., nonperforming, classified, etc.)
  (8) any other information that would be helpful to the other regulator

b. *Miscellaneous loan-debit and credit-suspense accounts.*
   - Discuss with management any large or old items.
   - Perform additional procedures as deemed appropriate.

c. *Loan commitments and other contingent liabilities.* Analyze the commitment or contingent liability if the borrower has been advised of the commitment and the combined amount of the current loan balance (if any) and the commitment or other contingent liability exceeds the cutoff.

d. *Loans classified during the previous examination.*
   - current balance and payment status, or
   - date the loan was repaid and the source of payment

   Investigate any situations in which all or part of the funds for the repayment came from the proceeds of another loan at the bank, or as a result of a participation, sale, or swap with another lending institution. If repayment was a result of a participation, sale, or swap, refer to step 7a of this section for the appropriate examination procedures.

e. *Review of leveraged buyouts.*
   - In evaluating individual loans and credit files, pay particular attention to the reasonableness of interest-rate assumptions and earnings projections relied on by the bank in extending the loan; the trend of the borrowing company's and the industry's performance over time and the history and stability of the company's earnings and cash flow, particularly over the most recent business cycle; the relationship between the company's cash-flow and debt-service requirements and the resulting margin of debt-service coverage; and the reliability and stability of collateral values and the adequacy of collateral coverage.
   - In reviewing the performance of individual credits, attempt to determine if debt-service requirements are being covered by cash flow generated by the company's operations or whether the debt-service requirements are being met out of the proceeds of additional or ancillary loans from the bank designed to cover interest changes.

- Review policies and procedures pertaining to leveraged buyout financing to ensure that they incorporate prudent and reasonable limits on the total *amount* and *type* (by industry) of exposure that the bank can assume through these financing arrangements.
- Review the bank's pricing, credit policies, and approval procedures to ensure that rates are reasonable in light of the risks involved and that credit standards are not compromised in order to increase market share. Credit standards and internal review and approval standards should reflect the degree of risk and leverage inherent in these transactions.
- Total loans to finance leveraged buyouts should be treated as a potential concentration of credit. If, in the aggregate, these loans are sufficiently large in relation to capital, the loans should be listed on the concentrations page in the examination report.
- Discuss significant deficiencies or risks regarding a bank's leveraged buyout financing on page 1 of the examination report, and bring them to the attention of the board of directors.

f. *Uniform review of Shared National Credits.*
   - Compare the schedule of commercial credits included in the uniform review of the Shared National Credit Program with the loans being reviewed to determine which loans are portions of Shared National Credits.
   - For each loan so identified, transcribe appropriate information from the schedule to line cards. (No further examination procedures are necessary for these credits.)

8. Consult with the examiner responsible for the asset/liability management analysis to determine the appropriate maturity breakdown of loans needed for the analysis. If requested, compile the information using bank records or other appropriate sources. See "Instructions for the Report of Examination," section 6000.1, for considerations to be taken into account when compiling maturity information for the gap analysis.
9. Transcribe or compare information from the schedules to commercial line cards, where appropriate.
10. Prepare commercial line cards for any loan not in the sample that, based on information derived from the above schedules, requires in-depth review.
11. Obtain liability and other information on common borrowers from examiners assigned to cash items, overdrafts, lease financing, and other loan areas, and together decide who will review the borrowing relationship.
12. Add collateral data to line cards selected in the preceding steps.
13. Obtain credit files for all borrowers for whom commercial line cards were prepared, and complete line cards. To analyze the loans, perform the following procedures:
    a. Analyze balance-sheet and profit-and-loss items as reflected in current and preceding financial statements, and determine the existence of any favorable or adverse trends.
    b. Review components of the balance sheet as reflected in the current financial statements, and determine the reasonableness of each item as it relates to the total financial structure.
    c. Review supporting information for the major balance-sheet items and the techniques used in consolidation, if applicable, and determine the primary sources of repayment and evaluate their adequacy.
    d. Ascertain compliance with provisions of loan agreements.
    e. Review digests of officers' memoranda, mercantile reports, credit checks, and correspondence to determine the existence of any problems that might deter the contractual liquidation program.
    f. Relate collateral values to outstanding debt.
    g. Compare interest rates charged with the interest-rate schedule, and determine that the terms are within established guidelines.
    h. Compare the original amount of loan with the lending officer's authority.
    i. Analyze secondary support afforded by guarantors and endorsers.
    j. Ascertain compliance with the bank's established commercial loan policy.
    k. Determine whether public officials are receiving preferential treatment and

whether there is any correlation between loans to public officials and deposits they may control or influence.

14. For selected loans, check the central liability file on borrowers indebted above the cutoff or borrowers displaying credit weakness or suspected of having additional liability in other loan areas.
15. Transcribe significant liability and other information on officers, principals, and affiliations of appropriate borrowers contained in the sample. Cross-reference line cards to borrowers, where appropriate.
16. Prepare "Report of Loans Supported by Bank Stock," if appropriate. Determine if a concentration of any bank's stock has been pledged.
17. Determine compliance with laws, rulings, and regulations pertaining to commercial lending by performing the following steps.
    a. *Lending limits.*
       - Determine the bank's lending limits as prescribed by state law.
       - Determine advances or combinations of advances with aggregate balances above the limit, if any.
    b. *Section 23A, Relations with Affiliates (12 USC 371c), and section 23B, Restrictions on Transactions with Affiliates (12 USC 371c-1), of the Federal Reserve Act, and Regulation W.*
       - Obtain a listing of loans to affiliates.
       - Test-check the listing against the bank's customer liability records to determine its accuracy and completeness.
       - Obtain a listing of other covered transactions with affiliates (i.e., purchase of loans from affiliates or acceptance of affiliates' securities as collateral for loan to any person).
       - Ensure that covered transactions with affiliates do not exceed the limits of section 23A and Regulation W.
       - Ensure that covered transactions with affiliates meet the appropriate collateral requirements of section 23A and Regulation W.
       - Determine that low-quality loans have not been purchased from an affiliate.
       - Determine that all covered transactions with affiliates are on terms and conditions that are consistent with safe and sound banking practices.
       - Determine that all transactions with affiliates comply with the market-terms requirement of section 23B and Regulation W.
    c. *18 USC 215, Receipt of Commission or Gift for Procuring Loans.*
       - While examining the commercial loan area, determine the existence of any possible cases in which a bank officer, director, employee, agent, or attorney may have received anything of value for procuring or endeavoring to procure any extension of credit.
       - Investigate any such suspected situation.
    d. *Federal Election Campaign Act (2 USC 441b), Political Contributions.*
       - While examining the commercial loan area, determine the existence of any loans in connection with any political campaigns.
       - Review each such credit to determine whether it is made in accordance with applicable banking laws and in the ordinary course of business.
    e. *12 USC 1972, Tie-In Provisions.* While reviewing credit and collateral files (especially loan agreements), determine whether any extension of credit is conditioned upon—
       - obtaining or providing an additional credit, property, or service to or from the bank or its holding company (or a subsidiary of its holding company), other than a loan, discount, deposit, or trust service;
       - the customer not obtaining a credit, property, or service from a competitor of the bank or its holding company (or a subsidiary of its holding company), other than a reasonable condition to ensure the soundness of the credit. (See "Tie-In Considerations of the BHC Act," section 3500.0 of the *Bank Holding Company Supervision Manual*.)
    f. *Insider lending activities.* The examination procedures for checking compliance with the relevant law and regulation covering insider lending activities and reporting requirements are as follows (the examiner should refer to the appropriate sections of the statutes for specific definitions, lending limitations, reporting requirements, and conditions indicating preferential treatment):

- *Regulation O (12 CFR 215), Loans to Executive Officers, Directors, and Principal Shareholders and Their Related Interests.* While reviewing information relating to insiders that is received from the bank or appropriate examiner (including loan participations, loans purchased and sold, and loan swaps)—
  — test the accuracy and completeness of information about commercial loans by comparing it with the trial balance or loans sampled;
  — review credit files on insider loans to determine that required information is available;
  — determine that loans to insiders do not contain terms more favorable than those afforded other borrowers;
  — determine that loans to insiders do not involve more than normal risk of repayment or present other unfavorable features;
  — determine that loans to insiders, as defined by the various sections of Regulation O, do not exceed the lending limits imposed by those sections;
  — if prior approval by the bank's board was required for a loan to an insider, determine that such approval was obtained;
  — determine compliance with the various reporting requirements for insider loans;
  — determine that the bank has made provisions to comply with the public disclosure requirements of Regulation O; and
  — determine that the bank maintains records of such public requests and the disposition of the requests for a period of two years after the dates of the requests.
- *Title VIII of the Financial Institutions Regulatory and Interest Rate Control Act of 1978 (FIRA) (12 USC 1972(2)), Loans to Executive Officers, Directors, and Principal Shareholders of Correspondent Banks.*
  — Obtain from or request that the examiners reviewing due from banks and deposit accounts verify a list of correspondent banks provided by bank management, and ascertain the profitability of those relationships.
  — Determine that loans to insiders of correspondent banks are not made on preferential terms and that no conflict of interest appears to exist.

g. *12 USC 1828(v), Loans Secured by Bank Stock.*
  - While examining the commercial loan area, determine the existence of any loans or discounts that are secured by the insured financial institution's own stock.
  - In each case, determine that the chief executive officer has promptly reported such fact to the proper regulatory authority.

h. *12 USC 83 (Rev. Stat. 5201), made applicable to state member banks by section 9, para. 6, of the Federal Reserve Act (12 USC 324), Loans Secured by Own Stock (see also 3-1505 in the* Federal Reserve Regulatory Service).
  - While examining the commercial loan area, determine the existence of any loans secured by the bank's own shares or capital notes and debentures.
  - Confer with the examiner assigned to investment securities to determine whether the bank owns any of its own shares or its own notes and debentures.
  - In each case in which such collateral or ownership exists, determine whether the collateral or ownership was taken to prevent loss on a debt previously contracted (DPC) transaction.

i. *Regulation U (12 CFR 221).* While reviewing credit files, check the following for all loans that are secured directly or indirectly by margin stock and that were extended for the purpose of buying or carrying margin stock:
  - Except for credits specifically exempted under Regulation U, determine that the required Form FR U-1 has been executed for each credit by the customer and that it has been signed and accepted by a duly authorized officer of the bank acting in good faith.
  - Determine that the bank has not extended more than the maximum loan value of the collateral securing such credits, as set by section 221.7 of Regulation U, and that the margin requirements are being maintained.

j. *Financial Recordkeeping and Reporting of Currency and Foreign Transactions (31 CFR 103), Retention of Credit Files.*
   - Determine compliance with other specific exceptions and restrictions of the regulation as they relate to the credits reviewed.
   - Review the operating procedures and credit file documentation, and determine if the bank retains records of each extension of credit over $10,000, specifying the name and address of the borrower, the amount of credit, the nature and purpose of the loan, and the date thereof. (See 31 CFR 103.33.) (Loans secured by an interest in real property are exempt.)

18. Determine whether the consumer compliance examination uncovered any violations of law or regulation in this department. If violations were noted, determine whether corrective action was taken. Test for subsequent compliance with any law or regulation so noted.
19. Perform the appropriate procedural steps in ''Concentration of Credits,'' section 2050.3.
20. Discuss with appropriate officers, and prepare summaries in appropriate report form of—
    a. delinquent loans
    b. violations of laws and regulations
    c. loans not supported by current and complete financial information
    d. loans on which collateral documentation is deficient
    e. concentrations of credits
    f. criticized loans
    g. inadequately collateralized loans
    h. Small Business Administration or other government-guaranteed delinquent or criticized loans
    i. transfers of low-quality loans to or from another lending institution
    j. extensions of credit to principal shareholders, employees, officers, directors, and related interests
    k. other matters regarding the condition of the department
21. Inform the Reserve Bank of all criticized participation loans that are not covered by the Shared National Credit Program. Include the names and addresses of all participating state member banks and copies of loan classification comments. (This step deals with loans that deteriorated subsequent to participation and does not duplicate step 7a, which deals with transfers of loans that were of low quality when transferred).
22. Inform the Reserve Bank of those loans eligible for the Shared National Credit Program that were not previously reviewed. Include the names and addresses of all participants and the amounts of their credit. (This step applies only to credits for which the bank under examination is the lead bank.)
23. Evaluate the function for—
    a. the adequacy of written policies relating to commercial loans,
    b. the manner in which bank officers are operating in conformance with established policy,
    c. adverse trends within the commercial loan department,
    d. the accuracy and completeness of the schedules obtained from the bank,
    e. internal control deficiencies or exceptions,
    f. recommended corrective action when policies, practices, or procedures are deficient,
    g. the competency of departmental management, and
    h. other matters of significance.
24. Update the workpapers with any information that will facilitate future examinations.

Review the bank's internal controls, policies, practices, and procedures for making and servicing commercial loans. The bank's system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flow charts, copies of forms used, and other pertinent information. Items marked with an asterisk require substantiation by observation or testing.

POLICIES

1. Has the board of directors, consistent with its duties and responsibilities, adopted written commercial loan policies that:
   a. Establish procedures for reviewing commercial loan applications?
   b. Define qualified borrowers?
   c. Establish minimum standards for documentation?
2. Are commercial loan policies reviewed at least annually to determine if they are compatible with changing market conditions?

RECORDS

*3. Is the preparation and posting of subsidiary commercial loan records performed or reviewed by persons who do not also:
   a. Issue official checks or drafts?
   b. Handle cash?
   c. Approve loans?
   d. Reconcile subsidiary records to the general ledger?

*4. Are the subsidiary commercial loan records reconciled daily with the appropriate general ledger accounts, and are reconciling items investigated by persons who do not also handle cash?

5. Are delinquent account collection requests and past-due notices checked to the trial balances that are used in reconciling commercial loan subsidiary records with general ledger accounts, and are they handled only by persons who do not also handle cash?
6. Are inquiries about loan balances received and investigated by persons who do not also handle cash?

*7. Are documents supporting recorded credit adjustments checked or tested subsequently by persons who do not also handle cash (if so, explain briefly)?

8. Is a daily record maintained summarizing note transaction details, i.e., loans made, payments received, and interest collected, to support applicable general ledger account entries?
9. Are frequent note and liability ledger trial balances prepared and reconciled with controlling accounts by employees who do not process or record loan transactions?
10. Is an overdue account report generated frequently (if so, how often ___________)?
11. Are subsidiary payment records and files pertaining to serviced loans segregated and identifiable?
12. Do loan records provide satisfactory audit trails which permit the tracing of transactions from initiation to final disposition?

LOAN INTEREST

*13. Is the preparation and posting of interest records performed or reviewed by persons who do not also:
   a. Issue official checks or drafts?
   b. Handle cash?

14. Are any independent interest computations made and compared or tested to initial interest record by persons who do not also:
   a. Issue official checks or drafts?
   b. Handle cash?

COLLATERAL

15. Are multicopy, prenumbered records maintained that:
   a. Detail the complete description of collateral pledged?
   b. Are typed or completed in ink?
   c. Are signed by the customer?
   d. Are designed so that a copy goes to the customer?

*16. Are the functions of receiving and releasing collateral to borrowers and of making entries in the collateral register performed by different employees?

17. Is negotiable collateral held under joint custody?
18. Are receipts signed by the customer obtained and filed for released collateral?

*19. Are securities and commodities valued and margin requirements reviewed at least monthly?

20. When the support rests on the cash surrender value of insurance policies, is a periodic accounting received from the insurance company and maintained with the policy?
21. Is a record maintained of entry to the collateral vault?
22. Are stock powers filed separately to bar negotiability and to deter abstraction of both the security and the negotiating instrument?
23. Are securities out for transfer, exchange, etc., controlled by prenumbered temporary vault-out tickets?
24. Has the bank instituted a system which:
    a. Ensures that security agreements are filed?
    b. Ensures that collateral mortgages are properly recorded?
    c. Ensures that title searches and property appraisals are performed in connection with collateral mortgages?
    d. Ensures that insurance coverage (including loss payee clause) is in effect on property covered by collateral mortgages?
25. Are coupon tickler cards set up covering all coupon bonds held as collateral?
26. Are written instructions obtained and held on file covering the cutting of coupons?
27. Are coupon cards under the control of persons other than those assigned to coupon cutting?
28. Are pledged deposit accounts properly coded to negate unauthorized withdrawal of funds?
29. Are acknowledgments received for pledged deposits held at other banks?
30. Is an officer's approval necessary before collateral can be released or substituted?

OTHER

31. Are notes safeguarded during banking hours and locked in the vault overnight?
32. Are all loan rebates approved by an officer and made only by official check?
33. Does the bank have an internal review system that:
    a. Re-examines collateral items for negotiability and proper assignment?
    b. Checks values assigned to collateral when the loan is made and at frequent intervals thereafter?
    c. Determines that items out on temporary vault-out tickets are authorized and have not been outstanding for an unreasonable length of time?
    d. Determines that loan payments are promptly posted?
34. Are all notes assigned consecutive numbers and recorded on a note register or similar record? Do numbers on notes agree to those recorded on the register?
35. Are collection notices handled by someone not connected with loan processing?
36. Are payment notices prepared and mailed by someone other than the loan teller?
37. Does the bank prohibit the holding of debtor's checks for payment of loans at maturity?

*38. Concerning livestock loans:
    a. Are inspections made at the inception of credit?
    b. Are inspections properly dated and signed?
    c. Is there a breakdown by sex, breed, and number of animals in each category?
    d. Is the condition of the animals noted?
    e. Are inspections required at least annually?

*39. Concerning crop loans:
    a. Are inspections of growing crops made as loans are advanced?
    b. Are disbursements closely monitored to ensure that the proceeds are properly channeled into the farmer's operation?
    c. Is crop insurance encouraged?

40. In mortgage warehouse financing, does the bank hold the original mortgage note, trust deed, or other critical document, releasing only against payment?
41. Concerning commodity lending:
    a. Is control for the collateral satisfactory, i.e., stored in the bank's vault, another bank, or a bonded warehouse?
    b. If collateral is not stored within the bank, are procedures in effect to ascertain the authenticity of the collateral?
    c. Does the bank have a documented

security interest in the proceeds of the future sale or disposition of the commodity as well as the existing collateral position?

d. Do credit files document that the financed positions are and remain fully hedged?

42. Concerning loans to commodity brokers and dealers:
    a. Does the bank maintain a list of the major customer accounts on the brokers or dealers to whom it lends? If so, is the list updated on a periodic basis?
    b. Is the bank aware of the broker-dealer's policy on margin requirements and the basis for valuing contracts for margin purposes (i.e., pricing spot vs. future)?
    c. Does the bank attempt to ascertain whether the positions of the broker-dealer's clients that are indirectly financed by bank loans remain fully hedged?

CONCLUSION

43. Is the foregoing information considered an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.

44. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

A statistically based sampling approach to loan reviews can serve as an alternative to the traditional ''top-down'' loan-coverage approach when scoping certain bank examinations. In some cases, sampling requires fewer loans[1] to be reviewed than would be required using the minimum-coverage approach, while in other cases it requires more. The results depend heavily on the number of commercial and industrial loans (C&I) and commercial real estate (CRE) loans and the structure of the loan portfolio. Asset size and the level of tier 1 capital also affect the sample size. Additionally, sampling may require fewer loans to be reviewed than under the traditional method in well-managed institutions whose portfolios are not dominated by a small number of relatively large exposures.

Significantly, sampling may provide examiners with a broader perspective on the accuracy of the bank's classification process than is typically provided by the traditional minimum-coverage target approach. At present, the sampling approach should be directed towards banks currently having a CAMELS composite and asset-quality rating of 1 or 2 and also assets of less than $1 billion. At present, the sampling approach should be directed towards banks currently having a CAMELS composite and asset-quality rating of 1 or 2 and also assets of less than $1 billion. The statistical sampling approach is not recommended, however, for use at de novo banks or other banks with unusually high or low capital ratios. Reserve Banks wishing to experiment with the sampling program at organizations with CAMELS or asset-quality ratings of 3 or above or at larger organizations should contact Board staff so that the examiner's experience that is gained in this area may be used to develop alternative sampling procedures for these other types of institutions. (See SR-02-19.)

1. The term ''loans'' encompasses all sources of credit exposure arising from loans and leases, including guarantees, letters of credit, and other loan commitments. The sampling methods described in this section select ''loans'' for review by obligor or related group of obligors (where identifiable). Thus, in the sampling procedures, the term ''loan'' refers to total credit exposure to an individual obligor or related group of obligors. As this implies, loan amounts referred to in this section should be determined on an exposure basis, including all outstanding notes and commitments.

CONCEPT AND STRUCTURE OF THE SAMPLING TECHNIQUE

The sampling approach builds on procedures examiners currently use to evaluate loan portfolios, which require coverage of a similar ''core'' group of exposures. The principal difference relates to the manner in which loans outside the core group are selected for review. Under the traditional approach, the largest remaining loans are selected until a desired coverage ratio is achieved. Using sampling, the remaining noncore loans are grouped into several strata, or buckets, based on the size of the borrowing relationship. Loans are randomly selected from each of these buckets proportionate to the dollar value of each bucket relative to the total noncore portfolio. The total number of sampled loans required is determined by the number and size distribution of loans in the bank's portfolio.

The sampling approach is an effective means to determine if the examiner can rely on the bank's classification process or whether the examiner must determine the level of classifications by traditional means. Although sampling may, in some cases, require examiners to review more loans than required by the traditional loan-coverage approach, sampling is more likely to detect problems among smaller loans and will provide a broader perspective of the bank's classifications across the entire portfolio.

In most cases, examiners should expect to find very few misclassifications within the sampled buckets, since those segments would exclude any credits that the bank's internal procedures have identified as weak and those that the examiner has otherwise identified for specific review (the ''core'' loans). When the examiner's classifications agree with the bank's internal loan classifications, then internal classification totals can be relied upon in calculating the total and weighted asset-classification ratios. However, if misclassifications are found within the sample, internal classifications may underestimate the true extent of problem loans, and the examiner must make adjustments to estimate the actual extent of problems. To make that estimate, the rate of misclassification is applied to the remaining loans in the sampled bucket to derive an estimate of other problems that the examiners would likely find if all the loans were read. This extrapolated amount of problem loans is then added to the total of specifically identified problems to evaluate the significance of credit weaknesses at the institution. Depending on the severity of misclassifications and the magnitude of problems specifically identified, expansion of the examination scope will probably be necessary to better assess the accuracy of loan grading.

Specific Procedures

Using electronic loan files provided by the bank (for example, those loan files available in the Automated Loan Examination Review Tool (ALERT) format) and the System's loan-sampling software, examiners are able to construct a variety of core and noncore borrower groups. (See table 1.) The "core" group—bucket 1—consists of several categories of loans that examiners have traditionally reviewed and would continue to review using sampling. These core borrowers include, for instance, the largest exposures and certain large problem or insider loans. The sampling program also permits examiners to select any additional borrower (or borrowers) for review based on the examiner's experience and judgment. These individually selected loans would be placed in the "examiner-selected" group—bucket 2. All loans contained in buckets 1 and 2 would be individually reviewed, not sampled, and examiners would not extrapolate their findings to other loans. All remaining internally identified problem borrowers are included in a separate "problem" group—bucket 3—designated as "discuss only"; these borrowers are not incorporated into the commercial-loan-coverage ratio nor are their findings extrapolated to other loans within the same bucket. However, any borrower in the "problem" group—bucket 3—may be individually selected for review by the examiner. Additionally, if the number of "discuss-only" borrowers in the "problem" group—bucket 3—is large, the examiner may select a number of borrowers to be randomly sampled.

The remaining noncore categories represent "pass" or creditworthy loans, grouped by the size of the borrowing relationship. Buckets 4 through 8 are composed of loans to be randomly sampled. The number of loans selected from buckets 4 through 8 is proportional to its total dollar value relative to the total noncore portfolio. Thus, if loans in a particular category represent 30 percent of the bank's total noncore exposures, then approximately 30 percent of the number of sampled credits will be drawn from that category. A "custom" group—bucket 4—is available for examiners to target specific borrowers meeting a variety of selection criteria. Buckets 5 through 8 represent all remaining loans in the commercial loan portfolio, segregated by size relative to the bank's tier 1 capital and loan-loss reserve. The results of examiners' findings for these sampled buckets would be extrapolated to the entire group of borrowers not reviewed.

Determination of Reliance on a Bank's Internal Classifications

Once the commercial loans have been selected for review, examiners are expected to use existing credit-analysis techniques as described in this manual to evaluate the borrower's creditworthiness, determine the level of adverse classifications, and identify any discrepancies with the bank's internal classifications.

In performing their analysis of the accuracy of classified credits, examiners should start with the assets internally classified by the bank's rating system and add any pass credits that were misclassified by the bank and downgraded to a classified status during the examiner's credit review. These classified assets are the key component for a "base" weighted asset-classification ratio.

Under the sampling program, the "base" weighted asset-classification ratio must be adjusted upward (extrapolated) to the extent misclassifications were uncovered within the randomly sampled loan buckets. The resulting extrapolated weighted asset-classification ratio is necessary to account for the likelihood that misclassifications uncovered from the sampled loans represent only a small portion of the total misclassified loans throughout the rest of the portfolio that was not reviewed. The extrapolated value provides examiners with a more comprehensive picture of the magnitude of the institution's credit problems.

In many cases, there will be no disagreements between the examiner's credit analysis and the bank's internal classifications. Consequently, there will be no difference between the weighted asset-classification ratio and the extrapolated ratio. Generally, no additional sampling would

Table 1—Groups of Loans Available for Review

Bucket	*Description*
	Nonsampled buckets
Bucket 1 Core	1A: 10 largest non-insider non-problem-borrower exposures 1B: 5 largest non-insider non-problem-borrower exposures underwritten in the previous 12 months 1C: 10 largest non-insider problem-borrower exposures 1D: 5 largest insider borrower exposures
Bucket 2 Examiner-selected	Examiner optional core group. Examiners may manually select any borrower to review.
Bucket 3 Problem	Problem loans (watch list, >59 days past due, internal ratings, and previously classified). Discuss-only borrowers.
	Sampled buckets
Bucket 4 Custom	Examiners may select to target specific borrowers meeting a variety of criteria.
Bucket 5 >3% T1	Remaining borrower exposures greater than 3 percent of tier 1 capital plus the ALLL.
Bucket 6 2%–3% T1	Remaining borrower exposures between 2 percent and 3 percent of tier 1 capital plus the ALLL.
Bucket 7 1%–2% T1	Remaining borrower exposures between 1 percent and 2 percent of tier 1 capital plus the ALLL.
Bucket 8 0.1%–1% T1	Remaining borrower exposures between 0.1 percent and 1 percent of tier 1 capital plus the ALLL.
Bucket 9 <0.1% T1	Remaining borrower exposures less than 0.1 percent of tier 1 capital plus the ALLL. These loans are not included in the sample.
Bucket 10 Noncommercial	All noncommercial borrowers. Examiners may scope into bucket 2.

be necessary. However, other types of credit-administration weaknesses may be discovered that warrant additional review and, as a result, an additional sample of loans may be selected. In this case, the number of loans selected is left to the examiner's judgment.

In other cases, either minor or significant disagreements will require examiners to more fully investigate the reliance that can be placed on the internal classifications. When there are only a minor number of disagreements within the sampled loans, examiners should be aware that those seemingly minor disagreements may translate into fairly large differences between the base and extrapolated problem-loan figures. When those differences are significant enough that they would alter an examiner's overall conclusion regarding the accuracy of the bank's loan-grading system, follow-up work is required. In particular, significant differences between the "base" and extrapolated weighted classification ratios should raise concerns as to whether the institution is systematically misreporting credit problems.

For example, a disagreement may arise between an examiner's analysis and the bank's internal classification of a single credit that was drawn from the sample buckets. Assuming a "base" weighted asset-classification ratio of 4 percent, the disagreed-upon sample loan, when extrapolated, could increase the weighted asset-classification ratio to 7 percent. When the difference between the "base" and extrapolated ratios is not material, it would not be necessary to select additional loans if the ratio difference would not alter the examiner's conclusions regarding the condition of the loan portfolio.

In another situation, there may be disagreement between the examiner's analysis and the bank's internal rating on two small-dollar loans sampled from bucket 8 (borrower exposures between 0.1 percent and 1 percent of tier 1 capital plus the allowance for loan and lease losses (ALLL)). In this example, the bank's "base" weighted asset-classification ratio is calculated to be 3 percent. Individually, these loans do not play a significant role in the level of the "base" ratio. However, when these same disagreed-upon classifications are extrapolated, the result is a significant difference between the "base" ratio and the extrapolated classification ratio of 18.5 percent. This can occur when there are only four loans that are sampled from bucket 8, and the two loans in disagreement account for 40 percent of the dollar volume of the sampled loans. Through extrapolation, 40 percent of the remaining bucket 8 loans would be considered classified, thereby increasing the extrapolated ratio to a level that may cause an examiner to question the reliability of the bank's classification system.

In the preceding example, to rule out the possibility that misclassifications were identified as a matter of chance, examiners should expand their loan coverage by pulling an additional sample from the bucket in which the misclassifications were identified. If the examiner selected four additional borrowers from bucket 8 to review and no new misclassifications were found, the extrapolated ratio would decline to 11 percent. As the base and extrapolated ratios move much closer together, the examiner may have greater confidence in the bank's internal loan-rating system and place greater reliance on bank-identified problems in evaluating the bank's asset quality. However, when reviewing the additional four back-up loans, if the examiner found one new misclassification, then the extrapolated ratio would be 15 percent. In these cases, it is highly unlikely that the misclassifications were caused by chance, and it is probable that a systematic problem exists in the ability of bank management to correctly risk-rate their commercial loans. Consequently, examiners should closely review the misclassifications and determine if any pattern exists, such as loans generated from a specific originating office or loan officer, or by type of credit extension. In these cases, internal classifications should be deemed unreliable and further credit review should be performed to evaluate the full extent of problem assets. That expanded review should be consistent with the minimum loan coverage of 55 percent to 65 percent or more, as required for banks posing supervisory concerns. (See SR-94-13.)

Factoring Sampling Results into Examination Findings

An evaluation of a bank's asset-quality rating within CAMELS should take into account both financial and managerial factors as detailed in SR-96-38. When using the sampling approach, the extrapolated weighted classification ratio is to be used as a tool for assessing the extent to which examiners may rely on the bank's internal classifications. To the extent loan sampling indicates that the bank's internal classifications are not reliable, the severity of that fundamental risk-management weakness should be factored into the asset-quality rating as well as the management and the risk-management rating. Results of the statistical loan sampling should be documented in the examination report. (See the examination procedures, section 2082.3, for a detailed description of the required information.)

Discussions with Management Regarding the Sampling Procedures

The sampling procedure produces an extrapolated estimate of weighted classified assets. The principal use of extrapolation is to provide an estimate of what the weighted asset-classification ratio would be for the entire loan portfolio. The extrapolated ratio will differ significantly from the traditional weighted asset-classification ratio when errors in the bank's internal classification system are detected through random sampling. Examiners may want to discuss (1) how the errors led to a widening of the loan-review scope and (2) the degree of errors found in the loans pulled beyond the initial sample. Any uncertainties regarding the integrity of the institution's classification system or the extent of its asset-quality problems uncovered from the use of sampling (that resulted from rating errors) should be discussed with management and included in the examination report, along with any necessary follow-up work required to gain more certainty. Those discussions may center on the number of errors uncovered in sampled and core loans.

1. To evaluate and improve, using statistical sampling, the comprehensiveness and effectiveness of the examination's credit review of a bank's loan portfolio.
2. To better evaluate, using statistical sampling, a bank's internal credit-review process and also the effectiveness of its credit risk-management practices.
3. To assess the accuracy of the bank's internal credit classifications.

1. Using the Federal Reserve System's loan-sampling software and the electronic files provided by the bank under examination (for example, those in the Automated Loan Examination Review Tool (ALERT) format), develop the bank's core and sampled borrower groups. (See table 1 in section 2082.1.) Follow the "Specific Procedures" of section 2082.1 for selecting loans for review, including those that are to be randomly sampled.
2. Use the bank examination credit-analysis techniques in this manual to—
   a. evaluate the borrower's creditworthiness,
   b. determine the level of adverse classifications, and
   c. identify any discrepancies within the bank's internal classifications.
3. Continue to follow the "Specific Procedures."
   a. Be especially alert when reviewing loan misclassifications to detect patterns of misclassifications (for example, whether the misclassified loans were generated by a specific originating office or loan officer).
   b. When misclassifications are identified, be prepared to expand the scope of the loan review.
   c. Ascertain whether the bank is systematically misreporting credit problems.
4. When it is determined that the bank's internal classifications are unreliable, factor the severity of this risk-management weakness into the asset-quality, management, and risk-management ratings.
5. Include the following information in the examination report (for instance, the information illustrated below):
   a. Report the traditional weighted asset-classification ratio in the open section of the examination report.
   b. Report the extrapolated weighted asset-classification ratio, the traditional asset-classification ratio, and the number of errors found in the sampled buckets in the confidential section of the report.
   c. If an expanded sample was undertaken because of misclassification errors, report in the confidential section the number of additional loans selected, any errors from the expanded sample, and the adjusted weighted and extrapolated asset-classification ratios.

The illustration below is a sample table format that may be used to highlight the sampling findings within the indicated sections of the examination report.

Loan-Sampling Results—Items to Be Reported in the Examination Report

Open section	
Traditional weighted asset-classification ratio	%
Confidential section	
Extrapolated weighted asset-classification ratio	%
Number of borrowers sampled	
Number of errors in sampled buckets	
Expanded-sample information	
Number of sampled borrowers in expanded review	
Number of errors in expanded review	
Adjusted weighted asset-classification ratio	%
Adjusted extrapolated weighted asset-classification ratio	%

INTRODUCTION

Real estate lending is a major function of most banks. However, the composition of banks' real estate loan portfolios will vary because of differences in the banks' asset size, investment objectives, lending experience, market competition, and location. Additionally, state member banks' lending activity is subject to supervision by state banking regulatory agencies, which may impose limitations such as restrictions on lending territory, types of lending, percentage of assets in real estate loans, loan limits, loan-to-value ratios, and loan terms.

Because of the differences in state banking laws, this section of the manual provides only an overview of the Federal Reserve's supervisory and regulatory requirements for a safe and sound real estate lending program. For specific information on lending limitations and restrictions, refer to the applicable state banking laws. In addition, information related to real estate construction lending is discussed in section 2100.1 of this manual.

REAL ESTATE LENDING POLICY MANDATED BY FDICIA SECTION 304

A bank's real estate lending policy is a broad statement of its standards, guidelines, and limitations that senior bank management and lending officers are expected to adhere to when making a real estate loan. The maintenance of prudent written lending policies, effective internal systems and controls, and thorough loan documentation is essential to the bank's management of the lending function.

The policies governing a bank's real estate lending activities must include prudent underwriting standards that are clearly communicated to the institution's management and lending staff. The bank should also have credit-risk control procedures that include, for example, an effective credit-review and classification process and a methodology for ensuring that the allowance for loan and lease losses is maintained at an adequate level. As part of the analysis of a bank's real estate loan portfolio, examiners should review lending policies, loan-administration procedures, and credit-risk control procedures, as well as the bank's compliance with its policy.

As mandated by section 304 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), the Federal Reserve Board, along with the other banking agencies, adopted in December 1992 uniform regulations prescribing standards for real estate lending. FDICIA defines real estate lending as extensions of credit secured by liens on or interests in real estate or made for the purpose of financing the construction of a building or other improvements to real estate, regardless of whether a lien has been taken on the property.

The Federal Reserve's Regulation H requires an institution to adopt real estate lending policies that are—

- consistent with safe and sound banking practices,
- appropriate to the size of the institution and the nature and scope of its operations, and
- reviewed and approved by the bank's board of directors at least annually.

These lending policies must establish—

- loan portfolio diversification standards;
- prudent underwriting standards that are clear and measurable, including loan-to-value limits;
- loan-administration procedures for the institution's real estate portfolio; and
- documentation, approval, and reporting requirements to monitor compliance with the bank's real estate lending policies.

Furthermore, the bank is expected to monitor conditions in the real estate market in its lending area to ensure that its policies continue to be appropriate for current market conditions.

GUIDELINES ESTABLISHED PURSUANT TO FDICIA SECTION 304

The criteria and specific factors that a bank should consider in establishing its real estate lending policies are set forth in the Interagency Guidelines for Real Estate Lending Policies, which is appendix C of Regulation H. These guidelines apply to transactions (including legally binding, but unfunded, lending commitments) originated on or after March 19, 1993.

Loan Portfolio Management

The bank's lending policy should contain a general outline of its market area; a targeted loan portfolio distribution; and the manner in which real estate loans are made, serviced, and collected. Lending policies should include—

- identification of the geographic areas in which the bank will consider lending;
- establishment of a loan portfolio diversification policy and limits for real estate loans by type and geographic market (for example, limits on higher-risk loans);
- identification of the appropriate terms and conditions by type of real estate loan;
- establishment of loan-origination and -approval procedures, both generally and by size and type of loan;
- establishment of prudent underwriting standards, including loan-to-value (LTV) limits, that are clear and measurable and consistent with the supervisory LTV limits contained in the interagency guidelines;
- establishment of review and approval procedures for exception loans, including loans with LTV ratios in excess of the interagency guidelines' supervisory limits;
- establishment of loan-administration procedures, including documentation, disbursement, collateral inspection, collection, and loan review;
- establishment of real estate appraisal and evaluation programs consistent with the Federal Reserve's appraisal regulation and guidelines; and
- a requirement that management monitor the loan portfolio and provide timely and adequate reports to the bank's board of directors.

The complexity and scope of these policies and procedures should be appropriate for the market, size, and financial condition of the institution and should reflect the expertise and size of the lending staff. The bank's policies should also consider the need to avoid undue concentrations of risk and compliance with all real estate–related laws and regulations (such as the Community Reinvestment Act, Truth in Lending Act, Real Estate Settlement Procedures Act, and antidiscrimination laws).

The bank should monitor the conditions in the real estate markets in its lending area so that it can react quickly to changes in market conditions that are relevant to the lending decision. This should include monitoring market supply-and-demand factors, such as employment trends; economic indicators; current and projected vacancy, construction, and absorption rates; and current and projected lease terms, rental rates, and sales prices.

Underwriting Standards

The bank's lending policies should reflect the level of risk that is acceptable to its board of directors, and provide clear and measurable underwriting standards that enable the bank's lending staff to evaluate all relevant credit factors. These factors include—

- the capacity of the borrower or income from the underlying property to adequately service the debt;
- the market value of the underlying real estate collateral;
- the overall creditworthiness of the borrower,
- the level of the borrower's equity invested in the property;
- any secondary sources of repayment; and
- any additional collateral or credit enhancements, such as guarantees, mortgage insurance, or takeout commitments.

While there is no one lending policy appropriate for all banks, there are certain standards that a bank should address in its policy, such as—

- the maximum loan amount by type of property,
- the maximum loan maturities by type of property,
- amortization schedules,
- the pricing structure for each type of real estate loan, and
- loan-to-value limits by type of property.

For development and construction projects and completed commercial properties, the bank's policy should also establish appropriate standards for the unique risks associated with these types of real estate loans by addressing the size, type, and complexity of the project. Such standards should include the acceptability of and limits for nonamortizing loans and interest reserves; requirements for pre-leasing and presale; limits on partial recourse or nonrecourse loans; requirements for guarantor support; requirements for takeout commitments; and minimum covenants for loan agreements. Furthermore, the bank's policy should set minimum requirements for initial investment by the borrower; maintenance of hard equity throughout the life of the project; and net worth, cash flow, and debt-service coverage of the borrower or underlying property.

Exceptions to Underwriting Standards

The bank should have procedures for handling loan requests from creditworthy borrowers whose credit needs do not conform with the bank's general lending policy. As a part of the permanent loan file, the bank should document justification for approving such loans. Moreover, in the course of monitoring compliance with its own real estate lending policy, bank management should report to its board of directors loans of a significant size that are exceptions to bank policy. An excessive volume of exceptions to the institution's own policies may signal weaknesses in its underwriting practices or a need to revise its policy.

Supervisory Loan-to-Value Limits

The bank should establish its own internal loan-to-value (LTV) limits for each type of real estate loan that is permitted by its loan policy. The LTV ratio is derived at the time of loan origination by dividing the extension of credit, including the amount of all senior liens on, or other senior interests in, the property, by the total value of the property or properties securing or being improved by the extension of credit, plus the amount of any other acceptable collateral and readily marketable collateral securing the credit.

In accordance with the Federal Reserve's appraisal regulation and guidelines, the value of the real estate collateral should be set forth in an appraisal or evaluation (whichever is appropriate) and should be expressed in terms of market value. However, for loans to purchase an existing property, the term ''value'' means the lesser of the actual acquisition cost to the borrower or the estimate of value as presented in the appraisal or evaluation. See ''Real Estate Appraisals and Evaluations,'' section 4140.1 of this manual for further discussion of the Federal Reserve's appraisal regulation and guidelines.

''Other acceptable collateral'' refers to any collateral in which the lender has a perfected security interest, that has a quantifiable value, and that is accepted by the lender in accordance with safe and sound lending practices. This includes inventory, accounts receivables, equipment, and unconditional irrevocable standby letters of credit.

Readily marketable collateral means insured deposits, financial instruments, and bullion in which the lender has a perfected interest. Financial instruments and bullion must be readily salable under ordinary circumstances at a market value determined by quotations based on actual transactions, on an auction, or similarly available daily bid and asking price.

Other acceptable collateral and readily marketable collateral should be appropriately discounted by the lender consistent with the bank's usual practices for making loans secured by such collateral. The lender may not consider the general net worth of the borrower, which might be a determining factor for an unsecured loan, as equivalent to other acceptable collateral for determining the LTV on a secured real estate loan. Furthermore, if an institution attempts to circumvent the supervisory LTV limits by lending a portion of the funds on a secured basis and a portion on an unsecured basis, examiners are instructed to consider the two loans as one if certain similarities are found. These similarities are based upon facts such as common origination dates or loan purposes, and should be used to determine compliance with the supervisory LTV limits. The bank's policy should reflect the supervisory limits set forth in the Interagency Guidelines for Real Estate Lending Policies, which are shown in the following table.

Table 1—Supervisory Loan-to-Value Limits

Loan Category	*Loan-to-Value Limit*
Raw land	65%
Land development, including improved land loans	75%
Construction:	
Commercial, multifamily, and other nonresidential	80%
One- to four-family residential	85%
Improved property	85%
Owner-occupied one- to four-family and home equity	**

** A loan-to-value limit has not been established for permanent mortgage or home equity loans on owner-occupied one- to four-family residential property. However, for any such loan with a loan-to-value ratio that equals or exceeds 90 percent at origination, an institution should require appropriate credit enhancement in the form of either mortgage insurance or readily marketable collateral.

For purposes of these supervisory limits, the loan categories are defined as follows:

Raw land loan means an extension of credit in which the funds are used to acquire and/or hold raw land.

Land development loan means an extension of credit for the purpose of improving unimproved real property before the erection of any structures. Such improvements include the laying or placement of sewers, water pipes, utility cables, streets, and other infrastructure necessary for future development. This loan category also includes an extension of credit for the acquisition of improved land, such as residential lots in an established development. If there are minimal improvements to the land, and the timeframe for construction of the dwelling or building has not been scheduled to commence in the foreseeable future, the loan generally should be considered a raw land loan.

Construction loan means an extension of credit for the purpose of erecting or rehabilitating buildings or other structures, including any infrastructure necessary for development.

One- to four-family residential loan means an extension of credit for a property containing fewer than five individual dwelling units, including manufactured homes permanently affixed to the underlying property.

Multifamily construction loan means an extension of credit for a residential property containing five or more individual units, including condominiums and cooperatives.

Improved property loan refers to (1) farmland, ranchland, or timberland committed to ongoing management and agricultural production; (2) one- to four-family residential property that is not owner-occupied; (3) residential property containing five or more individual dwelling units; (4) completed commercial property; or (5) other income-producing property that has been completed and is available for occupancy and use, except income-producing owner-occupied one- to four-family residential property.

Owner-occupied one- to four-family residential property means that the owner of the underlying real property occupies at least one unit of the real property as a principal residence.

For loans that fund multiple phases of the same real estate project, the appropriate LTV limit is the supervisory LTV limit applicable to the final phase of the project. For example, when the loan is for the acquisition and development of land and the construction of an office building in continuous phases of development, the appropriate supervisory LTV limit for the project loan would be 80 percent (the supervisory LTV limit for commercial construction). However, this does not imply that the lender can finance the total acquisition cost of the land at the time the raw land is acquired by assuming that this financing would be less than 80 percent of the project's final value. The lender is expected to fund the loan according to prudent disbursement procedures that set appropriate levels for the borrower's hard equity contributions throughout the disbursement period and term of the loan. As a general guideline, the funding of the initial acquisition of the raw land should not exceed the 65 percent supervisory LTV limit; likewise, the project cost to fund the land development phase of the project should not exceed the 75 percent supervisory LTV limit.

For a multiple-phase one- to four-family residential loan in which the lender is funding both the construction of the house and the permanent mortgage to a borrower who will be the owner-occupant, there is no supervisory LTV limit. However, if the LTV ratio equals or exceeds 90 percent, the bank should require an appropriate credit enhancement in the form of either mortgage insurance or readily marketable collateral.

When a loan is fully cross-collateralized by two or more properties, the maximum loan amount is determined by first multiplying each property's collateral value by the LTV ratio appropriate to that property and then deducting from that product any existing senior liens on that property. The resulting sum is the maximum loan amount that may be extended under cross-collateralization. To ensure that collateral margins remain within the supervisory limits, the bank should redetermine conformity whenever collateral substitutions are made to the collateral pool.

Loans in Excess of Supervisory LTV Limits

The Federal Reserve believes that it may be appropriate for a bank, in certain circumstances, to originate or purchase loans with LTV ratios in excess of supervisory limits, based on the support provided by other credit factors that the bank documented in its permanent credit files. While high LTV lending poses higher risk for lenders than traditional mortgage lending, high LTV lending can be profitable when these risks are effectively managed and loans are priced based on risk. Therefore, institutions involved in high LTV lending should implement risk-management programs that identify, measure, monitor, and control the inherent risks (see SR-99-26 and the attached ''Interagency Guidance on High LTV Residential Real Estate Lending,'' October 8, 1998). The primary credit risks associated with this type of lending are increased default risk and losses, inadequate collateral, longer term and thus longer exposure, and limited default remedies.

Capital limits. A bank's nonconforming loans—those in excess of the supervisory LTV limits—should be identified in bank records, and the aggregate amount, along with the performace experience of the portfolio, should be reported at least quarterly to the bank's board of directors. There should be increased supervisory scrutiny of a bank as its level of loans in excess of supervisory LTV limits approaches the capital limitations. Nevertheless, a nonconforming loan should not be criticized solely because it does not adhere to supervisory limits.

The aggregate amount of nonconforming loans may not exceed 100 percent of a bank's total risk-based capital (referred to as the nonconforming basket). Within this limit, the aggregate amount of non–one- to four-family residential loans (for example, raw land, commercial, multifamily, and agricultural loans) that do not conform to supervisory LTV limits may not exceed 30 percent of total risk-based capital. The remaining portion of the nonconforming basket includes the aggregate amount of one- to four-family residential development and construction loans, non-owner-occupied one- to four-family residential loans with an LTV ratio greater than 85 percent, and owner-occupied one- to four-family residential loans with an LTV ratio equal to or exceeding 90 percent without mortgage insurance or readily marketable collateral.

For the purpose of determining the loans subject to the 100 percent of risk-based capital limitation, and for the purposes of determining the aggregate amount of such loans, institutions should include loans that are secured by the *same* property, when the combined loan amount equals or exceeds 90 percent LTV and there is no additional credit support. In addition, institutions should include the recourse obligation of any such loan sold with recourse. If there is a reduction in principal or senior liens or if the borrower contributes additional collateral or equity that brings the LTV ratio into supervisory compliance, the loan is no longer considered nonconforming and may be deleted from the quarterly nonconforming loan report to the directors.

The following guidance is provided for calculating the LTV when multiple loans and more than one lender are involved. The institution should include its loan and all senior liens on or interests in the property in the total loan amount when calculating the LTV ratio. The following examples are provided:

- Bank A holds a first-lien mortgage on a property and subsequently grants the borrower a home equity loan secured by the same property. In this case, the bank would combine both loans to determine if the total amount outstanding equaled or exceeded 90 percent of the property's market value. If the LTV ratio equals or exceeds 90 percent and there is no other appropriate credit support, the entire amount of both loans is an exception to the supervisory LTV limits and is included in the aggregate capital limitation.

- Bank A grants a borrower a home equity loan secured by a second lien. Bank B holds a first-lien mortgage for the same borrower and on the same property. Bank A would combine the committed amount of its home equity loan with the amount outstanding on Bank B's first-lien mortgage to determine if the LTV ratio equaled or exceeded 90 percent of the property's market value. If the LTV ratio equals or exceeds 90 percent and there is no other appropriate credit support, Bank A's entire home equity loan is an exception to the supervisory LTV limits and is included in the aggregate capital limitation. Bank A does not report Bank B's first-lien mortgage loan as an exception, but must use it to calculate the LTV ratio.

When a loan's LTV ratio is reduced below 90 percent by amortization or additional credit support, it is no longer an exception to the guidelines and may be excluded from the institution's 100 percent of capital limitation.

Institutions will come under increased supervisory scrutiny as the total of all loans in excess of the supervisory LTV limits, including high LTV residential real estate loan exceptions, approaches 100 percent of total capital. If an institution exceeds the 100 percent of capital limit, a supervisory assessment may be needed to determine whether there is any concern that warrants taking appropriate supervisory action. Such action may include directing the institution (1) to reduce its loans in excess of the supervisory LTV limits to an appropriate level, (2) to raise additional capital, or (3) to submit a plan to achieve compliance. The institution's capital level and overall risk profile, and the adequacy of its controls and operations, as well as other factors will be the basis for determining whether such actions are necessary.

Transactions Excluded from Supervisory LTV Limits

There are a number of lending situations in which other factors significantly outweigh the need to apply supervisory LTV limits, thereby excluding such transactions from the application of the supervisory LTV and capital limits. This includes loans—

- guaranteed or insured by the U.S. government or its agencies, provided the amount of the guaranty or insurance is at least equal to the portion of the loan that exceeds the supervisory LTV limit.
- backed by the full faith and credit of a state government, provided the amount of the guaranty or insurance is at least equal to the portion of the loan that exceeds the supervisory LTV limit.
- guaranteed or insured by a state, municipal, or local government or agency, provided the amount of the guaranty or insurance is at least equal to the portion of the loan that exceeds the supervisory LTV limit and that the guarantor or insurer has the financial capacity and willingness to perform.
- sold promptly (within 90 days) after origination. A supervisory determination may be made that this exclusion is not available for an institution that has consistently demonstrated significant weaknesses in its mortgage banking operations. (If a loan is sold with recourse and the LTV is in excess of supervisory limits, the recourse portion of the loan counts toward the bank's limit for nonconforming loans.)
- renewed, refinanced, or restructured—
  - — without the advancement of new monies (except reasonable closing costs); or
  - — in conjunction with a clearly defined and documented workout, either with or without the advancement of new funds.
- facilitating the sale of real estate acquired by the lender in the course of collecting a debt previously contracted in good faith.
- in which a lien on real property is taken through an abundance of caution; for example, the value of the real estate collateral is relatively low compared with the aggregate value of other collateral, or a blanket lien is taken on all or substantially all of the borrower's assets.[1]
- for working-capital purposes in which the lender does not rely principally on real estate as security. The proceeds of the loan are not

1. Any residential mortgage or home equity loan with an LTV ratio that equals or exceeds 90 percent and that does not have the additional credit support should be considered an exception to the guidelines and included in the calculation of loans subject to the 100 percent of capital limit.

used to acquire, develop, or construct real property.
• financing permanent improvements to real property, but in which no security interest is taken or required by prudent underwriting standards. For example, a manufacturing company obtains a loan to build an addition to its plant. The bank does not take a lien on the plant because the bank is relying on the company's operating income and financial strength to repay the debt.

Risk Management for Supervisory Loan-to-Value Limits

Loan review and monitoring. Institutions should perform periodic quality analyses through loan review and portfolio monitoring. These periodic reviews should include an evaluation of various risk factors, such as credit scores, debt-to-income ratios, loan types, location, and concentrations. At a minimum, the high LTV loan portfolios should be segmented by their vintage (that is, age) and the performance of the portfolios should be analyzed for profitability, growth, delinquencies, classifications and losses, and the adequacy of the allowance for loan and lease losses based on the various risk factors. The ongoing performance of the high LTV loans should be monitored by a periodic re-scoring of the accounts, or by periodically obtaining updated credit bureau reports or financial information on borrowers. In addition, institutions involved in high LTV lending should adopt, as part of their loan-review program, the standards in the FFIEC's uniform retail-credit classification and account-management policy. (See section 2130.1.)

Sales of high LTV loans. When institutions securitize and sell high LTV loans, all the risks inherent in such lending may not be transferred to the purchasers. Institutions that actively securitize and sell high LTV loans must implement procedures to control the risks inherent in that activity. Only written counterparty agreements that specify the duties and responsibilities of each party and that include a regular schedule for loan sales should be entered into. A contingency plan should be developed that designates back-up purchasers and servicers in the event that either party is unable to meet its contractual obligations. To manage liquidity risk, commitment limits should be established for the amount of pipeline and warehoused loans, and alternate funding sources should be identified.

Institutions should refer to the Financial Accounting Standards Board's Statement of Financial Accounting Standards No. 125 (FAS 125), "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities," for guidance on accounting for these types of transactions. If a securitization transaction meets FAS 125 sale or servicing criteria, the seller must recognize any gain or loss on the sale of the pool immediately and carry any retained interests in the assets sold (including servicing rights or obligations and interest-only strips) at fair value. Management should ensure that the key assumptions used to value these retained interests are reasonable and well supported, both for the initial valuation and for subsequent quarterly revaluations.

Compliance risk. Institutions that originate or purchase high LTV real estate loans must take special care to avoid violating fair lending and consumer protection laws and regulations. Higher fees and interest rates combined with compensation incentives can foster predatory pricing or discriminatory "steering" of borrowers to high LTV products for reasons other than the borrower's creditworthiness. An adequate compliance-management program must identify, monitor, and control the compliance risks associated with high LTV real estate lending.

REAL ESTATE LENDING ACTIVITY AND RISKS

Real estate lending falls into two broad categories: short-term financing (primarily construction loans) and permanent financing (for example, a 30-year residential mortgage or a 10-year mortgage loan with payments based on a 25-year amortization schedule and a balloon payment due at the end of the 10 years on an existing commercial office building). Each type of lending carries with it unique underwriting risks as well as common risks associated with any type of lending. In all cases, the bank should understand the credit risks and structure of the proposed transaction, even if it is not the originating bank. This includes, at a minimum, understanding the borrower's ability to repay the debt and the value of the underlying real estate collateral.

Permanent financing, as the name implies, is long term and presents a funding risk since a bank's source of funds is generally of a shorter maturity. Accordingly, bank management should be aware of the source for funding this lending activity. While matching the maturity structures of assets to liabilities is particularly important for a bank's overall loan portfolio management, the importance of this task is even more evident in real estate lending activity. Many banks reduce their funding risk by entering into loan participations and sales with other institutions as well as asset securitization transactions.[2] For a detailed discussion on short-term financing, see section 2100.1, "Real Estate Construction Loans."

Unsound Lending Practices

Some banks have adversely affected their financial condition and performance by granting loans based on ill-conceived real estate projects. Apart from losses due to unforeseen economic downturns, these losses have generally been the result of poor or lax underwriting standards and improper management of the bank's overall real estate loan portfolio.

A principal indication of an unsound lending practice is an improper relationship between the loan amount and the market value of the property; for example, a high loan-to-value ratio in relationship to normal lending practice for a similar type of property. Another indication of unsound lending practices is the failure of the bank to examine the borrower's debt-service ability. For a commercial real estate loan, sound underwriting practices are critical to the detection of problems in the project's plans, such as unrealistic income assumptions, substandard project design, potential construction problems, and a poor marketing plan, that will affect the feasibility of the project.

Real Estate Loan Portfolio Concentration Risk

A bank should have in place effective internal policies, systems, and controls to monitor and manage its real estate loan portfolio risk. An indication of improper management of a bank's portfolio is an excessive concentration in loans to one borrower or related borrowers, in one type of real estate loan, or in a geographic location outside the bank's designated trade area.

In identifying loan concentrations, commercial real estate loans and residential real estate loans should be viewed separately when their performance is not subject to similar economic or financial risks. However, groups or classes of real estate loans should be viewed as concentrations when there are significant common characteristics and the loans are affected by similar adverse economic, financial, or business developments. Banks with asset concentrations should have in place effective internal policies, systems, and controls to monitor and manage this risk.

Concentrations that involve excessive or undue risks require close scrutiny by the bank and should be reduced over a reasonable period of time. To reduce this risk, the bank should develop a prudent plan and institute strong underwriting standards and loan administration to control the risks associated with new loans. At the same time, the bank should maintain adequate capital to protect it from the excessive risk while restructuring its portfolio.

Loan Administration and Servicing

Real estate loan administration is responsible for certain aspects of loan monitoring. While the administration may be segregated by property type, such as residential or commercial real estate loans, the functions of the servicing department may be divided into the following categories (although the organization will vary among institutions):

- *Loan closing and disbursement*—preparing the legal documents verifying the transaction, recording the appropriate documents in the public land records, and disbursing funds in accordance with the loan agreement.
- *Payment processing*—collecting and applying the loan payments.
- *Escrow administration*—collecting insurance premiums and property taxes from the borrower and remitting the funds to the insurance company and taxing authority.

2. See section 4030.1, "Asset Securitization," for additional information, including information on mortgage-backed securities (MBS), collateralized mortgage obligations (CMOs), and real estate mortgage investment conduits (REMICs).

- *Collateral administration*—maintaining documents to reflect the status of the bank's lien on the collateral (i.e., mortgage/deed of trust and title policy/attorney's opinion), the value of the collateral (i.e., real estate appraisal or evaluation and verification of senior lien, if in existence), and the protection of the collateral (i.e., hazard/liability insurance and tax payments).
- *Loan payoffs*—determining the pay-off amount, preparing the borrower release or assumption documents, confirming the receipt of funds, and recording the appropriate lien-release documents in the public land records.
- *Collections and foreclosure*—monitoring the payment performance of the borrower and pursuing collection of past-due amounts in accordance with bank policy on delinquencies.
- *Claims processing*—seeking recoveries on defaulted loans that are covered by a government guarantee or insurance program or a private mortgage insurance company.

The bank should have adequate procedures to ensure segregation of duties for disbursal and receipt of funds control purposes. Additionally, the procedures should address the need for document control because of the importance of the timely recording of the bank's security interests in the public land records.

Some institutions provide various levels of loan services for other institutions, which may range from solely the distribution of payments received to the ultimate collection of the debt through foreclosure. In such cases, the bank will have the additional responsibility of remitting funds on a timely basis to the other institutions in accordance with a servicing agreement. The servicing agreement sets forth the servicer's duties, reporting requirements, timeframe for remitting funds, and fee structure. If a bank relies on another institution for servicing, the bank should have adequate control and audit procedures to verify the performance of the servicer (also see section 4030.1, ''Asset Securitization''). For residential loans sold into the secondary mortgage market for which the bank has retained servicing, Fannie Mae, Freddie Mac, and the Government National Mortgage Corporation (Ginnie Mae) have specific standards the bank (that is, seller/servicer) must adhere to. Failure to meet these standards can result in the termination of the servicing agreement.

BANK ASSESSMENT OF THE BORROWER

Although the value of the real estate collateral is an important component of the loan-approval process, the bank should not place undue reliance on the collateral value in lieu of an adequate assessment of the borrower's ability to repay the loan. These assessment factors differ depending upon the purpose of the loan, such as single-family residential loans as compared with income-producing commercial property loans and commercial or residential development loans (referred to as ''commercial real estate lending''). The loan documentation must adequately support the bank's assessment of the borrower and contain the appropriate legal documentation to protect the bank's interests.

Single-Family Residential Loans

For single-family residential loans, the bank should evaluate the loan applicant's creditworthiness and whether the individual has the ability to meet monthly mortgage payments as well as all other obligations and expenses associated with home ownership. This includes an assessment of the borrower's income, liquid assets, employment history, credit history, and existing obligations.[3] The bank should also consider the availability of private mortgage insurance; a government guarantee; or a government insurance program, such as loans through the FHA-insured or VA-guaranteed programs, in assessing the credit risk of a loan applicant.

If a bank delegates the loan-origination function to a third party, the bank should have adequate controls to ensure that its loan policies and procedures are being followed. The controls should include a review of the third party's qualifications; a written agreement between the bank and the third-party originator to set forth the responsibilities of the third party as an agent for the bank; a periodic review of the third party's operations to ensure that the bank's

3. There are restrictions on the information a bank can request. The Federal Reserve's Regulation B, Equal Credit Opportunity (12 CFR 202), details the information that may and may not be requested on a loan application and provides a model form for a residential mortgage transaction. The Federal Reserve's Regulation Z, Truth in Lending (12 CFR 226), describes the bank-disclosure requirements to the potential borrower on the cost of financing.

policies and procedures are being adhered to; and development of quality controls to ensure that loans originated by the third party meet the bank's lending standards, as well as those of the secondary mortgage market if the bank expects to sell the mortgages.

Secondary Residential Mortgage Market

In the secondary market, a bank (the primary mortgage originator) sells all or a portion of its interest in residential mortgages to other financial institutions (investors). Thus, the secondary mortgage market provides an avenue for a bank to liquidate a long-term asset as the need for funds arises. The majority of the secondary mortgage market activity is supported by three government-related or -controlled institutions: Fannie Mae,[4] Freddie Mac,[5] and Ginnie Mae.[6] These entities were created or sponsored by the federal government to encourage the financing and construction of residential housing. Fannie Mae, Freddie Mac, and Ginnie Mae have specific underwriting standards and loan-documentation requirements for mortgages purchased or guaranteed by them. Generally, financial institutions enter into either a mandatory or a standby commitment agreement with these entities wherein the financial institution agrees to sell loans according to certain delivery schedules, terms, and performance penalties.

Commercial Real Estate Loans

As with other types of lending activities, the extent of commercial real estate lending activity should be contingent upon the lender's expertise and the bank's experience. In considering an application for a commercial real estate loan, a bank should understand the relationship of the actual borrower to the project being financed. The form of business ownership varies for commercial real estate projects and can affect the management, financial resources available for the completion of the project, and repayment of the loan.

Information on past and current projects constructed, rented, or managed by the potential borrower can help the bank assess the borrower's experience and the likelihood of the proposed project's success. For development and construction projects, the bank should closely review the project's feasibility study. The study should provide sensitivity and risk analyses of the potential impact of changes in key economic variables, such as interest rates, vacancy rates, or operating expenses. The bank should also conduct credit checks of the borrower and of all principals involved in the transaction to verify relationships with contractors, suppliers, and business associates.

Finally, the bank should assess the borrower's financial strength to determine if the principals of the project have the necessary working capital and financial resources to support the project until it reaches stabilization. As with any type of lending on income-producing properties,[7] the bank should quantify the degree of protection from the borrower's (or collateral's) cash flow, the value of the underlying collateral, and any guarantees or other collateral that may be available as a source of loan repayment.

BANK ASSESSMENT OF REAL ESTATE COLLATERAL

Banks should obtain an appraisal or evaluation, as appropriate, for all real estate–related financial transactions before making the final credit or other decision. The Federal Reserve's appraisal regulation requires institutions to obtain appraisals when certain criteria are met. See ''Real

4. Although Fannie Mae was originally created in 1938 as an organization within the federal government, it became a federally chartered, stockholder corporation in 1968 when some of its functions were placed under the newly created Ginnie Mae. Financial institutions can either sell mortgages directly to Fannie Mae or pool mortgages for placement in a Fannie Mae–guaranteed mortgage-backed security.

5. Freddie Mac was sponsored by the Federal Home Loan Bank Board and its members in 1970. Its primary purpose is to provide a secondary market for conventional mortgages originated by thrifts.

6. Ginnie Mae, a government agency under the Department of Housing and Urban Development (HUD), was created in 1968 when Fannie Mae became a private corporation. It has several functions to assist in government housing programs, such as managing and liquidating loans acquired by the government. In the secondary market, Ginnie Mae acts as a guarantor of mortgage-backed securities for pools of loans originated and securitized by financial institutions.

7. Income-producing commercial properties include rental apartments, retail properties, office buildings, warehouses, and hotels.

Estate Appraisals and Evaluations'' section 4140.1, for a description of the related requirements a bank must follow for real estate–related financial transactions. The appraisal section explains the standards for appraisals, indicates which transactions require an appraisal or an evaluation, states qualifications for an appraiser and evaluator, provides guidance on evaluations, and describes the three appraisal approaches.

Management is responsible for reviewing the reasonableness of the appraisal's or evaluation's assumptions and conclusions. Also, management's rationale for accepting and relying upon the appraisal or evaluation should be documented in writing. In assessing the underwriting risks, management should reconsider any assumptions used by an appraiser that reflect overly optimistic or pessimistic values. If management, after its review of the appraisal or evaluation, determines that there are unsubstantiated assumptions, the bank may request the appraiser or evaluator to provide a more detailed justification of the assumptions or obtain a new appraisal or evaluation.

Single-Family Residential Loans

The assessment of a residential property's market value is critical to the bank's estimate of loan-to-value ratio. This assessment provides the bank with an estimate of the borrower's equity in the property and the bank's potential credit risk if the borrower should default on the loan. For mortgages over $250,000, a bank is required to obtain an appraisal in conformance with the Federal Reserve's appraisal regulation. As of January 1, 1993, the appraisal must be performed by a state-certified or -licensed appraiser, as specified in the regulation. While transactions under $250,000 do not require an appraisal, a bank is expected to perform an appropriate evaluation of the underlying real estate collateral. Loans that are wholly or partially insured or guaranteed by a U.S. government agency or government-sponsored agency are exempt from the Federal Reserve's appraisal regulation, so long as the loan meets the underwriting requirements of the federal insurer or guarantor. Additionally, state laws for appraisals may differ from the Federal Reserve's requirements.

Loans qualifying for sale to any U.S. government agency or government-sponsored agency or conforming to the appraisal standards of Fannie Mae and Freddie Mac are also exempt from the Federal Reserve's appraisal regulation. Fannie Mae and Freddie Mac jointly developed and adopted the Uniform Residential Appraisal Report (URAR) as the standard form for residential loans sold to them. As a result, a properly completed URAR form is considered the industry standard for appraising one- to four-family residential properties.

Commercial Real Estate Loans

Due to the variety of uses and the complexity of most commercial projects, there is not a uniformly accepted format for valuing commercial properties like there is for valuing one- to four-family residential properties. A bank relies on outside appraisers, or in some instances in-house expertise, to prepare appraisals. For the most part, appraisals on commercial real estate projects are presented in a narrative format with supporting schedules. As the complexity of a commercial project increases, the detail of the appraisal report or evaluation should also increase to fully support the analysis.

When estimating the value of income-producing real estate, the appraiser generally relies to a greater degree on the income approach to valuation than on the comparable-sales approach or the cost approach. The income approach converts all expected future net operating income into present-value terms, using different analytical methods. One method, known as the direct capitalization method, estimates the present value of a property by discounting its stabilized net operating income at an appropriate capitalization rate (commonly referred to as a cap rate). Stabilized net operating income is the net cash flow derived from a property when market conditions are stable and no unusual patterns of future rents and occupancy are expected. To approximate stabilized net operating income, the appraiser or bank may need to adjust the current net operating income of a property either up or down to reflect current market conditions. The direct capitalization method is appropriate only for use in valuing stabilized properties.

Another method, known as the discounted cash-flow method, requires the discounting of expected future cash flows at an appropriate discount rate to ascertain the net present value of a property. This method is appropriate for use in estimating the values of new properties that have not yet stabilized, or for troubled properties that are experiencing fluctuations in income.

The discount rates and cap rates, used in estimating property values, should reflect reasonable expectations about the rate of return that investors and lenders require under normal, orderly, and sustainable market conditions. The appraiser's analysis and assumptions should support the discount and cap rates used in the appraisal. The appraiser should not use exaggerated, imprudent, or unsustainably high or low discount rates, cap rates, or income projections.

In assessing the reasonableness of the facts and assumptions associated with the valuation of commercial real estate, the bank should consider—

- current and projected vacancy and absorption rates;
- lease-renewal trends and anticipated rents;
- volume and trends in past-due leases;
- the project's feasibility study and market survey to determine support for the assumptions concerning future supply-and-demand factors;
- effective rental rates or sale prices (taking into account all concessions);
- net operating income of the property as compared with budget projections; and
- discount rates and direct capitalization rates.

Because the income approach is generally relied on to a greater degree than the other methods, with specific emphasis on arriving at stabilized values, the bank must use judgment in determining the time it will take for a property to achieve stabilized occupancy and rental rates. The analysis of collateral values should not be based on a simple projection of current levels of net operating income if markets are depressed or reflect speculative pressures but can be expected over a reasonable period of time to return to normal (stabilized) conditions.

The capacity of a property to generate cash flow to service a loan is evaluated on the basis of rents (or sales), expenses, and rates of occupancy that are reasonably estimated to be achieved over time. The determination of the level of stabilized occupancy, rental rates, and net operating income should be based on an analysis of current and reasonably expected market conditions, taking into consideration historical levels when appropriate.

EARLY INDICATIONS OF TROUBLED COMMERCIAL REAL ESTATE LOANS

Market-Related

To evaluate the collectibility of their commercial real estate portfolio, banks should be alert for economic indicators of weakness in their real estate markets as well as for indicators of actual or potential problems in the individual commercial real estate projects. Available indicators useful in evaluating the condition of the local real estate market include permits for and the value of new construction, absorption rates, employment trends, vacancy rates, and tenant lease incentives. Weaknesses disclosed by these types of statistics may signify that a real estate market is experiencing difficulties that may cause cash-flow problems for individual real estate projects, declining real estate values, and ultimately, troubled real estate loans.

Project-Related

Characteristics of potential or actual difficulties in commercial real estate projects may include—

- an excess supply of similar projects under construction in the same trade area.
- the lack of a sound feasibility study or analysis that reflects current and reasonably anticipated market conditions.
- changes in concept or plan (for example, a condominium project converted to an apartment project because of unfavorable market conditions).
- rent concessions or sales discounts, resulting in cash flow below the level projected in the original feasibility study, appraisal, or evaluation.
- concessions on finishing tenant space, moving expenses, and lease buyouts.
- slow leasing or lack of sustained sales activity and increasing sales cancellations that may reduce the project's income potential, resulting in protracted repayment or default on the loan.
- delinquent lease payments from major tenants.
- land values that assume future rezoning.
- tax arrearages.
- environmental hazards and liability for cleanup.

As the problems associated with a commercial real estate loan become more pronounced, the borrower/guarantor may experience a reduction in cash flow to service-related debts, which could result in delinquent interest and principal payments.

While some real estate loans become troubled because of a general downturn in the market, others become troubled because the loans were originated on an unsound or a liberal basis. Common examples of unsound loans include—

- loans with no or minimal borrower equity
- loans on speculative undeveloped property in which the borrower's only source of repayment is the sale of the property
- loans based on land values that have been driven up by rapid turnover of ownership, but without any corresponding improvements to the property or supportable income projections to justify an increase in value
- additional advances to service an existing loan without evidence that the loan will be repaid in full
- loans to borrowers with no development plans or noncurrent development plans
- renewals, extensions, and refinancings that lack credible support for full repayment from reliable sources and that do not have a reasonable repayment schedule[8]

EXAMINER REVIEW OF COMMERCIAL REAL ESTATE LOANS

The focus of an examiner's review of a real estate loan is on the ability of the loan to be repaid. The principal factors that bear on this review are the income-producing potential of the underlying collateral and the borrower's willingness and ability to repay the loan from other resources, if necessary, and according to existing loan terms. In evaluating the overall risk associated with a real estate loan, examiners should consider a number of factors, including the borrower's character, overall financial condition and resources, and payment history; the prospects for support from any financially responsible guarantors; and the nature and degree of protection provided by the cash flow and value of the underlying collateral.[9] As the borrower's and guarantor's ability to repay a troubled real estate loan decreases, the importance of the collateral value of the loan increases commensurately.

Examiner Review of the Real Estate Collateral

An examiner's analysis of the collateral value is based on the bank's most recent appraisal or evaluation and includes a review of the major facts, assumptions, and approaches used by the appraiser or person performing the evaluation (including any comments made by management relative to the reasonableness of the appraisal or evaluation assumptions and conclusions). While the examiner may make adjustments to the assessment of value, these adjustments should be made solely for purposes of an examiner's analysis and assessment of credit quality and should not involve an adjustment to the actual appraisal or evaluation.

Furthermore, examiners should not make adjustments to appraisal or evaluation assumptions for credit-analysis purposes based on worst-case scenarios that are unlikely to occur. For example, an examiner should not necessarily assume that a building will become vacant just because an existing tenant who is renting at a rate above today's market rate may vacate the property when the current lease expires. On the other hand, an adjustment to value may be appropriate for credit-analysis purposes when the valuation assumes renewal at the above-market rate, unless that rate is a reasonable estimate of the expected market rate at the time of renewal.

Assumptions, when recently made by qualified appraisers or persons performing the evalu-

8. As discussed more fully in the section on classification guidelines, the refinancing or renewing of loans to sound borrowers would not result in a supervisory classification or criticism unless well-defined weaknesses exist that jeopardize repayment of the loans. As consistent with sound banking practices, institutions should work appropriately and constructively with borrowers who may be experiencing temporary difficulties.

9. The primary basis for the review and classification of the loan should be the original source of repayment and the borrower's intent and ability to fulfill the obligation without relying on third-party guarantees. However, the examiner should also consider the support provided by any guarantees when determining the appropriate classification treatment for a troubled loan. The treatment of guarantees in the classification process is discussed in "Classification of Credits," section 2060.1.

ation and when consistent with the discussion above, should be given a reasonable amount of deference. Examiners should not challenge the underlying assumptions, including discount rates and cap rates used in appraisals or evaluations, that differ only in a limited way from norms that would generally be associated with the property under review. However, the estimated value of the underlying collateral may be adjusted for credit-analysis purposes when the examiner can establish that underlying facts or assumptions are inappropriate and can support alternative assumptions.

CLASSIFICATION GUIDELINES

As with other types of loans, real estate loans that are adequately protected by the current sound worth and debt-service capacity of the borrower, guarantor, or the underlying collateral generally are not classified. The examiner should focus on the ability of the borrower, guarantor, or the collateral to provide the necessary cash flow to adequately service the loan. The loan's record of performance is also important and must be taken into consideration. As a general principle, a performing real estate loan should not be automatically classified or charged off solely because the value of the underlying collateral has declined to an amount that is less than the loan balance. Conversely, the fact that the underlying collateral value equals or exceeds the current loan balance, or that the loan is performing, does not preclude the loan from classification if well-defined weaknesses jeopardize the repayment ability of the borrower, such as the lack of credible financial support for full repayment from reliable sources.[10]

Similarly, loans to sound borrowers that are refinanced or renewed according to prudent underwriting standards, including loans to creditworthy commercial or residential real estate developers, should not be categorized as special mention unless potential weaknesses exist or should not be classified unless well-defined weaknesses exist that jeopardize repayment. An institution should not be criticized for working with borrowers whose loans are classified or categorized as special mention as long as the institution has a well-conceived and effective workout plan for such borrowers, along with effective internal controls to manage the level of these loans.

In evaluating real estate credits for special-mention categorization or classification, examiners should apply the standard definitions as set forth in ''Classification of Credits,'' section 2060.1. In assessing credit quality, examiners should consider all important information regarding repayment prospects, including information on the borrower's creditworthiness, the value of and cash flow provided by all collateral supporting the loan, and any support provided by financially responsible guarantors.

These guidelines apply to individual credits, even if portions or segments of the industry to which the borrower belongs are experiencing financial difficulties. The evaluation of each credit should be based upon the fundamental characteristics affecting the collectibility of the particular credit. The problems broadly associated with some sectors or segments of an industry, such as certain commercial real estate markets, should not lead to overly pessimistic assessments of particular credits in the same industry that are not affected by the problems of the troubled sectors.

Troubled Project-Dependent Commercial Real Estate Loans

The following guidelines for classifying a troubled commercial real estate loan apply when the repayment of the debt will be provided solely by the underlying real estate collateral, and there are no other available and reliable sources of repayment. As a general principle, for a troubled project-dependent commercial real estate loan, any portion of the loan balance that exceeds the amount that is adequately secured by the value of the collateral, and that can be clearly identified as uncollectible, should be classified loss. The portion of the loan balance that is adequately secured by the value of the collateral should generally be classified no worse than substandard. The amount of the loan balance in excess of the value of the collateral, or portions thereof, should be classified doubtful

10. Another issue that arises in the review of a commercial real estate loan is its accrual or nonaccrual treatment for reporting purposes. The federal banking agencies, under the auspices of the FFIEC, have provided guidance on nonaccrual status in the instructions for the Reports of Condition and Income (call reports) and in related supervisory guidance of the agencies. This guidance is summarized in ''Loan Portfolio Management,'' section 2040.1.

when the potential for full loss may be mitigated by the outcome of certain pending events, or when loss is expected but the amount of the loss cannot be reasonably determined. If warranted by the underlying circumstances, an examiner may use a doubtful classification on the entire loan balance. However, this would occur infrequently.

Partially Charged-Off Loans

An evaluation based upon consideration of all relevant factors may indicate that a credit has well-defined weaknesses that jeopardize collection in full, although a portion of the loan may be reasonably assured of collection. When a charge-off has been taken in an amount sufficient to ensure that the remaining recorded balance of the loan (1) is being serviced (based upon reliable sources) and (2) is reasonably assured of collection, classification of the remaining recorded balance may not be appropriate. Classification would be appropriate when well-defined weaknesses continue to be present in the remaining recorded balance. In such cases, the remaining recorded balance would generally be classified no more severely than substandard.

A more severe classification than substandard for the remaining recorded balance would be appropriate, however, if the loss exposure cannot be reasonably determined—for example, when significant risk exposures are perceived, such as in the case bankruptcy or loans collateralized by properties subject to environmental hazards. In addition, classifying the remaining recorded balance more severly than substandard would be appropriate when sources of repayment are considered unreliable.

Formally Restructured Loans

The classification treatment previously discussed for a partially charged-off loan would also generally be appropriate for a formally restructured loan when partial charge-offs have been taken. For a formally restructured loan, the focus of the examiner's analysis is on the ability of the borrower to repay the loan in accordance with its modified terms. Classification of a formally restructured loan would be appropriate if, after the restructuring, well-defined weaknesses exist that jeopardize the orderly repayment of the loan in accordance with reasonable modified terms.[11] Troubled commercial real estate loans whose terms have been restructured should be identified in the institution's internal credit-review system and closely monitored by management.

Home Equity Loans

Home equity loans (HELs) are defined as loans that are usually collateralized by a second mortgage or deed of trust on the borrower's principal residence or second residence; however, the collateral may be a first mortgage or deed of trust. The borrower's equity in the residence, pledged as collateral, provides protection for the loan and determines the maximum amount of credit that may be advanced. Traditionally, HELs were used to fund home improvements or to consolidate debt, and they were usually amortized without a revolving feature. Because of these characteristics, home equity loans were commonly maintained and administered in a bank's consumer or installment loan department and were monitored based on delinquency status. However, since enactment of the Tax Reform Act of 1986, which allows home equity loan interest of up to $100,000 to be deducted from a taxpayer's gross income, the popularity and usage of HELs have expanded considerably. The proceeds of home equity loans are now used for increasingly diverse purposes, such as consumer purchases, personal investments, working capital for small businesses, and a supplement to personal income.

The structure and repayment terms of home equity loans have become more varied. Amortization periods may be as long as 15 years, with possible balloon maturities of three to five years. In some instances, the payment requirement is only interest due for an initial period. Revolving lines of credit have also gained popularity as a way to accommodate the many different uses of loan proceeds. Lines of credit to individuals with high incomes or high net worths may substantially exceed $100,000. These loans are often housed in the bank's private-banking

11. An example of a restructured commercial real estate loan that does not have reasonable modified terms would be a cash-flow mortgage, which requires interest payments only when the underlying collateral generates cash flow but provides no substantive benefits to the lending institution.

division or within the commercial loan portfolio, rather than in the consumer loan department.

In addition to the increasingly varied purposes of HELs, there has also been an upsurge in loans in which the combined first and second mortgages result in very high LTV ratios. To remain competitive with other residential lenders, some banks have relaxed their underwriting standards by permitting higher LTV ratios. In addition, some banks may have offset declines in residential mortgage refinancing during periods of higher interest rates by competing more aggressively for home equity loan business. Consumer demand for HELs may also increase during periods of higher interest rates because they provide an alternative source of financing for consumer purchases.

Examiners must ensure that a bank's policies for originating and acquiring HELs comply with the real estate lending standards and guidelines stipulated in the Board's Regulation H, subpart C. While the guidelines permit banks to make residential real estate loans with LTV ratios in excess of 90 percent without the appropriate credit enhancements, these loans are treated as exceptions to the guidelines and are subject to the aggregate limitation of 100 percent of the bank's total capital.

As with all types of lending, the bank should have strong underwriting standards for HELs. In assessing these standards, the examiner should determine whether the bank primarily emphasizes the borrower's ability and willingness to repay the loan from income or cash flow versus the amount of equity in the real estate. Extended repayment terms and liberal loan structures can increase the risk of default on HELs. Normally, longer repayment terms increase the likelihood of events that could jeopardize the borrower's ability to repay, for example, the loss of a job, a change in marital status, a prolonged spike in prevailing interest rates, or a deflationary economic environment. Additionally, the examiner should review the bank's policy (or practice) for obtaining appraisals or evaluations to determine the lendable equity in the borrower's residence. The examiner should determine that the bank has not relaxed its appraisal requirements to accommodate the growth of its HEL portfolio. For example, a bank's reliance on drive-by appraisals rather than full appraisals or evaluations could represent an unsafe and unsound practice depending on the size of the loan, the total volume of HELs, and the condition of the local real estate market.

Economic periods of increasing unemployment, rising interest rates, or other recessionary factors can negatively affect the repayment ability of borrowers and erode the value and marketability of residential real estate. Moreover, most HELs are collateralized by junior lien positions. Therefore, if the bank forecloses, it must pay off or service the senior mortgage lender, further increasing its exposure. Foreclosure proceedings may entail lengthy and costly litigation, and real estate law commonly protects the home owner.

Examiners should ensure that banks have proper controls to manage this exposure, particularly those that have a high concentration of home equity loans with excessively high combined LTV ratios. Banks with concentrations that lack proper controls and monitoring procedures should be criticized for these credit deficiencies. If the examiner judges the deficiencies to be severe, the bank should be cited for unsafe and unsound banking practices.

ALLOWANCE FOR LOAN AND LEASE LOSSES

A bank bases the adequacy of its allowance for loan and lease losses (ALLL), including amounts resulting from an analysis of the real estate portfolio, on a careful, well-documented, and consistently applied analysis of its loan and lease portfolio.[12] Guidance related to the ALLL is primarily addressed in the section 2070.1. The following discussion summarizes general principles for assessing the adequacy of the ALLL.

Examiners should evaluate the methodology and process that management has followed in arriving at an overall estimate of the ALLL to ensure that all of the relevant factors affecting the collectibility of the portfolio have been appropriately considered. In addition, the examiner should review the reasonableness of management's overall estimate of the ALLL, as well as the range of possible credit losses, by taking into account these factors. The examiner's anal-

12. The estimation process described in this section permits a more accurate estimate of anticipated losses than could be achieved by assessing the loan portfolio solely on an aggregate basis. However, it is only an estimation process and does not imply that any part of the ALLL is segregated for, or allocated to, any particular asset or group of assets. The ALLL is available to absorb all credit losses originating from the loan and lease portfolio.

ysis should also consider the quality of the bank's systems and management's ability to identify, monitor, and address asset-quality problems.

As discussed in the previous subsection on classification guidelines, examiners should consider the value of the collateral when reviewing and classifying a loan. For a performing commercial real estate loan, however, the supervisory policy does not require automatic increases to the ALLL solely because the value of the collateral has declined to an amount that is less than the loan balance.

In assessing the ALLL during examinations, it is important that the examiner recognize that management's process, methodology, and underlying assumptions require a substantial degree of judgment. Even when an institution maintains sound loan-administration and collection procedures and effective internal systems and controls, the estimation of anticipated losses may not be precise because of the wide range of factors that must be considered. Furthermore, the ability to estimate anticipated losses on specific loans and categories of loans improves over time as substantive information accumulates regarding the factors affecting repayment prospects. The examiner should give considerable weight to management's estimates in assessing the adequacy of the ALLL when management has (1) maintained effective systems and controls for identifying, monitoring, and addressing asset-quality problems and (2) analyzed all significant factors affecting the collectibility of the portfolio.

REGULATORY COMPLIANCE

Banks are expected to comply with laws, regulations, and Federal Reserve policy in all aspects of their real estate lending programs. Moreover, banks should establish adequate internal controls to detect deficiencies or exceptions to their lending policy that result in unsafe and unsound lending practices. In regard to lending limits, the examiner should review the bank's lending practices in accordance with the applicable state laws in the following areas that prescribe limits on aggregate advances to a single borrower and related borrowers:

Transactions with affiliates. All transactions with affiliates should be on terms and conditions that are consistent with safe and sound banking practices. The bank is expected to comply with the limits and collateral requirements of sections 23A and 23B of the Federal Reserve Act (12 USC 371c and 371c-1) and Regulation W (12 CFR 223).

Tie-in provisions. Section 106 of the Bank Holding Company Act Amendments of 1970 states that a bank is prohibited from fixing or varying the consideration for extending credit, leasing or selling property of any kind, or furnishing any product or service on the condition or requirement that the customer—

- obtain additional credit, property, or service from the bank, other than a loan, discount, deposit, or trust service (a ‘‘traditional bank product’’);
- obtain additional credit, property, or service from the bank's parent holding company or the parent's other subsidiaries;
- provide additional credit, property, or service to the bank, other than those related to and usually provided in connection with a loan, discount, deposit, or trust service;
- provide additional credit, property, or service to the bank's parent holding company or any of the parent's other subsidiaries; or
- not obtain other credit, property, or service from the competitors of the bank, the bank's parent holding company, or the parent's other subsidiaries, except that the lending bank may impose conditions and requirements in a credit transaction to ensure the soundness of the credit.

See the statutory exceptions in section 106(b) of the Bank Holding Company Act Amendments and the exceptions in the Federal Reserve's Regulation Y (12 CFR 225.7).

Insider lending activities. Loans to insiders should not contain more favorable terms than those afforded to other borrowers nor should they pose a more than normal risk of repayment. The bank is expected to maintain adequate loan documentation of insider loans showing that proper approval for the loan was obtained. Such loans should comply with the Federal Reserve's Regulation O, Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks (12 CFR 215, subpart A).

Loans to executives, officers, directors, and principal shareholders of correspondent banks. There should be no preferential treatment on loans to insiders of correspondent banks nor should there be the appearance of a conflict of interest. The bank should comply with title VIII of the Financial Institutions Regulatory and Interest Rate Control Act of 1978 (FIRA) (12 USC 1972(2)). (See also 12 CFR 215, subpart B.)

Appraisals and evaluations. Banks should obtain an appraisal or evaluation for all real estate–related financial transactions before making the final credit decision in conformance with title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) (12 USC 3310, 3331–3351) and the Federal Reserve's Regulation H, Membership of State Banking Institutions in the Federal Reserve System (12 CFR 208), as set forth in subpart G of Regulation Y (12 CFR 225). The Federal Reserve's appraisal and evaluation requirements are separately discussed in section 4140.1, "Real Estate Appraisals and Evaluations."

Consumer compliance. The bank's residential lending program should ensure that the loan applicant is adequately informed of the annual interest rate, finance charges, amount financed, total payments, and repayment schedule as mandated in the Federal Reserve's Regulation Z, Truth in Lending (12 CFR 226). The bank's process for taking, evaluating, and accepting or rejecting a credit application is subject to the Federal Reserve's Regulation B, Equal Credit Opportunity (12 CFR 202).

1. To determine if policies, practices, procedures, and internal controls regarding real estate loans are adequate to identify and manage the risks the bank is exposed to.
2. To ascertain if the institution has implemented risk-management programs that identify, measure, monitor, and control the inherent risks involved in real estate lending.
3. To determine if bank officers and staff are operating in conformance with the bank's established guidelines.
4. To evaluate the portfolio for collateral sufficiency, performance, credit quality, and collectibility.
5. To determine compliance with applicable laws and regulations.
6. To initiate corrective action when policies, practices, procedures, objectives, or internal controls are deficient or when violations of laws or regulations have been noted.

1. Determine the scope of the examination based upon the evaluation of internal controls and the work performed by internal/external auditors.
2. Review the board of directors minutes to ensure that real estate loan policies are reviewed and approved at least annually.
3. Test real estate loans for compliance with policies, practices, and procedures by performing the remaining examination procedures in this section. Obtain a listing of any deficiencies noted in the latest internal/external audit report and determine if appropriate corrections have been made. Additionally, obtain a list of personnel changes and determine if these changes are significant enough to influence the scope of the examination.
4. Obtain a trial balance and delinquency listing for all real estate loans and—
   a. reconcile the real estate department's trial balance totals to the bank's general ledger accounts;
   b. review reconciling items for reasonableness; and
   c. obtain information (for example, paid-to dates, last date paid, and date of nonaccrual status) on past-due loans and loans on nonaccrual status.
5. Evaluate the bank with respect to—
   a. the adequacy of written policies and procedures relating to real estate loans;
   b. the operating compliance with established bank policy;
   c. favorable or adverse trends in the overall real estate lending activity;
   d. the accuracy and completeness of the bank's records;
   e. the adequacy of internal controls;
   f. adherence to lending policies, procedures, and authority by all appropriate personnel;
   g. compliance with laws, regulations, and Federal Reserve policy on real estate lending activity, including lending limits and restrictions; loans to officers, directors, and shareholders; appraisal and evaluation of real estate collateral; and lending practices;
   h. compliance with the Interagency Guidelines for Real Estate Lending Policies, including whether the bank is adequately documenting exceptions to supervisory loan-to-value (LTV) limits, whether the volume of nonconforming loans exceeds the capital limitations, and whether risk-management programs have been established and maintained to identify, measure, monitor, and control the inherent risks associated with high LTV lending; and
   i. other matters of significance, including mortgage servicing, warehousing operations, and the loan origination/resale process.
6. Select loans for examination using an appropriate sampling technique drawn from judgmental (cut-off amount approach) or statistical sampling. Analyze the performance of the loans selected for review by transcribing the appropriate information from the following list onto the real estate loan line cards, when applicable:
   a. collateral records and credit files
   b. loan agreements relative to any purchases, transfers, participations, or sales that have been entered into since the last examination
   c. loan commitments and other contingent liabilities
   d. loan modification agreements or restructuring terms to identify a reduction in interest rate or principal payments, deferral of interest or principal payments, or other restructurings of terms
   e. past-due/nonaccrual–related information
   f. loan-specific internal problem credit analyses information
   g. escrow analysis reports, including the status of property tax payments and escrow advances by the bank to cover delinquent property taxes
   h. the status of mortgage insurance claims either for government insurance or guarantee programs or for private mortgage insurance, including procedures for ensuring coverage and reporting procedures for filing claims and contested claims, if any
   i. loans to insiders and their interests
7. In analyzing the selected real estate loans, consider the following procedures, taking

appropriate action if necessary:

a. Determine the primary source of repayment and evaluate its adequacy.
b. Assess the quality of any secondary collateral afforded by the loan guarantors or partners.
c. Compare collateral values with outstanding debt and determine whether the loan's LTV ratio is in excess of the supervisory LTV limits. If so, ascertain whether the loan has been properly reported as a nonconforming loan.
d. Assess the adequacy of the appraisal or evaluation.
e. Ascertain whether the loan complies with established bank policy.
f. Identify any deficiencies in the loan's documentation both in the credit files and in the collateral records.
g. Identify whether the loan is to an officer, director, or shareholder of the bank or a correspondent bank and whether an officer, director, or shareholder of the bank is a guarantor on the loan.
h. Review the borrower's compliance with provisions of the loan agreement and the borrower's payment performance, indicating whether the loan is past due.
i. Determine if there are any problems that may jeopardize the repayment of the real estate loan.
j. Determine whether the loan was classified during the preceding examination, and, if the loan has been paid off, whether all or part of the funds for repayment came from another loan at the bank, from a participation or sale with another institution, or from the repossession of the property.
k. Identify whether the loan is to a firm or to individuals who are principals of a firm that provided professional services to the bank, including attorneys, accountants, and appraisers. If so, determine if the loan has received preferential treatment.

8. For loan participations, either in whole or in part, to or with another lending institution, review, if applicable—
   a. participation certificates and agreements, on a test basis, to determine if the contractual terms are being adhered to;
   b. loan documentation to see if it meets the bank's underwriting procedures as if the loan had been originated by the bank;
   c. the transfer of loans immediately before the date of the examination to determine if the loan was either nonperforming or classified and if the transfer was made to avoid possible criticism during the current examination; and
   d. losses to determine if such losses are shared on a pro rata basis.
9. For participations between an institution with a different primary regulator and the shared national credit program loans—
   a. identify loans to be included in the shared national credit review;
   b. inform the Reserve Bank of any criticized participation loans that were not covered by the shared national credit program and in which the participant(s) has a different primary regulator; and
   c. inform the Reserve Bank of those loans eligible for the shared national credit program that were not previously reviewed.
10. In connection with the examination of other lending activity in the bank—
    a. check the central liability file on the borrower(s) and determine whether the total indebtedness of the borrower exceeds the lending limit to a single borrower; and
    b. obtain information and related performance status on common borrowers and their interests from examiners assigned to other examination areas (such as non–real estate loans, leasing, overdrafts, and cash items) and determine the total indebtedness of the borrower to the bank. Additionally, one examiner should be assigned to review the borrower's overall borrowing relationship with the bank.
11. Consult with the examiner responsible for the asset/liability management analysis portion of the examination to determine the appropriate maturity breakdown of real estate loans needed for the analysis, and prepare the necessary schedules.
12. Summarize the findings of the real estate loan portfolio review and address the following:
    a. the scope of the examination
    b. the quality of the policies, procedures, and controls
    c. the general level of adherence to policies and procedures
    d. the competency of management and loan officers, including identification of indi-

viduals with an excessively high level of problem loans or documentation exceptions
e. the quality of the loan portfolio
f. loans not supported by current and complete financial information
g. loans with incomplete documentation, addressing deficiencies related to items such as appraisals or evaluations, title policy, proof of insurance, deeds of trust, and mortgage notes
h. loans to officers, directors, shareholders, or their interests
i. causes of existing problems
j. delinquent loans and the aggregate amount of statutory bad debts. (See section 2060.1, ‘‘Classification of Credits.’’)
k. concentrations of credits
l. classified loans
m. violations of laws, regulations, and Federal Reserve policy
n. action taken by management to correct previously noted deficiencies and corrective actions recommended to management at this examination, with the bank’s response to them

Review the bank's internal controls, policies, practices, and procedures for making and servicing real estate loans. The bank's system should be documented completely and concisely and should include, where appropriate, narrative descriptions, flow charts, copies of forms used, and other pertinent information. Negative responses to the questions in this section should be explained, and additional procedures deemed necessary should be discussed with the examiner-in-charge. Items marked with an asterisk require substantiation by observation or testing.

LOAN POLICIES

1. Has the board of directors and management, consistent with their duties and responsibilities, adopted and, at least annually, reviewed and approved written real estate loan policies that define—
   a. the institution's target market?
   b. loan portfolio diversification standards?
   c. acceptable collateral types?
   d. prudent, clear, and measurable underwriting standards, including relevant credit factors such as—
      - maximum loan amount by type of property?
      - maximum loan maturity by type of property?
      - repayment terms?
      - pricing structure for each type of real estate loan?
      - loan-to-value (LTV) limits by type of property?
   e. procedures for reviewing real estate loan applications?
   f. loan-origination and -approval procedures (including loan authority limits) by size and type of loan?
   g. review and approval procedures for exception loans?
   h. loan-administration procedures that include documentation, disbursement, collateral inspection, collection, and loan review?
   i. minimum loan-documentation standards, such as minimum frequency and type of financial information required for each category of real estate loan?
   j. LTV limits that are consistent with regulatory supervisory limits?
   k. real estate appraisal and evaluation programs consistent with the Federal Reserve's appraisal regulation and guidelines?
   l. reporting requirements to the board of directors relative to loan portfolio monitoring, including items such as compliance with lending policies and procedures, delinquency trends, and problem loans?
2. Are real estate policies and objectives appropriate to the size and sophistication of the bank, and are they compatible with changing market conditions?

LOAN RECORDS

*3. Are the preparation and posting of subsidiary real estate loan records performed or adequately reviewed by persons who do not also—
   a. issue official checks and drafts?
   b. handle cash receipts?
   c. reconcile subsidiary records to general ledger controls?

*4. Are the subsidiary real estate loan records reconciled at least monthly to the appropriate general ledger accounts? Are reconciling items adequately investigated by persons who do not also handle cash or prepare/post subsidiary controls?

5. Are loans in excess of supervisory LTV limits identified in the bank's records, and are the aggregate amounts of such loans reported at least quarterly to the board of directors, along with the experience of the high LTV loan portfolio?
6. Are loan statements, delinquent account collection requests, and past-due notices reconciled to the real estate loan subsidiary records? Are the notices and reconciliations handled by persons who do not also handle cash?
7. Are inquiries about loan balances received and investigated by persons who do not also handle cash?

*8. Are documents supporting recorded credit adjustments subsequently checked or tested by persons who do not also handle cash?
9. Does the bank maintain a daily record summarizing note transaction details (loans made, payments received, and interest collected) to support applicable general ledger account entries?
10. Are note and liability trial balances frequently reconciled to the general ledger by employees who do not process or record loan transactions?
11. Are subsidiary payment records and files pertaining to serviced loans segregated and identifiable?
12. Are past-due loan reports generated daily?

LOAN INTEREST AND COMMITMENT FEES

*13. Are the preparation and posting of loan interest and fee records performed or adequately reviewed by persons who do not also—
    a. issue official checks or drafts?
    b. handle cash?
14. Are any independent interest and fee computations made and compared with or adequately tested to loan interest records by persons who do not also—
    a. issue official checks or drafts?
    b. handle cash?

PROCESSING AND DOCUMENT CONTROL

*15. Are all real estate loan commitments issued in written form?
16. Are loan officers prohibited from processing loan payments?
*17. Are loan payments received by mail recorded upon receipt independently before being sent to and processed by a note teller?
*18. Regarding mortgage documents—
    a. Has the responsibility for the document files been established?
    b. Does the bank use a check sheet to ensure that required documents are received and on file?
    c. Are safeguards in effect to protect notes and other documents?
    d. Does the bank obtain a signed application form for all real estate mortgage loan requests?
    e. Are separate credit files maintained?
    f. Is there a program of systematic follow-up to determine that all required documents are received after the loan closing and from public recording offices?
    g. Does a designated employee conduct a review after loan closing to determine if all documents are properly drawn, executed, recorded, and filed within the loan files?
    h. Are all notes and other instruments pertaining to paid-off loans returned promptly to the borrower, cancelled, and marked paid, where appropriate?
    i. Are charged-off notes and related files segregated and adequately controlled?

LOAN ORIGINATION

19. Does the bank have a written schedule of fees, rates, terms, and types of collateral for all new loans?
20. Does the bank have a mortgage errors and omission policy?
21. Are procedures in effect to ensure compliance with the requirements of governmental agencies that insure or guarantee loans or with the requirements of private mortgage insurance companies?

ESCROW PROCESSING

22. Regarding insurance and property taxes coverage—
    a. Is there a procedure for determining that private mortgage insurance premiums are current on insured loans?
    b. Is there a procedure for determining that property and hazard insurance premiums are current on properties securing loans?
    c. Does the bank require that the hazard insurance policies include a loss payable clause to the bank?
    d. Are escrow accounts reviewed at least annually to determine if monthly deposits will cover anticipated disbursements?

e. Are disbursements for taxes and insurance supported by records showing the nature and purpose of the disbursement?
f. If advance deposits for taxes and insurance are not required, does the bank have a system to determine that taxes and insurance are being paid?

LOAN ADMINISTRATION

*23. Are approvals of real estate advances reviewed, before disbursement, to determine that such advances do not increase the borrower's total liability to an amount in excess of the bank's legal lending limit?

24. Are detailed statements of account balances and activity mailed to mortgagors at least annually?

COLLECTIONS AND FORECLOSURES

25. Does the bank have adequate collection procedures to monitor delinquencies and, as necessary, procedures to pursue foreclosure?
26. Are properties under foreclosure proceedings segregated?
27. Are properties to which the bank has obtained title appropriately transferred to other real estate owned (OREO)? See "Other Real Estate Owned," section 2200.1, for requirements.
28. Does the bank have an adequate management and sales disposition program for timely liquidation of OREO that takes into account the maximum retention period for OREO allowed under state law?
29. Does the bank have adequate procedures for filing and monitoring its mortgage insurance claims for government-insured or -secured programs and for private mortgage insurance?

CONCLUSION

30. Does the foregoing information provide an adequate basis for evaluating internal control in that deficiencies in areas not covered by this questionnaire do not significantly impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
31. Are internal controls adequate based on a composite evaluation, as evidenced by answers to the foregoing questions?

INTRODUCTION

A construction loan is used to finance the construction of a particular project within a specified period of time and is funded by supervised disbursements of a predetermined amount over the construction period. When properly controlled, a bank can promote commercial or residential development through its construction lending as well as receive significant profits over a relatively short time frame. However, the higher rate of return demanded by construction lenders is indicative of the higher risks assumed.

Inasmuch as construction lending is a form of interim financing, loan repayment is contingent upon the borrower either obtaining permanent financing or finding a buyer with sufficient funds to purchase the completed project. Because many borrowers anticipate retaining ownership after construction, the cost and availability of funds from permanent financing is a primary factor to be considered by the bank in assessing the risk of a construction loan.

A construction loan is generally secured by a first mortgage or deed of trust on the land and improvements, which is often backed by a purchase agreement from a financially sound investor or by a takeout financing agreement from a responsible permanent lender. A long-term mortgage loan (permanent financing) is typically obtained prior to or simultaneous with the construction loan and is made to refinance the short-term construction loan. Additionally, the bank may require a borrower to provide secondary collateral in the form of a junior interest in another real estate project or a personal guarantee.

BANK LENDING POLICY

Banks can limit the risk inherent in construction lending by establishing policies that specify the type and extent of bank involvement. The bank's lending policies should reflect prudent lending standards and set forth pricing guidelines, limits on loan-to-value ratios and debt-coverage ratios, and yield requirements. Such policies should also address procedures relative to controlling disbursements in a manner that is commensurate with the construction progress.

Lending Limits

A bank should have established and well-controlled construction lending limits that are within the acceptable standards of state banking regulations. State banking statutes governing construction lending may contain minimum standards of prudence without specifying actual loan terms.

The bank's internal limits should not exceed the supervisory loan-to-value (LTV) limits set forth in the Interagency Guidelines for Real Estate Lending Policies, as required by section 304 of the Federal Deposit Insurance Corporation Improvement Act of 1991 and included as appendix C of the Federal Reserve's Regulation H. These guidelines, and the accompanying LTV limits, are discussed in the Real Estate Loans section of this manual. Generally, the LTV ratio should not exceed the following supervisory limits:

- 65 percent for raw land loans;
- 75 percent for land development and improved land loans;
- 80 percent for commercial, multifamily, and other nonresidential construction loans; and
- 85 percent for one- to four-family residential construction loans.

For loans that fund multiple phases of the same real estate project, the appropriate LTV limit is the supervisory LTV limit applicable to the final phase of the project.

Lending Risks

Construction loans are vulnerable to a wide variety of risks. Critical to the evaluation of any construction loan is the analysis of the project's feasibility study to ascertain the developer's risk, which affects the lender's risk. The major portion of the risk is attributable to the need to complete a project within specified cost and time limits. Examples of difficulties that may arise include:

- Completion of a project after takeout dates, which voids permanent funding commitments.

- Cost overruns, which may exceed takeout commitments or sale prices.
- The possibility that the completed project will be an economic failure.
- The diversion of progress payments resulting in nonpayment of material bills or subcontractors.
- A financial collapse of or the failure of the contractors, subcontractors, or suppliers to perform before the completion date.
- Increased material or labor costs.
- The destruction of improvements from unexpected natural causes.
- An improper or lax monitoring of funds advanced by the bank.

TYPES OF CONSTRUCTION LOANS

The basic types of construction lending are unsecured front money, land development, residential construction, and commercial construction loans. It is not uncommon for a bank to provide the acquisition, development, and construction loans for a particular project.

Unsecured Front Money Loans

Front money loans are considered very risky and should not be undertaken unless the bank has the expertise to evaluate the credit risk. These loans may represent working capital advances to a borrower who may be engaged in a new and unproven venture. The funds may be used to acquire or develop a building site, eliminate title impediments, pay architect or standby fees, and meet minimum working capital requirements established by construction lenders. Because repayment often comes from the first draw against construction financing, many construction loan agreements prohibit the use of the first advance to repay nonconstruction costs. Unsecured front money loans used as a developer's equity investment in a project or to cover initial cost overruns are symptomatic of an undercapitalized or possibly an inexperienced or inept builder.

Land Development Loans

Land development or off-site improvement loans are intended to be secured-purchase loans or unsecured advances to creditworthy borrowers. A development loan involves the purchase of land and lot development in anticipation of further construction or sale of the property. In addition to funding the acquisition of the land, a development loan may be used to fund the preparation of the land for future construction, including the grading of land, installation of utilities, and construction of streets.

Effective administration of a land development loan begins with a plan defining each step of the development. The development plan should incorporate cost budgets, including legal expenses for building and zoning permits, environmental impact statements, costs of installing utilities, and all other projected costs of the development. Bank management's review of the plan and related cost breakdowns should provide the basis for determining the size, terms, and restrictions for the development loan. Refer to the subsection below on the assessment of real estate collateral for further discussion.

The LTV ratio should provide for sufficient margin to protect the bank from unforeseen events (such as unplanned expenses) that would otherwise jeopardize the bank's collateral position or repayment prospects. If the loan involves the periodic development and sale of portions of the property under lien, each separately identifiable section of the project should be independently appraised and any collateral should be released in a manner that maintains a reasonable margin. The repayment program should be structured to follow the sales or development program. Control over development loans can be best established when the bank finances both the development and the construction or sale phases of the project.

In the case of an unsecured land development loan, it is essential to analyze the borrower's financial statements to determine the source of loan repayment. In establishing the repayment program, the bank should review sales projections to ensure that they are not overly optimistic. Additionally, banks should avoid granting loans to illiquid borrowers or guarantors who provide the primary support for a borrower (project).

Residential Construction Loans

Residential construction loans are made either on a speculative basis, where homes are built to be sold later in the general market, or for a specific buyer with prearranged permanent financing. Loans financing residential projects that do not have prearranged homebuyer financing are usually limited to a predetermined number of speculative homes, which are permitted to get the project started. However, smaller banks are often engaged in this type of financing and the aggregate total of individual speculative construction loans may equal a significant portion of their capital funds. It is important to ensure that the homebuyer has arranged permanent financing before the bank finances the construction; otherwise, the bank may find itself without a source of repayment. Construction loans without permanent takeout commitments generally should be aggregated to determine whether a concentration of credit exists, that is, in those situations when the amount exceeds 25 percent of the bank's capital structure (tier 1 capital plus loan loss reserves).

Proposals to finance speculative construction should be evaluated according to predetermined policies that are compatible with the institution's size, the technical competence of its management, and the housing needs of its service area. The prospective borrower's reputation, experience, and financial condition should also be reviewed to assess the likelihood of completing the proposed project. Until the project is completed, the actual value of the real estate is questionable. Thus, the marketability of the project should be substantiated in a feasibility study, reflecting a realistic assessment of current favorable and unfavorable local housing market conditions. As in any real estate loan, the bank must also obtain an appraisal or evaluation for the project. The appraisal or evaluation and the feasibility study are important tools to be used by lenders in evaluating project risks. For projects located out of area, the lender may lack market expertise, which makes evaluating the reasonableness of the marketing plan and feasibility study more difficult, and therefore makes the loan inherently riskier.

A bank dealing with speculative builders should have control procedures tailored to the individual project. A predetermined limit on the number of unsold units to be financed at any one time should be included in the loan agreement to avoid overextending the builder's capacity. The construction lender should receive current inspection reports indicating the project's progress. In some instances, the construction lender is also the permanent mortgagor. Loans on larger residential construction projects are usually negotiated with prearranged permanent financing as part of the construction loan.

Commercial Construction Loans

A bank's commercial construction lending activity can encompass a wide range of projects—apartments, condominiums, office buildings, shopping centers, and hotels—with each requiring a special set of skills and expertise to successfully manage, construct, and market.

Commercial construction loan agreements should normally require the borrower to have a precommitted extended-term loan to ''takeout'' the construction lender. Takeout financing agreements, however, are usually voidable if construction is not completed by the final funding date, if the project does not receive occupancy permits, or if the preleasing or occupancy rate does not meet an agreed-upon level. A bank can also enter into an ''open-end'' construction loan where there is no precommitted source to repay the construction loan. Such loans pose an added risk because the bank may be forced into providing permanent financing, oftentimes in distressed situations. In evaluating this risk, the bank should consider whether the completed project will be able to attract extended-term financing, supportable by the projected net operating income.

The risk of commercial construction requires a complete assessment of the real estate collateral, borrower's financial resources, source of the extended-term financing, and construction plans. As in any real estate loan, the bank must obtain an appraisal or evaluation of the real estate in accordance with the Federal Reserve's appraisal regulation. Additionally, the borrower should provide a feasibility study for the project that details the project's marketing plan, as well as an analysis of the supply-and-demand factors affecting the projected absorption rate. For an open-end construction loan, the feasibility study is particularly important to the bank's assessment of the credit because the repayment of the loan becomes increasingly dependent on the sales program or leasing of the project.

The bank also needs to assess the borrower's development expertise, that is, whether the borrower can complete the project within budget and according to the construction plans. The financial risk of the project is contingent on the borrower's development expertise because the source of the extended-term loan may be predicated upon a set date for project completion. Until the project is completed, the actual value of the real estate is questionable.

A bank may reduce its financial risk by funding the construction loan after the borrower has funded its share of the project equity (for example, by paying for the feasibility study and land acquisition and development costs). An alternative approach would require the borrower to inject its own funds into the project at agreed-upon intervals during the project's management, construction, and marketing phases to coincide with the construction lender's contributions. In larger projects, equity injections can be provided by equity partners or joint ventures. These can take the form of equity syndications,[1] whose contributions are injected in the project in phases. A bank should assess the likelihood of the syndication being able to raise the necessary equity.

BANK ASSESSMENT OF THE BORROWER

The term ''borrower'' can refer to different types of entities. These forms can range from an entity whose sole asset is the project being financed to an entity that has other assets available to support the debt in addition to the project being financed (a multi-asset entity).

Although the value of the real estate collateral is an important component of the loan approval process, the bank should not place undue reliance on the collateral value in lieu of an adequate analysis of the borrower's ability to repay the loan. The analytical factors differ depending on the purpose of the loan, such as residential construction versus the various types of commercial construction loans.

The bank's analysis is contained in its documentation files, which should include background information on the borrower and partner/guarantor concerning their character and credit history, expertise, and financial statements (preferably audited) for the most recent fiscal years. Background information regarding a borrower's and partner's/guarantor's character and credit history is based upon their work experience and previous repayment practices, both relative to trade creditors and financial institutions. The documentation files should indicate whether the borrower has demonstrated it can successfully complete the type of project to be undertaken. The financial statements should be analyzed to ensure that the loan can be repaid in the event that a takeout does not occur.

The degree of analysis depends on whether the borrower is in reality a single-asset entity or a multi-asset entity. A loan to a single-asset entity is often predicated upon the strength of the partners/guarantors. Accordingly, understanding their financial strength, which frequently is made up of various partnership interests, is key to assessing the project's strength. In this example, it would be necessary to obtain financial information on the partner's/guarantor's other projects, even those not financed by the bank, to understand their overall financial condition. This is necessary because other unsuccessful projects may cause financial trouble for the partner/guarantor, despite a successful sales program by the bank's borrower. Issues to be considered, in addition to those raised in the preceding paragraph, include the vacancy rates of the various projects, break-even points, and rent rolls.

A loan to a multi-asset entity has similar characteristics to those found in the single-asset entity, in that it is necessary to evaluate all of the assets contained therein to ascertain the actual financial strength. In both cases, assessment of the project under construction would include preleasing requirements. For a loan with a takeout commitment, the financial strength and reputation of the permanent lender should be analyzed. For a loan without a takeout commitment, or one where the construction lender provides the permanent financing for its construction loan, the long-term risks also need to be evaluated. Refer to the Real Estate Loans section in this manual, on the bank's assessment of the borrower, for additional factors to be considered.

In instances where approval for the loan is predicated upon the strength of entities other than the borrower (partner/guarantor), the bank should obtain information on their financial condition, income, liquidity, cash flow, contingent liabilities, and any other relevant factors

1. Syndication generally refers to the act of bringing together a group of individuals or entities to invest in a real estate project and does not refer to any particular legal form of ownership. The legal form varies depending on the investors' investment objectives, division of tax benefits, responsibility for project management, and desire to limit personal liability. The investment vehicle may be a general partnership, limited partnership, joint venture, tenancy in common, corporation, real estate investment trust, and common law trust.

that exist to demonstrate their financial capacity to fulfill the obligation in the event that the borrower defaults.

Partners/guarantors generally have investments in other projects included as assets on their financial statements. The value of these investments frequently represents the partner's/guarantor's own estimate of the investment's worth, as opposed to a value based upon the investment's financial statements. As a result, it is necessary to obtain detailed financial statements for each investment to understand the partner's/guarantor's complete financial picture and capacity to support the loan. The statements should include detailed current and accurate cash flow information since cash flow is often the source of repayment.

It is also important to consider the number and amount of the guarantees currently extended by a partner/guarantor to determine if they have the financial capacity to fulfill the contingent claims that exist. Furthermore, the bank should review the prior performance of the partner/guarantor to voluntarily honor the guarantee as well as the marketability of the assets collateralizing the guarantee. Since the guarantee can be limited to development and construction phases of a project, the bank should closely monitor the project before issuing a release to the partner/guarantor.

BANK ASSESSMENT OF REAL ESTATE COLLATERAL

Banks should obtain an appraisal or evaluation, as appropriate, for all real estate–related financial transactions prior to making the final credit or other decision. Refer to the Real Estate Appraisals and Evaluations section of this manual for a description of the related requirements a bank must follow for real estate–related financial transactions. The appraisal section explains the standards for appraisals, indicates which transactions require an appraisal or an evaluation, states qualifications for an appraiser and evaluator, provides guidance on evaluations, and describes the three appraisal approaches.

The appraisal or evaluation techniques used to value a proposed construction project are essentially the same as those used for other types of real estate. The aggregate principal amount of the loan should be based on an appraisal or evaluation that provides, at a minimum, the ''as is'' market value of the property.[2] Additionally, the bank will normally request the appraiser to report the ''as completed'' value.[3] Projections should be accompanied by a feasibility study explaining the effect of projected property improvements on the market value of the land. The feasibility study may be a separate report or incorporated into the appraisal report. If the appraiser uses the feasibility study, the appraiser's acceptance or rejection of the study and its effect on the value should be fully explained in the appraisal.

Management is responsible for reviewing the reasonableness of the appraisal's or evaluation's assumptions and conclusions. Also, management's rationale in accepting and relying upon the appraisal or evaluation should be in writing and made a part of loan documentation. In assessing the underwriting risks, management should reconsider any assumptions used by an appraiser that reflect overly optimistic or pessimistic values. If management, after its review of the appraisal or evaluation, determines that there are unsubstantiated assumptions, the bank may request the appraiser or evaluator to provide a more detailed justification of the assumptions or obtain a new appraisal or evaluation. Since the approval of the loan is based upon the value of the project after the construction is completed, insofar as the value component of the loan-to-value ratio is concerned, it is important for the bank to closely monitor the project's progress (value) during the construction period. Refer to the Real Estate Loans section of the manual for additional information relative to the real estate collateral assessment.

LOAN DOCUMENTATION

The loan documentation should provide infor-

2. The ''as is'' value is the value of the property in its current physical condition and subject to the zoning in effect as of the date of appraisal.

3. The ''as completed'' value reflects the value of the land and the projected improvements. A bank may also request a value based on stabilized occupancy or a value based on the sum of retail sales. However, the sum of retail sales for a proposed development is not the market value of the development. For proposed residential developments that involve the sale of individual houses, units, or lots, the appraisal should reflect deductions and discounts for holding costs, marketing costs, and entrepreneurial profit. For proposed and rehabilitated income-producing properties, the appraisal should reflect appropriate deductions and discounts for leasing commissions, rent losses, and tenant improvements from the estimated value based on stabilized occupancy.

mation on the essential details of the loan transaction, the security interest in the real estate collateral, and the takeout loan commitment, if any. The necessary documentation before the start of construction generally includes:

- Financial and background information on the borrower to substantiate the borrower's expertise and financial strength to complete the project.
- The construction loan agreement, which sets forth the rights and obligations of the lender and borrower, conditions for advancing funds, and events of default. In some states, the agreement must be cited in either the deed of trust or the mortgage.
- A recorded mortgage or deed of trust, which can be used to foreclose and to obtain title to the collateral.
- A title insurance binder or policy, usually issued by a recognized title insurance company or, in some states, an attorney's opinion. The title should be updated with each advance of funds to provide additional collateral protection.
- Insurance policies and proof of payment as evidence that the builder has adequate and enforceable coverage for liability, fire and other hazards, and vandalism and malicious mischief losses.
- An appropriate appraisal or evaluation showing the value of the land and improvements to date or, possibly, a master appraisal based on specifications for a multiphase development.
- Project plans, a feasibility study, and a construction budget showing the development plans, project costs, marketing plans, and equity contributions. A detailed cost breakdown of land and "hard" construction costs, as well as indirect or "soft" costs for construction loan interest, organizational and administration cost, and architectural, engineering, and legal fees should be included.
- Property surveys, easements, an environmental impact report, and soil reports that indicate construction is feasible on the selected development site. The bank should also obtain the architect's certification of the plan's compliance with all applicable building codes and zoning, environmental protection, and other government regulations, as well as the engineer's report on compliance with building codes and standards. If internal expertise is not available, a bank may need to retain an independent construction expert to review these documents to assess the reasonableness and appropriateness of the construction plans and costs.
- The takeout commitment from the permanent lender, if applicable, and the terms of the loan. The bank should verify the financial strength of the permanent lender to fund the takeout commitment.
- A completion or performance bond signed by the borrower that guarantees the borrower will apply the loan proceeds to the project being financed.
- An owners' affidavit or a borrowing resolution empowering the borrower or its representative to enter into the loan agreement.
- Evidence that property taxes have been paid to date.

These documents furnish evidence that the lending officer is obtaining the information necessary for processing and servicing the loan and protect the bank in the event of default.

Documentation for Residential Construction Loans on Subdivisions

The documents mentioned above are usually available for residential construction loans on subdivisions (tracts). Documentation of tract loans frequently includes a master note in the gross amount of the entire project, and a master deed of trust covering all of the land involved in the project. In addition to an appraisal or evaluation for each type of house to be constructed, the bank should also obtain a master appraisal including a feasibility study for the entire development. The feasibility study compares the projected demand for housing against the anticipated supply of housing in the market area of the proposed tract development. This analysis should indicate whether there will be sufficient demand for the developer's homes given the project's location, type of homes, and unit sales price.

Documentation for the Takeout Commitment

Most construction lenders require the developer to have an arrangement for permanent financing for each house to be constructed. Exceptions include model homes, typically one for each style of home offered, and a limited number of housing starts ahead of sales (speculative houses). The starts ahead of sales, however, contain additional risk. If the bank finances too many houses without purchase contracts, and housing sales decline rapidly, it may have to foreclose on the unsold houses and sell them for less than their loan value. A takeout of this type is usually an arrangement between the developer and a permanent mortgage lender, but construction lenders may also finance the permanent mortgages.

The essential information required for a commercial real estate takeout to proceed includes the floor and ceiling rental rates and minimum occupancy requirements; details of the project being financed; expiration date; standby fee requirement; assignment of rents; and, generally, a requirement that the construction loan be fully disbursed and not in any way in default at the time settlement occurs.

The commitment agreement, referred to as the buy/sell contract or the tri-party agreement, is signed by the borrower, the construction lender, and the permanent lender. The purpose of this agreement is to permit the permanent lender to buy the loan directly from the construction lender upon completion of the construction, with the stipulation that all contingencies have been satisfied. Examples of contingencies include project completion by the required date, clear title to the property, and minimum lease-up requirements. A commitment agreement also protects the construction lender against unforeseen possibilities, such as the death of a principal, before the permanent loan documents are signed.

ADMINISTERING THE LOAN

The bank and the borrower[4] must effectively cooperate as partners if controls relative to construction progress are to be maintained. The loan agreement specifies the performance of each party during the entire course of construction. Any changes in construction plans should be approved by both the construction lender and the takeout lender. Construction changes can result in increased costs, which may not necessarily increase the sale value of the completed project. On the other hand, a decrease in costs may not indicate a savings but may suggest the use of lesser quality materials or workmanship, which could affect the marketability of the project.

Disbursement of Loan Funds

Loan funds are generally disbursed through either a stage payment plan or a progress payment plan. Regardless of the method of disbursement, the amount of each construction draw should be commensurate with the improvements made to date. Funds should not be advanced unless they are used in the project being financed and as stipulated in the draw request. Therefore, the construction lender must monitor the funds being disbursed and must be assured, at every stage of construction, that sufficient funds are available to complete the project.

Stage Payment Plan

The stage payment plan, which is normally applied to residential and smaller commercial construction loans, uses a preestablished schedule for fixed disbursements to the borrower at the end of each specified stage of construction. The amount of the draw is usually based upon the stage of development because residential housing projects normally consist of houses in various stages of construction. Nevertheless, loan agreements involving tract financing typically restrict further advances in the event of an accumulation of completed and unsold houses. Disbursements are made when construction has reached the agreed-upon stages, verified by an actual inspection of the property. These typically include advances at the conclusion of various stages of construction, such as the foundation, exterior framing, the roof, interior finishing, and completion of the house. The final payment is made after the legally stipulated lien period for mechanic’s liens has lapsed.

Disbursement programs of this type are usually required for each house constructed within a tract development. As each house is completed and sold, the bank makes a partial release relative to that particular house covered by its

4. The borrower may not be the entity responsible for the actual construction of the project. Depending on the size, type, and complexity of the project, the borrower may strictly be a developer who assembles the land, designs the project, and contracts with a construction company to handle the actual construction of the building. If this is the case, the bank should obtain financial and project history information on the builder/contractor.

master deed of trust. The amount of the release is set forth in the loan agreement, which specifies the agreed-upon release price for each house sold with any excess over the net sales proceeds remitted to the borrower.

Progress Payment Plan

The progress payment plan is normally used for commercial projects.[5] Under a progress payment system, funds are released as the borrower completes certain phases of construction as agreed upon in the loan agreement. Normally, the bank retains a percentage of the funds as a hold back (or retainage) to cover project cost overruns or outstanding bills from suppliers or subcontractors. Hold backs occur when a developer/contractor uses a number of subcontractors and maintains possession of a portion of the amounts owed to the subcontractors during the construction period. This is done to ensure that the subcontractors finish their work before receiving the final amount owed. Accordingly, the construction lender holds back the same funds from the developer/contractor to avert the risk of their misapplication or misappropriation.

The borrower presents a request for payment from the bank in the form of a ‘‘construction draw’’ request or ‘‘certification for payment,’’ which sets forth the funding request by construction phase and cost category for work that has been completed. This request should be accompanied by receipts for the completed work (material and labor) for which payment is being requested. The borrower also certifies that the conditions of the loan agreement have been met—that all requested funds have been used in the subject project and that suppliers and subcontractors have been paid. Additionally, the subcontractors and suppliers should provide the bank with lien waivers covering the work completed for which payment has been received. Upon review of the draw request and independent confirmation on the progress of work, the bank will disburse funds for construction costs incurred, less the hold back. The percentage of the loan funds retained are released when a notice of the project’s completion has been filed, and after the stipulated period has elapsed under which subcontractors or suppliers can file a lien.

Monitoring Progress of Construction and Loan Draws

It is critical that a bank has appropriate procedures and an adequate tracking system to monitor payments to ensure that the funds requested are appropriate for the given stage of development. The monitoring occurs through physical inspections of the project once it has started. The results of the inspections are then documented in the inspection reports, which are kept in the appropriate file. Depending on the complexity of the project, the inspection reports can be completed either by the lender or by an independent construction consulting firm, the latter generally staffed by architects and engineers. The reports address both the quantity and the quality of the work for which funds are being requested. They also verify that the plans are being followed and that the construction is proceeding on schedule and within budget.

The bank must be accurately informed of the progress to date in order to monitor the loan. It is also important that the bank ascertain whether draws are being taken in accordance with the predetermined disbursement schedule. Before any draw amount is disbursed, however, the bank must obtain verification of continued title insurance. Generally, this means verifying that no liens have been filed against the title of the project since the previous draw. The title insurance insuring the construction lender’s mortgage or lien is then increased to include the new draw, which results in an increase in the title insurance commensurate with the disbursement of funds. The lender frequently examines title to the property securing the construction loan to also be certain that the borrower is not pledging it for other borrowings and to be sure that mechanic’s liens are not being filed for unpaid bills. When the project is not proceeding as anticipated, that fact should be reflected in the inspection reports.

5. Other methods for disbursing commercial construction loans include the voucher system and the monthly draw method. The voucher system is similar to the progress system except that borrower prepares a voucher of all invoices to be paid with signatures of the subcontractors attesting to the invoiced amount. The bank then issues checks directly to the subcontractors or suppliers. The monthly draw method is used in long-term projects wherein the borrower makes a draw request each month for the previous month’s work. In turn, the bank determines the amount of work completed to date and releases funds based on the value of work completed versus the value of the work remaining.

Another important component in the process is the ongoing monitoring of general economic factors that will affect the marketing and selling of the residential or commercial properties and affect their success upon completion of the project.

Monitoring Residential Projects

An inventory list is maintained for each tract or phase of the project. The inventory list should show each lot number, the style of house, the release price, the sale price, and the loan balance. The list should be posted daily with advances and payments indicating the balance advanced for each house, date completed, date sold, and date paid, and should age the builder's inventory by listing the older houses completed and unsold.

Inspections (usually monthly) during the course of construction of each house should be documented in progress reports. The progress report should indicate the project's activity during the previous month, reflecting the number of homes under construction, the number completed, and the number sold. The monthly report should indicate whether advances are being made in compliance with the loan agreement.

Monitoring Commercial Projects

To have an effective control over its commercial construction loan program, the bank must have an established loan administration process that continually monitors each project. The process should include monthly reporting on the work completed, the cost to date, the cost to complete, construction deadlines, and loan funds remaining. Any changes in construction plans should be documented and reviewed by the construction consulting firm and should be approved by the bank and takeout lender. A significant number of change orders may indicate poor planning or project design, or problems in construction, and should be tracked and reflected in the project's budget. Soft costs such as advertising and promotional expenses normally are not funded until the marketing of the project has started.

Final Repayment

Before the final draw is made, the construction loan should be in a condition to be converted to a permanent loan. Usually the final draw includes payment of the hold back stipulated in the loan agreement and is used to pay all remaining bills. The bank should obtain full waivers of liens (releases) from all contractors, subcontractors, and suppliers before the loan is released and the hold back is disbursed. The bank should also obtain a final inspection report to confirm the project is completed and meets the building specifications, including confirmation of the certificate of occupancy from the governing building authority.

Sources of permanent funding for commercial projects vary greatly, depending upon the type of project. For condominium projects, the construction lender may also be providing the funding for marketing the individual units and would be releasing the loan on a unit-by-unit basis similar to a residential development construction loan. If there is a precommitted takeout lender, the new lender could purchase the construction loan documents and assume the security interest from the construction lender. If the project is being purchased for cash, the bank would release its lien and cancel the note.

Additionally, as the commercial project is leased, the lender should ensure that the bank's position is protected in the event that extended-term funding is not obtained. The bank may require tenants to enter into subordination, attornment, and nondisturbance agreements, which protect the bank's interests in the lease by providing for the assumption of the landlord's position by the bank in the event the borrower declares bankruptcy. Furthermore, to ensure that the bank has full knowledge of all provisions of the lease agreements, tenants should be required to sign an estoppel certification.

In some cases, the takeout lender may only pay off a portion of the construction loan because a conditional requirement for full funding has not been met, such as the project not attaining a certain level of occupancy. The construction lender would then have a second mortgage on the remaining balance of the construction loan. When the conditions of the takeout loan are met, the construction lender is repaid in full and the lien is released.

Interest Reserves

A construction loan is generally an interest-only loan because of the fact that cash flow is not available from most projects until they are completed. The borrower's interest expense is therefore borrowed from the construction lender as part of the construction loan for the purpose of "paying" the lender interest on the "portion" of the loan used for actual construction. The funds advanced to pay the interest are included as part of the typical monthly draw. As a result, the balance due to the lender increases with each draw by the full amount of construction costs, plus the interest that is borrowed.

The borrower's interest cost is determined by the amount of credit extended and the length of time needed to complete the project. This interest cost is referred to as an interest reserve. This period of time should be evaluated for reasonableness relative to the project being financed. In larger projects cash flow may be generated prior to the project's completion. In such cases, any income from the project should be applied to debt service before there is a draw on the interest reserve. The lender should closely monitor the lease-up of the project to ensure that the project's net income is being applied to debt service and not diverted to the borrower as a return of the developer's capital or for use in the developer's other projects.

Loan Default

The inherent exposure in construction financing is that the full value of the collateral is not realized until the project is completed. In default situations the bank must consider the alternatives available to recover its advances. For uncompleted projects, the bank must decide whether it is more advantageous to complete the project or to sell on an "as is" basis. The various mechanic's and materialmen's liens, tax liens, and other judgments that arise in such cases are distressing to even the most seasoned lender. Due to these factors, the construction lender may not be in the preferred position indicated by documents in the file. Therefore, the lender should take every precaution to minimize any third-party claim on the collateral. Because laws regarding the priority of certain liens may vary among states, the bank should take the necessary steps to ensure that its lien is recorded prior to the commencement of work or the delivery of materials and supplies.

Signs of Problems

To detect signs of a borrower's financial problems, the bank should review the borrower's financial statements on a periodic (quarterly) basis, assessing the liquidity, debt level, and cash flow. The degree of information the financial statements provide the bank, insofar as understanding the borrower's financial condition is concerned, depends primarily on whether the borrower is a single-asset entity or a multi-asset entity.

The financial statements of a single-asset entity only reflect the project being constructed; therefore, they are of a more limited use than statements of multi-asset entities. Nevertheless, one issue that is of importance to financial statements of both entities relates to monitoring changes in accounts and trade payables. Monitoring these payables in a detailed manner helps the bank to determine if trade payables are paid late or if there are any unpaid bills. In the event of problems, a bank might choose to either contact the payables directly or request an additional credit check on the borrower. Another source of information indicating borrower problems is local publications that list lawsuits or judgments that have been filed or entered against the borrower. Additionally, the bank should also verify that the borrower is making its tax payments on time.

In a multi-asset entity, on the other hand, more potential problems could arise due to the greater number of assets (projects/properties) that make up the borrower. As a result, it is necessary to obtain detailed financial statements of each of the assets (projects/properties) and the consolidating financial statements, as well as the consolidated financial statements. This is important because each kind of statement can provide significant insight into problems that could adversely affect the borrower's overall financial condition.

Assessing the financial condition of the multi-asset entity includes evaluating the major sources of cash and determining whether cash flow is dependent on income generated from completed projects, the sale of real estate, or infusion of outside capital. Additionally, the bank should also review the borrower's account receivables for the appropriateness of intercompany transactions and to guard against diversion of funds.

Depending upon the structure of the loan, it may also be desirable to obtain a partner's/

guarantor's financial statements on a periodic basis. In such cases it is important to obtain detailed current and accurate financial statements that include cash flow information on a project-by-project basis.

Slow unit sales, or excessive inventory relative to sales, indicate the borrower may have difficulty repaying the loan. Although sometimes there are mitigating factors beyond the control of the borrower, such as delays in obtaining materials and supplies, adverse weather conditions, or unanticipated site work, the borrower may be unable to overcome these problems. Such delays usually increase project costs and could hamper the loan's repayment.

The construction lender should be aware of funds being misused—for example, rebuilding to meet specification changes not previously disclosed, starting a new project, or possibly paying subcontractors for work performed elsewhere. The practice of ''front loading,'' whereby a builder deliberately overstates the cost of the work to be completed in the early stages of construction, is not uncommon and, if not detected early on, will almost certainly result in insufficient loan funds with which to complete construction in the event of a default.

Loan Workouts

Sound workout programs begin with a full disclosure of all relevant information based on a realistic evaluation of the borrower's ability to manage the business entity (business, technical, and financial capabilities), and the bank's ability to assist the borrower in developing and monitoring a feasible workout/repayment plan. Management should then decide on a course of action to resolve the problems with the terms of the workout in writing and formally agreed to by the borrower. If additional collateral is accepted or substituted, the bank should ensure that the necessary legal documents are filed to protect the bank's collateral position.

In those cases where the borrower is permitted to finish the project, additional extensions of credit for completing the project, due to cost overruns or an insufficient interest reserve, may represent the best alternative for a workout plan. At the same time, the bank should evaluate the cause of the problem(s), such as mismanagement, and determine whether it is in its best interest to allow the borrower to complete the project.

SUPERVISORY POLICY

As a result of competitive pressures, many banks in the early 1980s made construction loans on an open-end basis, wherein the borrower did not have a commitment for longer-term or takeout financing before construction was started. Although there was sufficient demand for commercial real estate space when this practice commenced, the supply of space began to exceed demand. One symptom of the excess supply was an increase in vacancy rates, which led to declining rental income caused by the ever greater need for rent concessions. The commensurate declining cash flow from income-producing properties, and the uncertainty regarding future income, reduced the market value of many properties to levels considered undesirable by permanent mortgage lenders. As a result of the subsequent void created by the permanent lenders, banks in the mid- and late 1980s began to extend medium-term loans with maturities for up to seven years (also referred to as mini-perms). These mini-perms were granted with the expectation by banks that as the excess supply of space declined, the return on investment would improve, and permanent lenders would return.

As these loans mature in the 1990s, borrowers may continue to find it difficult to obtain adequate sources of long-term credit. In some cases, banks may determine that the most desirable and prudent course is to roll over or renew loans to those borrowers who have demonstrated an ability to pay interest on their debts, but who presently may not be in a position to obtain long-term financing for the loan balance.

The act of refinancing or renewing loans to sound borrowers, including creditworthy commercial or residential real estate developers, generally should not be subject to supervisory criticism in the absence of well-defined weaknesses that jeopardize repayment of the loans. Refinancings or renewals should be structured in a manner that is consistent with sound banking, supervisory, and accounting practices, and that protects the bank and improves its prospects for collecting or recovering on the asset.

Real Estate Construction Loans Examination Objectives

Effective date November 1993

Section 2100.2

1. To determine if policies, practices, procedures, and internal controls regarding real estate construction loans are adequate.
2. To determine if bank officers are operating in conformance with the bank's established guidelines.
3. To evaluate the portfolio for collateral sufficiency, performance, credit quality, and collectibility.
4. To determine compliance with applicable laws and regulations.
5. To initiate corrective action when policies, practices, procedures, or internal controls are deficient or when violations of law or regulations have been noted.

1. Refer to the Real Estate Loan Examination Procedures section of this manual for examination procedures related to all types of real estate lending activity, and incorporate into this checklist those procedures applicable to the review of the real estate construction loans. The procedures in this checklist are unique to the review of a bank's construction lending activity.
2. Determine the scope of the examination based on the evaluation of internal controls and the work performed by internal/external auditors.
3. Test real estate construction loans for compliance with policies, practices, procedures, and internal controls by performing the remaining examination procedures in this section. Also, obtain a listing of any deficiencies noted in the latest internal/external audit reviews and determine if appropriate corrections have been made.
4. Review management reports on the status of construction lending activity, economic developments in the market, and problem loan reports.
5. Evaluate the bank with respect to—
   a. the adequacy of written policies and procedures relating to construction lending.
   b. operating compliance with established bank policy.
   c. favorable or adverse trends in construction lending activity.
   d. the accuracy and completeness of the bank's records.
   e. the adequacy of internal controls, including control of construction draws.
   f. the adherence of lending staff to lending policies, procedures, and authority as well as the bank's adherence to the holding company's loan limits, if applicable.
   g. compliance with laws, regulations, and Federal Reserve policy on construction lending activity, including supervisory loan-to-value (LTV) limits and restrictions; loans to officers, directors, and shareholders; appraisal and evaluation of real estate collateral; and prudent lending practices.
6. Select loans for examination, using an appropriate sampling technique drawn from judgmental (cut-off line) or statistical sampling. Analyze the performance of the loans selected for examination by transcribing the following kinds of information onto the real estate construction loan line cards, when applicable:
   a. Collateral records and credit files, including the borrower's financial statements, review of related projects, credit report of the borrower and guarantors, appraisal or evaluation of collateral, feasibility studies, economic impact studies, and loan agreement and terms.
   b. Loan modification or restructuring agreements to identify loans where interest or principal is not being collected according to the terms of the original loan. Examples include reduction of interest rate or principal payments, deferral of interest or principal payments, or renewal of a loan with accrued interest rolled into the principal.
   c. The commitment agreement—a buy/sell contract or the tri-party agreement—from the extended-term or permanent lender for the takeout loan.
   d. Cash-flow projections and any revisions to projections based on cost estimates from change orders.
   e. Estimates of the time and cost to complete construction.
   f. Inspection reports and evaluations of the cost to complete, construction deadlines, and quality of construction.
   g. Construction draw schedules and audits for compliance with the schedules.
   h. Documentation on payment of insurance and property taxes.
   i. Terms of a completion or performance bond.
   j. Past-due/nonaccrual–related information.
   k. Loan-specific internal problem credit analyses information.
   l. Loans to insiders and their interests.
   m. Loans classified during the preceding examination.
7. In analyzing the selected construction loans, the examiner should consider the following procedures, taking appropriate action if necessary:

a. Determine the primary source of repayment and evaluate its adequacy, including whether—
   - the permanent lender has the financial resources to meet its commitment.
   - the amount of the construction loan and its estimated completion date correspond to the amount and expiration date of the takeout commitment and/or completion bond.
   - the permanent lender and/or the bonding company have approved any modifications to the original agreement.
   - properties securing construction loans that are not supported by a takeout commitment will be marketable upon completion.

b. Analyze secondary support afforded by guarantors and partners.

c. Relate collateral values to outstanding debt by—

   assessing the adequacy of the appraisal and evaluation.
   - ascertaining whether inspection reports support disbursements to date.
   - determining whether the amount of undisbursed loan funds is sufficient to complete the project.
   - establishing whether title records assure the primacy of the bank's liens.
   - determining if adequate hazard, builder's risks, and worker's compensation insurance is maintained.

d. Determine whether the loan's loan-to-value (LTV) ratio is in excess of the supervisory LTV limits. If so, ascertain whether the loan has been properly reported as a nonconforming loan.

e. Ascertain whether the loan complies with established bank policy.

f. Identify any deficiencies in the loan's documentation in both the credit files and the collateral records.

g. Identify whether the loan is to an officer, director, or shareholder of the bank or a correspondent bank and whether an officer, director, or shareholder of the bank is a guarantor on the loan.

h. Review the borrower's compliance with the provisions of the loan agreement, indicating whether the loan is in default or in past-due status.

i. Determine if there are any problems that may jeopardize the repayment of the construction loan.

j. Determine whether the loan was classified during the preceding examination, and, if the loan has been paid off, whether all or part of the funds for repayment came from another loan at the bank or from the repossession of the property.

8. In connection with the examination of other lending activity in the bank, the examiner should—
   a. check the central liability file on the borrower(s) and determine whether the total construction lending activity exceeds the lending limit to a single borrower.
   b. obtain information and related performance status on common borrowers and their interests from examiners assigned to other examination areas (such as non–real estate loans, leasing, overdrafts, and cash items) and determine the total indebtedness of the borrower to the bank. Additionally, one examiner should be assigned to review the borrower's overall borrowing relationship with the bank.
   c. perform appropriate procedural steps as outlined in the Concentration of Credits section of this manual. Interim construction loans that do not have firm permanent takeout commitments are to be treated as concentrations of credit.
9. Consult with the examiner responsible for the asset/liability management analysis portion of the examination to determine the appropriate maturity breakdown of construction loans needed for the analysis and prepare the necessary schedules.
10. Summarize the findings of the construction loan portfolio review and address—
    a. the scope of the examination.
    b. the quality of the policies, procedures, and controls.
    c. the general level of adherence to policies and procedures.
    d. the competency of management.
    e. the quality of the loan portfolio.
    f. loans not supported by current and complete financial information.
    g. loans with incomplete documentation, addressing deficiencies related to items such as appraisals or evaluations, feasibility studies, the environmental impact study, takeout commitment, title policy, construction plans, inspection reports, change orders, proof of payment for

insurance and taxes, deeds of trust, and mortgage notes.

h. the adequacy of control over construction draws and advances.
i. loans to officers, directors, shareholders, or their interests.
j. causes of existing problems.
k. delinquent loans and the aggregate amount of statutory bad debts. Refer to the manual section on classification of credits for a discussion on statutory bad debts or A Paper.
l. concentrations of credits.
m. classified loans.
n. violations of laws, regulations, and Federal Reserve policy.
o. action taken by management to correct previously noted deficiencies and corrective actions recommended to management at this examination, with the bank's response to such recommendations.

Review the bank's internal controls, policies, practices, and procedures for making and servicing real estate construction loans. The bank's system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used, and other pertinent information. Negative responses to the questions in this section should be explained, and additional procedures deemed necessary should be discussed with the examiner-in-charge. Items marked with an asterisk require substantiation by observation or testing.

POLICIES AND OBJECTIVES

*1. Has the board of directors and management, consistent with their duties and responsibilities, adopted and, at least annually, reviewed and approved written construction lending policies that—
   a. outline construction lending objectives regarding—
      - the aggregate limit for construction loans?
      - concentrations of credit in particular types of construction projects?
   b. establish minimum standards for documentation?
   c. define qualified collateral and minimum margin requirements?
   d. define the minimum equity requirement for a project?
   e. define loan-to-value (LTV) limits that are consistent with supervisory LTV limits?
   f. require an appraisal or evaluation that complies with the Federal Reserve real estate appraisal regulation and guidelines?
   g. delineate standards for takeout commitments?
   h. indicate completion bonding requirements?
   i. establish procedures for reviewing construction loan applications?
   j. detail methods for disbursing loan proceeds?
   k. detail project inspection requirements and progress reporting procedures?
   l. require agreements by borrowers for completion of improvements according to approved construction specifications, and cost and time limitations?
2. Are construction lending policies and objectives appropriate to the size and sophistication of the bank, and are they compatible with changing market conditions?

REVIEWING LOAN APPLICATIONS

3. Does bank policy require a personal guarantee from the borrower on construction loans?
4. Does bank policy require personal completion guarantees by the property owner and/or the contractor?
5. Does the bank require a construction borrower to contribute equity to a proposed project in the form of money or real estate? If so, indicate which form of equity.
6. Does the project budget include the amount and source of the builder's and/or owner's equity contribution?
7. Does the bank require—
   a. background information on the borrower's, contractor's, and major subcontractors' development and construction experience, as well as other projects currently under construction?
   b. payment history information from suppliers and trade creditors on the aforementioned's previous projects?
   c. credit reports?
   d. detailed current and historical financial statements, including cash flow–related information?
8. Do the borrower's project cost estimates include—
   a. land and construction costs?
   b. off-site improvement expenses?
   c. soft costs, such as organizational and administrative costs, and architectural, engineering, and legal fees?
   d. interest, taxes, and insurance expenses?
9. Does the bank require an estimated cost breakdown for each stage of construction?

10. Does the bank require that cost estimates of more complicated projects be reviewed by qualified personnel: experienced in-house staff, an architect, construction engineer, or independent estimator?
11. Are commitment fees required on approved construction loans?

CONSTRUCTION LOAN AGREEMENT

12. Is the construction loan agreement signed before an actual loan disbursement is made?

*13. Is the construction loan agreement reviewed by counsel and other experts to determine that improvement specifications conform to—
   a. building codes?
   b. subdivision regulations?
   c. zoning and ordinances?
   d. title and/or ground lease restrictions?
   e. health and handicap access regulations?
   f. known or projected environmental protection considerations?
   g. specifications required under the National Flood Insurance Program?
   h. provisions in tenant leases?
   i. specifications approved by the permanent lender?
   j. specifications required by the completion or performance bonding company and/or guarantors?

*14. Does the bank require all change orders to be approved in writing by the—
   a. bank?
   b. bank's counsel?
   c. permanent lender?
   d. architect or supervising engineer?
   e. prime tenants bound by firm leases or letters of intent to lease?
   f. completion bonding company?

15. Does the construction loan agreement set a date for project completion?
16. Does the construction loan agreement require that—
   a. the contractor not start work until authorized to do so by the bank?
   b. on-site inspections be permitted by the lending officer or an agent of the bank without prior notice?
   c. disbursement of funds be made as work progresses, supported by documentation that the subcontractors are receiving payment and that the appropriate liens are being released?
   d. the bank be allowed to withhold disbursements if work is not performed according to approved specifications?
   e. a percentage of the loan proceeds be retained pending satisfactory completion of the construction?
   f. the lender be allowed to assume prompt and complete control of the project in the event of default? If a commercial project, are the leases assignable to the bank?
   g. the contractor carry builder's risk and worker's compensation insurance? If so, has the bank been named as mortgagee or loss payee on the builder's risk policy?
   h. periodic increases in the project's value be reported to the builder's risk and title insurance companies?
17. In addition to the aforementioned points, does the construction loan agreement for residential tract construction loans require—
   a. bank authorization for individual tract housing starts?
   b. periodic sales reports be submitted to the bank?
   c. periodic reports on tract houses occupied under a rental, lease, or purchase option agreement be submitted to the bank?
   d. limitations on the number of speculative houses and the completion of one tract prior to beginning another?

COLLATERAL

18. Are liens filed on non–real estate construction improvements, i.e., personal property that is movable from the project?
19. When entering into construction loans, does the bank, consistent with supervisory loan-to-value limits—
   a. limit the loan amount to a reasonable percentage of the appraised value of the project when there is no prearranged permanent financing?
   b. limit the loan amount to a percentage of the appraised value of the completed

project when subject to the bank's own takeout commitment?
   c. limit the loan amount to the floor of a takeout commitment that is based upon achieving a certain level of rents or lease occupancy?
20. Are unsecured credit lines to contractors or developers, who are also being financed by secured construction loans, supervised by the construction loan department or the officer supervising the construction loan?
21. Does the bank have adequate procedures to determine whether construction appraisal or evaluation policies and procedures are consistently being followed in conformance with regulatory requirements, and that the appraisal or evaluation documentation supports the value indicated in the conclusions?

INSPECTION

22. Are inspection authorities noted in the—
   a. construction loan commitment?
   b. construction loan agreement?
   c. tri-party buy-and-sell agreement?
   d. takeout commitment?
23. Are inspections conducted on an irregular basis?
24. Are inspection reports sufficiently detailed to support disbursements?
25. Are inspectors rotated from project to project?
26. Are spot checks made of the inspectors' work?
27. Do inspectors determine compliance with plans and specifications as well as the progress of the work? If so, are the inspectors competent to make the determination?

DISBURSEMENTS

*28. Are disbursements—
   a. advanced on a prearranged disbursement plan?
   b. made only after reviewing written inspection reports?
   c. authorized in writing by the contractor, borrower, inspector, subcontractors, and/or lending officer?
   d. reviewed by a bank employee who had no part in granting the loan?
   e. compared to original cost estimates?
   f. checked against previous disbursements?
   g. made directly to subcontractors and suppliers?
   h. supported by invoices describing the work performed and the materials furnished?
29. Does the bank obtain waivers of subcontractor's and mechanic's liens as work is completed and disbursements are made?
30. Does the bank obtain sworn and notarized releases of mechanic's liens from the general contractor at the time construction is completed and before final disbursement is made?
31. Does the bank periodically review undisbursed loan proceeds to determine their adequacy to complete the projects?
32. Are the borrower's undisbursed loan proceeds and contingency or escrow accounts independently verified at least monthly by someone other than the individuals responsible for loan disbursements?

TAKEOUT COMMITMENT

33. Does counsel review takeout agreements for acceptability?
34. Does the bank obtain and review the permanent lender's financial statements to determine the adequacy of its financial resources to fulfill the takeout commitment?
35. Is a tri-party buy-and-sell agreement signed before the construction loan is closed?
36. Does the bank require takeout agreements to include a *force majeure*—an act of God clause—that provides for an automatic extension of the completion date in the event that construction delays occur for reasons beyond the builder's control?

COMPLETION BONDING REQUIREMENTS

37. Does the bank require completion insurance for all construction loans?
38. Has the bank established minimum financial standards for borrowers who are not required to obtain completion bonding? Are these standards observed in all cases?

39. Does counsel review completion insurance bonds for acceptability?

DOCUMENTATION

40. Does the bank require and maintain documentary evidence of—
    a. the contractor's payment of—
        • employee withholding taxes?
        • builder's risk insurance?
        • worker's compensation insurance?
        • public liability insurance?
        • completion insurance?
    b. the property owner's payment of real estate taxes?
41. Does the bank require that documentation files include—
    a. loan applications?
    b. financial statements for the—
        • borrower?
        • builder?
        • proposed prime tenant?
        • takeout lender?
        • guarantors/partners?
    c. credit and trade checks on the—
        • borrower?
        • builder?
        • major subcontractor?
        • proposed tenants?
    d. a copy of plans and specifications?
    e. a copy of the building permit?
    f. a survey of the property?
    g. the construction loan agreement?
    h. an appraisal or evaluation and feasibility study?
    i. an up-to-date title search?
    j. the mortgage?
    k. ground leases?
    l. assigned tenant leases or letters of intent to lease?
    m. a copy of the takeout commitment?
    n. a copy of the borrower's application to the takeout lender?
    o. the tri-party buy-and-sell agreement?
    p. inspection reports?
    q. disbursement authorizations?
    r. undisbursed loan proceeds and contingency or escrow account reconcilements?
    s. insurance policies?
42. Does the bank employ standardized checklists to control documentation for individual files and perform audit reviews for adequacy?
43. Does the documentation file indicate all of the borrower's other loans and deposit account relationships with the bank and a summary of other construction projects being financed by other banks? Does the bank analyze the status of these projects and the potential effect on the borrower's financial position?
44. Does the bank use tickler files that—
    a. control scheduling of inspections and disbursements?
    b. assure prompt administrative follow-up on items sent for—
        • recording?
        • attorney's opinion?
        • expert review?
45. Does the bank maintain tickler files that provide advance notice (such as 30 days' prior notice) to staff of the expiration dates for—
    a. the takeout commitment?
    b. hazard insurance?
    c. worker's compensation insurance?
    d. public liability insurance?

LOAN RECORDS

*46. Are the preparation, addition, and posting of subsidiary real estate construction loan records performed or adequately reviewed by persons who do not also—
    a. issue official checks or drafts?
    b. handle cash?
    c. reconcile subsidiary records to general ledger controls?

*47. Are the subsidiary real estate construction loan records reconciled at least monthly to the appropriate general ledger accounts? Are reconciling items adequately investigated by persons who do not also handle cash or prepare/post subsidiary controls?

*48. Are loan statements, delinquent account collection requests, and past-due notices reconciled to the real estate construction loan subsidiary records? Are the reconciliations handled by a person who does not also handle cash?

49. Are inquiries about construction loan balances received and investigated by persons who do not also handle cash?

*50. Are documents supporting recorded credit adjustments subsequently checked or tested by persons who do not also handle cash?

51. Is a delinquent accounts report generated daily?
52. Are loans in excess of supervisory LTV limits identified in the bank's records and are the aggregate amounts of such loans reported at least quarterly to the board of directors?
53. Does the bank maintain a daily record summarizing note transaction details (loans made, payments received, and interest collected) to support applicable general ledger account entries?
54. Are note and liability trial balances frequently reconciled to the general ledger by employees who do not process or record loan transactions?

LOAN INTEREST AND COMMITMENT FEES

*55. Are the preparation and posting of loan interest and fee records performed or adequately reviewed by persons who do not also—
  a. issue official checks or drafts?
  b. handle cash?

56. Are any independent interest and fee computations made and compared or adequately tested to loan interest by persons who do not also—
  a. issue official checks or drafts?
  b. handle cash?

CONCLUSION

57. Does the foregoing information provide an adequate basis for evaluating internal control in that deficiencies in areas not covered by this questionnaire do not significantly impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
58. Are internal controls adequate based on a composite evaluation, as evidenced by answers to the foregoing questions?

INTRODUCTION

Floor-plan lending is a form of dealer-inventory financing in which each loan advance, which may be as much as 100 percent of the dealer's invoiced cost, is collateralized by a specific piece of inventory. As each unit of inventory is sold by the dealer, the loan advance against that unit of inventory is repaid. Floor-planned items typically have broad consumer demand. Items commonly subject to floor-plan debt are automobiles, large home appliances, furniture, televisions and stereo equipment, boats, mobile homes, and other types of merchandise usually sold under a sales-finance contract. Floor-plan financing involves all the basic risks inherent in any form of inventory financing. However, because of the high loan-to-value ratios typical of floor-plan financing, the exposure to loss is generally greater than in other types of inventory financing.

COLLATERAL

As with all inventory financing, collateral value is of prime importance. Control over collateral value requires the bank to determine the value at the time the loan is placed on the books, to periodically inspect the collateral to determine its condition and location, and to determine whether any curtailment payments[1] are needed to keep the loan balance in line with depreciating collateral values. As a general rule, curtailment payments are not required for new automobile models until the model year is approximately one-half over. Periodic curtailment payments are then expected to commence at some predetermined percentage of the amount financed.

Collateral Inspections

The examiner should determine whether the bank is inspecting the collateral frequently and thoroughly enough to ensure compliance with the floor-plan agreement. Inspections should be conducted on a surprise basis. Floor-plan inspection reports should be reviewed and retained by the bank. Where practical, inspection duties should be rotated among the bank's staff. Banks should verify the floor-planned inventory by comparing serial numbers with manufacturers' certificates of origin or titles and to the bank's records, and the inspection reports should reflect whether the floor-planned inventory is available for sale. Any missing inventory or other exceptions revealed by the inspection, and the dealer's explanation, should be noted in the inspection report.

SECURITY INTEREST

In most banks, the security interest to floor-planned inventory is evidenced by a trust receipt.[2] Generally, trust receipts are created by two methods. First, the bank may enter into a drafting agreement with the manufacturer, which is similar to a letter of credit. In this situation, the bank agrees to pay documentary drafts covering shipments of merchandise to the dealer. The drafts are payable at the time the merchandise is received by the dealer or, if the manufacturer permits, after a grace period, which allows the dealer to prepare the inventory for sale. The drafting agreement usually limits the number of units, the per-unit cost, and the aggregate cost that can be shipped at one time. Drafting agreements are frequently used in conjunction with repurchase agreements when the manufacturer agrees to repurchase inventory that remains unsold after a specified period of time. The inventory and related title documents remain with the dealer until they are sold and are evidenced by a trust receipt. Banks should physically inspect all the documents during the floor-plan inspection to prevent dual financing.

Second, trust receipts are also created when merchandise is shipped under an invoice sys-

1. Curtailment payments are payments made by the dealer to the floor-plan lender when an item of floor-planned inventory is not sold during the anticipated time frame. The implicit assumption is that if the floor-planned inventory is not sold as anticipated, the inventory value depreciates over time. Unless a curtailment payment is made, the bank's loan-to-value ratio would increase and place the bank in a riskier position than desired.

2. A trust receipt is a document issued to the floor-plan lender by the dealer receiving the floor-plan financing. The trust receipt provides evidence that the dealer possesses the floor-planned inventory. It establishes the bank's rights to the inventory collateral and its proceeds or refers to other documents that set forth the rights of the bank.

tem. The dealer receives the inventory accompanied by invoices and titles, where appropriate. The dealer presents the documents to the bank and the bank pays the invoice, attaching duplicates of the documents to a trust receipt that is signed by the borrower. Depending on the type of inventory and the dealer, the title may remain in the bank or be released. For example, used car inventories are usually financed with trust receipts listing each item of the inventory and its loan value.

The method of perfecting a security interest varies from state to state, and there can be divergences from the Uniform Commercial Code. The examiner should determine that the security interest has been properly perfected. For a detailed discussion of the UCC requirements regarding secured transactions, refer to section 2080.1, ‘‘Commercial and Industrial Loans.’’

BANK/DEALER RELATIONSHIP

Two important facets of the bank's relationship with a dealer are (1) the quality of the paper generated and (2) the deposit account maintained. The income derived from a floor-plan loan may not be sufficient to justify the credit risk. However, additional income derived from quality loans to purchasers of the dealer's inventory may justify the credit risk. If the bank is not receiving an adequate portion of loans generated by the dealer or if the paper is of inferior quality, the relationship is of questionable value to the bank. The dealer's deposit relationship represents both a compensating balance and a tool by which the loan officer can monitor customer activity. A review of the flow of funds into and out of the dealer's account may suggest that inventory has been sold without debt reduction, that the dealer is incurring abnormal expenses, or that unreported diversification, expansion, or other financial activity has occurred that might warrant a reconsideration of the credit arrangement. Token or overdrawn balances should also trigger increased attention to the value of the relationship.

DEALER FINANCIAL ANALYSIS

Many dealers have minimal liquidity and capital relative to total debt. Therefore, the bank should closely and frequently review the dealer's financial information. Annual and interim financial statements are necessary to monitor the dealer's condition. Interim financial statements are often in the form of monthly financial reports to the dealer's franchiser. In analyzing the data, the bank should review the number of units sold and the profitability of those sales, as well as compare the number of units sold with the number financed to determine that inventory levels are reasonable.

Inventory will invariably be a dealer's primary asset, and its acquisition will normally create the dealer's major liability. The dealer's financial statement should show an inventory figure at least equal to the related flooring liability. Unless the difference is represented by short-term sales receivables, including contracts in transit, a floor-plan liability that is greater than the amount of inventory is an indication that the dealer has sold inventory and has not made the appropriate loan payment. To assess credit quality, it is essential that the examiner closely evaluate the level of floor-plan debt relative to inventory.

IDENTIFYING PROBLEMS

Missing inventory, reportedly sold and unpaid, should be verified to related contracts-in-process. Time to collect on contracts-in-process should be reasonable and conform to the floor-plan agreement. Floor-planned inventory sold and *not* in the process of payment is termed ‘‘sold out of trust’’ and represents a breach of trust by the dealer—and a significant exposure to the bank.

During floor-plan inspections, recurring out-of-trust positions that are not cleared in a reasonable time frame (three to five days) should be a red flag. If a bank discovers that a dealer is deliberately withholding funds or diverting funds received from the sale of pledged inventory, bank officials should meet with the borrower to discuss this situation and, if appropriate, consider terminating the lending relationship. Banks should avoid complicated situations in which they finance only part of the dealer's floor-plan debt that originates from one particular manufacturer or distributor. Other warning signs banks should be aware of include interest or curtailment payment delinquencies, extended maturities beyond reasonable expectations, slow-moving inventory, and the absence of interim financial statements.

LOAN POLICY

The bank's loan policy should establish sound standards to control the credit and operational risks associated with floor-plan lending. At a minimum, the policy should address the need for detailed tri-party (manufacturer, dealer, and banker) floor-plan agreements, loan-to-value requirements, the percentage amount and timing of curtailment payments, inspection standards, and the frequency for obtaining and evaluating financial statements.

Floor-Plan Loans
Examination Objectives
Effective date May 1996

Section 2110.2

1. To determine if policies, practices, procedures, and internal controls for floor-plan loans are adequate.
2. To determine if bank officers are conforming to established guidelines.
3. To evaluate the quality of the loan portfolio and the sufficiency of its collateral.
4. To determine the scope and effectiveness of the audit function.
5. To determine compliance with applicable laws and regulations.
6. To initiate corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws or regulations have been noted.

1. If selected for implementation, complete or update the floor-plan loans section of the internal control questionnaire.
2. On the basis of the evaluation of internal controls and the work performed by internal or external auditors, determine the scope of the examination.
3. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examination procedures. Also, obtain a listing of any deficiencies noted in the latest review done by internal or external auditors from the examiner assigned to internal control, and determine if corrections have been accomplished.
4. Request that the bank supply the following:
   a. schedule of curtailment requirements for each dealer
   b. schedule of approved floor-plan lines for each dealer, including outstanding balances
   c. delinquent curtailment billing report
   d. drafting agreements and amount of outstanding drafts
   e. delinquent interest billings, date billed, and amount of past-due interest
5. Obtain a trial balance of all floor-plan accounts.
   a. Agree balances to department controls and general ledger.
   b. Review reconciling items for reasonableness.
6. Using an appropriate technique, select borrowers for examination.
7. Using the trial balance, transcribe the following information for each borrower selected onto the credit line cards:
   a. total outstanding liability
   b. number of items
   c. status of any outstanding interest or curtailment billings
   d. amount of approved floor-plan line
8. Obtain liability and other information on common borrowers from examiners assigned to overdrafts, lease financing, and other loan areas, and together decide who will review the borrowing relationship.
9. Obtain from the bank or appropriate examiner the following schedules, if applicable to this area:
   a. past-due loans
   b. loans in a nonaccrual status
   c. loans on which interest is not being collected in accordance with the terms of the loan (Particular attention should be given to loans that have been renewed with interest being rolled into principal.)
   d. loans whose terms have been modified by a reduction on interest rate or principal payment, by a deferral of interest or principal, or by other restructuring of repayment terms
   e. loans transferred, either in whole or in part, to another lending institution as a result of a sale, participation, or asset swap since the previous examination
   f. loans acquired from another lending institution as a result of a purchase, participation, or asset swap since the previous examination
   g. loan commitments and other contingent liabilities
   h. extensions of credit to employees, officers, directors, and principal shareholders and their interests specifying which officers are considered executive officers
   i. extensions of credit to executive officers, directors, and principal shareholders and their interests of correspondent banks
   j. a list of correspondent banks
   k. miscellaneous loan-debit and credit-suspense accounts
   l. loans considered “problem loans” by management
   m. specific guidelines in the lending policy
   n. each officer’s current lending authority
   o. current interest-rate structure
   p. any useful information obtained from the review of the minutes of the loan and discount committee or any similar committee
   q. reports furnished to the loan and discount committee or any similar committee
   r. reports furnished to the board of directors
   s. loans classified during the previous examination
10. Review the information received, and perform the following procedures.
   a. *Loans transferred, either in whole or in part, to or from another lending institu-*

tion as a result of a participation, sale or purchase, or asset swap.

- Participations only:
  - — Test participation certificates and records, and determine that the parties share in the risks and contractual payments on pro rata basis.
  - — Determine that the bank, as lead or agent in a credit, exercises similar controls and procedures over syndications and participations sold as for loans in its own portfolio.
- Procedures pertaining to *all* transfers:
  - — Investigate any situations in which loans were transferred immediately before the date of examination to determine if any were transferred to avoid possible criticism during the examination.
  - — Determine whether any of the loans transferred were either nonperforming at the time of transfer or classified at the previous examination.
  - — Determine that low-quality loans transferred to (but not purchased) or from the bank are properly reflected on its books at fair market value (while fair market value may be difficult to determine, it should at a minimum reflect both the rate of return being earned on such loans as well as an appropriate risk premium). Section 23A of the Federal Reserve Act prohibits a state member bank from purchasing low-quality assets.
  - — Determine that low-quality loans transferred to the parent holding company or a nonbank affiliate are properly reflected at fair market value on the books of both the bank and its affiliate.
  - — If low-quality loans were transferred to or from another lending institution for which the Federal Reserve is not the primary regulator, prepare a memorandum to be submitted to the Reserve Bank supervisory personnel. The Reserve Bank will then inform the local office of the primary federal regulator of the other institution involved in the transfer. The memorandum should include the following information, as applicable:
    (1) name of originating institution
    (2) name of receiving institution
    (3) type of transfer (i.e., participation, purchase or sale, swap)
    (4) date of transfer
    (5) total number of loans transferred
    (6) total dollar amount of loans transferred
    (7) status of the loans when transferred (e.g., nonperforming, classified, etc.)
    (8) any other information that would be helpful to the other regulator

b. *Miscellaneous loan-debit and credit-suspense accounts.*
   - Discuss with management any large or old items.
   - Perform additional procedures as deemed appropriate.

c. *Loans classified during the previous examination.* Determine the disposition of loans so classified by reviewing—
   - current balances and payment status,
   - date loan was repaid and sources of payment, and
   - any situations in which all or part of the funds for the repayment came from the proceeds of another loan at the bank, or as a result of a participation, sale, or swap with another lending institution. If repayment was a result of a participation, sale or swap, refer to step 10a of this section for the appropriate examination procedures.

d. *Loan commitments and other contingent liabilities.* Analyze whether—
   - the borrower has been advised of the contingent liability, and
   - the combined amounts of the current loan balance and the commitment or contingent liability exceeds the cutoff.

e. Select loans that require in-depth review on the basis of the information derived from the above schedules.

11. Consult with the examiner responsible for the asset/liability management analysis to determine the appropriate maturity breakdown of loans needed for the analysis. If requested, compile the information using bank records or other appropriate sources. See“ Instructions for the Report of Exami-

nation," section 6000.1, for considerations to be taken into account when compiling maturity information for the gap analysis.

12. For those loans selected in step 6 and for any other loans selected while performing the above steps—
    a. transcribe the following information from the bank's collateral record onto the credit line card:
       - a list of items floored, including date of entry, description of property, amount advanced, and curtailment, if any (Similar items and model year should be shown in aggregate, and entry dates should be shown as a range, except on stale or not properly curtailed items.)
       - a summary of the wholesale agreement between the bank and the dealer
       - a summary of the agreement between the manufacturer and the bank
       - a summary of any repurchase agreement
       - evidence that security interest has been perfected
       - details of any guarantees that may be held
       - details of any other collateral held
    b. review the two most recent floor-plan inspection reports and determine—
       - if any items were sold out of trust,
       - that where trust receipts were used, all title documents were physically inspected, and
       - that appropriate follow-up was made on all missing items.
13. Determine compliance with laws and regulations pertaining to floor-plan loans by performing the following steps.
    a. *Lending limits.*
       - Determine the bank's lending limits as prescribed by state law.
       - Determine advances or combinations of advances with aggregate balances above the limit, if any.
    b. *18 USC 215, Commission or Gift for Procuring Loan.*
       - While examining the floor-plan loan area, determine the existence of any possible cases in which a bank officer, director, employee, agent, or attorney may have received anything of value for procuring or endeavoring to procure any extension of credit.
       - Investigate any such suspected situation.
    c. *12 USC 1972, Tie-In Provisions.* While reviewing credit and collateral files (especially loan agreements), determine whether any extension of credit is conditioned upon—
       - obtaining or providing an additional credit, property, or service to or from the bank or its holding company (or a subsidiary of its holding company), other than a loan, discount, deposit, or trust service, or
       - the customer not obtaining a credit, property, or service from a competitor of the bank or its holding company (or a subsidiary of its holding company), other than a reasonable condition to ensure the soundness of the credit.
    d. *Insider lending activities.* The examination procedures for checking compliance with the relevant law and regulation covering insider lending activities and reporting requirements are as follows (the examiner should refer to the appropriate sections of the statutes for specific definitions, lending limitations, reporting requirements, and conditions indicating preferential treatment):
       - *Regulation O (12 CFR 215), Loans to Executive Officers, Directors, and Principal Shareholders and Their Interests.* While reviewing information relating to insiders that is received from the bank or appropriate examiner (including loan participations, loans purchased and sold, and loan swaps)—
         — test the accuracy and completeness of information about floor-plan loans by comparing it with the trial balance or loans sampled;
         — review credit files on insider loans to determine that required information is available;
         — determine that loans to insiders do not contain terms more favorable than those afforded other borrowers;
         — determine that loans to insiders do not involve more than normal risk of repayment or present other unfavorable features;
         — determine that loans to insiders, as defined by the various sections of Regulation O, do not exceed the

lending limits imposed by those sections;
- if prior approval by the bank's board was required for a loan to an insider, determine that such approval was obtained;
- determine compliance with the various reporting requirements for insider loans;
- determine that the bank has made provisions to comply with the public disclosure requirements for insider loans; and
- determine that the bank maintains records of public disclosure requests and the disposition of the requests for a period of two years after the date of the requests.

• *Title VIII of the Financial Institutions Regulatory and Interest Rate Control Act of 1978 (FIRA) (12 USC 1972(2)), Loans to Executive Officers, Directors, and Principal Shareholders of Correspondent Banks.*
- Obtain from or request that the examiners reviewing due from banks and deposit accounts verify a list of correspondent banks provided by bank management, and ascertain the profitability of those relationships.
- Determine that loans to insiders of correspondent banks are not made on preferential terms and that no conflict of interest appears to exist.

14. Perform the appropriate procedural steps in ''Concentrations of Credit,'' section 2050.3.
15. Discuss with appropriate officers, and prepare summaries in appropriate report form for—
    a. delinquent loans;
    b. extensions of credit to employees, officers, directors, and/or their interests;
    c. loans on which collateral documentation is deficient;
    d. transfers of low-quality loans to or from another lending institution;
    e. the adequacy of written policies relating to floor-plan loans;
    f. the manner in which bank officers are conforming with established policy;
    g. schedules applicable to the department that were discovered to be incorrect or incomplete;
    h. the performance of departmental management;
    i. internal control deficiencies or exceptions;
    j. recommended corrective action when policies, practices, or procedures are deficient; and
    k. other matters of significance.
16. Update the workpapers with any information that will facilitate future examinations.

Review the bank's internal controls, policies, practices and procedures for making and servicing floor plan loans. The bank's system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used and other pertinent information. Items marked with an asterisk require substantiation by observation or testing.

POLICIES

1. Has the board of directors, consistent with its duties and responsibilities, adopted written floor plan loan policies that:
   a. Establish procedures for reviewing floor plan applications?
   b. Define qualified borrowers, overall limits, and types of merchandise to be floor planned?
   c. Establish minimum standards for documentation?
   d. Establish curtailment amounts and time limits?
2. Are floor plan loan policies reviewed at least annually to determine if they are compatible with changing market conditions?

RECORDS

*3. Is the preparation and posting of subsidiary floor plan loan records performed or reviewed by persons who do not also:
   a. Issue official checks or drafts?
   b. Handle cash?

4. Are the subsidiary floor plan loan records reconciled daily with the appropriate general ledger accounts, and are reconciling items investigated by persons who do not also handle cash?

*5. Are delinquent account collection requests and past-due notices checked to the trial balances used in reconciling floor plan subsidiary records with general ledger accounts, and are they handled only by persons who do not also handle cash?

*6. Are inquiries about loan balances received and investigated by persons who do not also handle cash?

*7. Are documents supporting recorded credit adjustments checked or tested subsequently by persons who do not also handle cash (if so, explain briefly)?

8. Is a daily record maintained summarizing note transaction details, i.e., loans made, payments received and interest collected, to support applicable general ledger account entries?
9. Are frequent note and liability ledger trial balances prepared and reconciled with controlling accounts by employees who do not process or record loan transactions?
10. Is an overdue account report generated frequently (if so, state frequency _______)?

LOAN INTEREST

*11. Is the preparation and posting of interest records performed or reviewed by persons who do not also:
   a. Issue official checks or drafts singly?
   b. Handle cash?

12. Are any independent interest computations made and compared or adequately tested to initial interest records by persons who do not also:
   a. Issue official checks or drafts singly?
   b. Handle cash?

COLLATERAL

13. Are floor plan checks, physical inventories, conducted at least monthly and on a surprise basis (if so, state frequency _______)?
14. Are more frequent floor plan checks required if the dealer is experiencing financial difficulties?
15. Are individuals performing floor plan checks rotated?
16. Are floor plan inspector(s) required to determine or verify the following and indicate their findings on the floor plan check sheet:
   a. Serial number of item?
   b. Odometer reading of vehicles?
   c. Condition of item?

   d. Location of item, if other than normal place of business?
   e. Existence of any fire or theft hazards?
17. Does the floor plan inspector include on the check sheet:
   a. Date inspection was performed?
   b. Date any item located elsewhere was checked?
   c. His or her signature?
   d. Summary of his or her report, if appropriate?
18. Are all demonstrators checked?
19. Are floor plan reports reviewed by an officer?
20. Are follow-up inspections made of items not seen during the regular inspection?
21. Are items reported by the dealer as being sold, required to be paid off immediately?
22. Does the floor plan inspector determine the date that item(s) reported as sold were sold from that on the dealer's copy of the sales agreement?
23. Are dealer sales patterns reviewed to determine that the number of units reported sold at the time of floor plan inspection is not excessive and does not indicate a float?
24. Are payments-in-process reported by the dealer during floor plan inspection verified by bank personnel?
25. When a dealer trade or ‘‘swap’’ occurs, does the bank:
   a. Obtain the manufacturer's invoice from the selling dealer on the new unit acquired?
   b. Obtain the invoice from the borrowing dealer for the new unit?
   c. Have a trust receipt executed on the new unit?
26. Does the bank have a procedure to check all indirect paper received from a dealer against the trust receipts of items floored for that dealer to determine that there is no duplication of loans against the same security?
27. Does the bank have floor plan property damage insurance or require that the dealer maintain such coverage with the bank named as loss payee?
28. Is the insurance coverage periodically reviewed for adequacy?
29. Are all trust receipts required to be supported by invoices or other evidence that title to the security is vested in the bank?
30. Are trust receipts required to include:
   a. Description of each item?
   b. Serial number of each item?
   c. Loan amount for each item?
   d. Interest rate?
   e. Date?
   f. Authorized signature of dealer or person holding power-of-attorney to execute the trust receipt?
31. If the bank and dealer permit a bank employee to execute trust receipts using the dealer's power-of-attorney:
   a. Are proper documents on file granting the power-of-attorney?
   b. Does the bank maintain a numbered register for trust receipt notes?
   c. Are trust receipt notes under dual control?

OTHER

32. Are all floor plan loans granted under an established line?
33. Are line approvals structured to permit the bank to cancel or suspend shipments of unwanted merchandise?
34. Are dealer floor plan line limits strictly adhered to?
35. Is a trial balance of each dealer's trust receipts/security agreements prepared at least monthly?
36. Are dealer trial balances reconciled to department and general ledger controls?
37. Are floor plan interest charges systematically computed and regularly billed?
38. Are notices of past due interest payments sent promptly?
39. Are all interest, curtailment and unit pay off payments from dealers posted promptly?
40. Are disbursements for floor plan loans on new units made only against the original copy of the manufacturer's invoices?
41. Are the original invoices retained in the bank's files?
42. Are loan proceeds on new units paid directly to the manufacturer rather than to the dealer?
43. Are accounting records established so that the bank has records of all floored items with adequate individual identification?
44. Are limits on loan advance versus invoice price (current wholesale value, if used) clearly established?
45. Are wholesale values determined independently of dealer appraisals?

46. Are wholesale values that are assigned by floor plan department personnel periodically reviewed by someone independent of the department?
47. Is amount of loan advance prohibited from exceeding 100 percent of the invoice price of a new item or of the wholesale value of a used item?
48. Has a curtailment policy been established and is it being followed?
49. Does the policy provide proper incentives to the dealer to turn over inventory on a timely basis?
50. Is the loan written so that the floored items never depreciate faster than the loan balance is reduced?
51. If a manufacturer of floored items has entered into a repurchase agreement, are curtailments structured to keep the loan balance in line with any declining repurchase amount?
52. Are records maintained on curtailment billings so that delinquency is easily determinable?
53. Are notices of past due curtailment payments sent promptly?
54. If assignment of rebates has been made, have procedures been established to ensure that factory rebate checks payable at the end of the model year are promptly forwarded to the bank?
55. If demonstrators are floored, are they subject to separate curtailment requirements which keep the loan balance in line with their liquidation value?
56. Are floor plan agreements required for all dealers?
57. Must agreements be accompanied by borrowing resolutions?
58. Is a written agreement between the manufacturer and the bank required on any flooring line which includes drafting arrangements with the manufacturer?
59. Do such agreements with the manufacturer stipulate under what conditions the bank will accept items to be floored?
60. Are checks made periodically to determine that only those individuals granted power-of-attorney are signing the trust receipts?
61. Are dealers required to submit financial and operating statements on a continuing basis?
62. Are all dealers who prepare internal financial and operating statements more frequently than annually required to submit copies of those statements to the bank?
63. Are all financial statements received from dealers reviewed promptly?
64. Do financial statement reviews include a determination that floor plan loans, deposit accounts and other information agree with the bank's records?
65. Are periodic reviews made of deposit accounts to detect any possible out-of-trust sales?
66. Are periodic reviews made of the retail paper being generated to determine if the bank is receiving an adequate portion?

CONCLUSION

67. Does the foregoing information constitute an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
68. Based on a composite evaluation as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

Leveraged financing is an important financing vehicle for mergers and acquisitions, business recapitalizations, and business expansions. Leveraged transactions are characterized by a degree of financial leverage that significantly exceeds industry norms, as measured by ratios such as debt-to-assets, debt-to-equity, cash flow-to-total debt, or other ratios and standards unique to particular industry norms for leverage. Leveraged borrowers typically have a diminished ability to respond to changing economic conditions or unexpected events, creating significant implications for an institution's overall credit-risk exposure and challenges for bank risk-management systems.

Leveraged-finance activities can be conducted in a safe and sound manner if a risk-management structure provides appropriate underwriting, pricing, monitoring, and controls. Comprehensive credit-analysis processes, frequent monitoring, and detailed portfolio reports are needed to better understand and manage the inherent risk in these leveraged-finance portfolios.

Many leveraged transactions are underwritten with reliance on the imputed value of a business (enterprise value), which is often highly volatile. Sound valuation methodologies must be used for these types of transactions, in addition to ongoing stress testing and monitoring of enterprise values.

On April 9, 2001, the Federal Reserve, along with the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision, issued the following guidance concerning sound risk-management practices for institutions engaged in leveraged financing.[1] The statement also provides guidance about risk-rating for leveraged-finance loans and how enterprise value should be evaluated in the risk-rating process. (See SR-01-9.) (The introductory paragraphs and some other material have been omitted from the policy statement here, as indicated by a line of asterisks. Other wording has been slightly altered, as indicated by brackets.)

1. This guidance augments previously issued supervisory statements on sound credit-risk management. See SR-99-23, ‘‘Recent Trends in Bank Lending Standards for Commercial Loans,’’ and SR-98-18, ‘‘Lending Standards for Commercial Loans.’’ (See also sections 2040.1, ‘‘Loan Portfolio Management,’’ and 2040.3, ‘‘Examination Procedures—Loan Portfolio Management.’’)

INTERAGENCY STATEMENT ON LEVERAGED FINANCING

* * * * *

Institutions participate in leveraged financing on a number of levels. In addition to providing senior secured financing, they extend credit on a subordinated basis (mezzanine financing). Institutions and their affiliates also may take equity positions in leveraged companies with direct investments through affiliated securities firms, small business investment companies (SBICs), and venture capital companies or take equity interests via warrants and other equity ‘‘kickers’’ received as part of a financing package. Institutions also may invest in leveraged loan funds managed by investment banking companies or other third parties. Although leveraged financing is far more prevalent in large institutions, this type of lending can be found in institutions of all sizes * * * The extent to which institutions should apply these sound practices will depend on the size and risk profile of their leveraged exposures relative to assets, earnings, and capital; and the nature of their leveraged-financing activities (i.e., origination and distribution, participant, equity investor, etc.) * * *

Risk-Management Guidelines

[Institutions substantively engaged in leveraged financing are expected to] adequately risk-rate, track, and monitor these transactions and to maintain policies specifying conditions that would require a change in risk rating, accrual status, loss recognition, or reserves. In general, the risk-management framework for leveraged finance is no different from that which should be applied to all lending activities. However, because of the potential higher level of risk, the degree of oversight should be more intensive.

Loan Policy

The loan policy should specifically address the institutions' leveraged-lending activities by including—

- a definition of leveraged lending;

- an approval policy that requires sufficient senior-level oversight;
- pricing policies that ensure a prudent tradeoff between risk and return; and
- a requirement for action plans whenever cash flow, asset-sale proceeds, or collateral values decline significantly from projections. Action plans should include remedial initiatives and triggers for rating downgrades, changes to accrual status, and loss recognition.

Underwriting Standards

Either the loan policy or separate underwriting guidelines should prescribe specific underwriting criteria for leveraged financing. The standards should avoid compromising sound banking practices in an effort to broaden market share or realize substantial fees. The policy should—

- describe appropriate leveraged loan structures;
- require reasonable amortization of term loans (i.e., allow a moderate time period to realize the benefit of synergies or augment revenues and institute meaningful repayment);
- specify collateral policies including acceptable types of collateral, loan-to-value limits, collateral margins, and proper valuation methodologies;
- establish covenant requirements, particularly minimum interest and fixed-charge coverage and maximum leverage ratios;
- describe how enterprise values and other intangible business values may be used; and
- establish minimum documentation requirements for appraisals and valuations, including enterprise values and other intangibles.

Limits

Leveraged-finance and other loan portfolios with above-average default probabilities tend to behave similarly during an economic or sectoral downturn. Consequently, institutions should take steps to avoid undue concentrations by setting limits consistent with their appetite for risk and their financial capacity. Institutions should ensure that they monitor and control as separate risk concentrations those loan segments most vulnerable to default. Institutions may wish to identify such concentrations by the leveraged characteristics of the borrower, by the institution's internal-risk grade, by particular industry or other factors that the institution determines are correlated with an above-average default probability. In addition, sublimits may be appropriate by collateral type, loan purpose, industry, secondary sources of repayment, and sponsor relationships. Institutions should also establish limits for the aggregate number of policy exceptions.

Credit Analysis

Effective management of leveraged-financing risk is highly dependent on the quality of analysis during the approval process and after the loan is advanced. At a minimum, analysis of leveraged-financing transactions should ensure that—

- cash-flow analyses do not rely on overly optimistic or unsubstantiated projections of sales, margins, and merger and acquisition synergies;
- projections provide an adequate margin for unanticipated merger-related integration costs;
- projections are stress-tested for one or two downside scenarios;
- transactions are reviewed quarterly to determine variance from financial plans, the risk implications thereof, and the accuracy of risk ratings and accrual status;
- collateral valuations are derived with a proper degree of independence and consider potential value erosion;
- collateral-liquidation and asset-sale estimates are conservative;
- potential collateral shortfalls are identified and factored into risk-rating and accrual decisions;
- contingency plans anticipate changing conditions in debt or equity markets when exposures rely on refinancing or recapitalization; and
- the borrower is adequately protected from interest-rate and foreign-exchange risk.

Enterprise Value

Enterprise value is often relied upon in the underwriting of leveraged loans to evaluate the feasibility of a loan request, determine the debt-reduction potential of planned asset sales, assess a borrower's ability to access the capital markets, and to provide a secondary source of repayment. Consideration of enterprise value is appropriate in the credit-underwriting process. However, enterprise value and other intangible values can be difficult to determine, are frequently based on projections, and may be subject to considerable change. Consequently, reliance upon them as a secondary source of repayment can be problematic.

Because enterprise value is commonly derived from the cash flows of a business, it is closely correlated with the primary source of repayment. This interdependent relationship between primary and secondary repayment sources increases the risk in leveraged financing, especially when credit weaknesses develop. Events or changes in business conditions that negatively affect a company's cash flow will also negatively affect the value of the business, simultaneously eroding both the lender's primary and secondary source of repayment. Consequently, lenders that place undue reliance upon enterprise value as a secondary source of repayment or that utilize unrealistic assumptions to determine enterprise value are likely to approve unsound loans at origination or experience outsize losses upon default.

It is essential that institutions establish sound valuation methodologies for enterprise value, apply appropriate margins to protect against potential changes in value, and conduct ongoing stress testing and monitoring.

Rating Leveraged-Finance Loans

Institutions need thoroughly articulated policies that specify requirements and criteria for risk-rating transactions, identifying loan impairment, and recognizing losses. Such specificity is critical for maintaining the integrity of an institution's risk-management system. Institutions' internal rating systems should incorporate both the probability of default and loss given default in their ratings to ensure that the risk of the borrower and the risk of the transaction structure itself are clearly evaluated. This is particularly germane to leverage-finance-transactions structures, which in many recent cases have resulted in large losses upon default.

In cases where a borrower's condition or future prospects have significantly weakened, leveraged-finance loans will likely merit a substandard classification based on the existence of well-defined weaknesses. If such weaknesses appear to be of a lasting nature and it is probable that a lender will be unable to collect all principal and interest owed, the loan should be placed on nonaccrual and will likely have a doubtful component. Such loans should be reviewed for impairment in accordance with FAS 114, "Accounting by Creditors for Impairment of a Loan."

If the primary source of repayment is inadequate and a loan is considered collateral-dependent, it is generally inappropriate to consider enterprise value unless the value is well supported. Well-supported enterprise values may be evidenced by a binding purchase and sale agreement with a qualified third party or through valuations that fully consider the effect of the borrower's distressed circumstances and potential changes in business and market conditions. For such borrowers, where a portion of the loan is not protected by pledged assets or a well-supported enterprise value, examiners will generally classify the unprotected portion of the loan doubtful or loss.

In addition, institutions need to ensure that the risks in leveraged-lending activities are fully incorporated in the allowance-for-loan-and-lease-loss and capital-adequacy analysis. For allowance purposes, leverage exposures should be taken into account either through analysis of the expected losses from the discrete portfolio or as part of an overall analysis of the portfolio utilizing the institution's internal risk grades or other factors. At the transaction level, exposures heavily reliant on enterprise value as a secondary source of repayment should be scrutinized to determine the need for and adequacy of specific allocations.

Problem-Loan Management

For adversely rated borrowers and other high-risk borrowers who significantly depart from planned cash flows, asset sales, collateral values, or other important targets, institutions should formulate individual action plans with critical objectives and time frames. Actions may include working with the borrower for an orderly resolution while preserving the institution's interests, sale in the secondary market, and liquidation. Regardless of the action, examiners and bankers need to ensure such credits are reviewed regularly for risk-rating accuracy, accrual status, recognition of impairment through specific allocations, and charge-offs.

Portfolio Analysis

Higher-risk credits, including leveraged-finance transactions, require frequent monitoring by banking organizations. At least quarterly, management and the board of directors should receive comprehensive reports about the characteristics and trends in such exposures. These reports at a minimum should include—

- total exposure and segment exposures, including subordinated debt and equity holdings, compared to established limits;
- risk-rating distribution and migration data;
- portfolio performance—noncompliance with covenants, restructured loans, delinquencies, nonperforming assets, and impaired loans; and
- compliance with internal procedures and the aggregate level of exceptions to policy and underwriting standards.

Institutions with significant exposure levels to higher-risk credits should consider additional reports covering—

- collateral composition of the portfolio, e.g., percentages supported by working assets, fixed assets, intangibles, blanket liens, and stock of borrower's operating subsidiaries;
- unsecured or partially secured exposures, including potential collateral shortfalls caused by defaults that trigger pari passu [equable] collateral treatment for all lender classes;
- absolute amount and percentage of the portfolio dependent on refinancing, recapitalization, asset sales, and enterprise value;
- absolute amounts and percentages of scheduled and actual annual portfolio amortizations; and
- secondary-market pricing data and trading volume for loans in the portfolio.

Internal Controls

Institutions engaged in leveraged finance need to ensure their internal-review function is appropriately staffed to provide timely, independent assessments of leveraged credits. Reviews should evaluate risk-rating integrity, valuation methodologies, and the quality of risk management. Because of the volatile nature of these credits, portfolio reviews should be conducted on at least an annual basis. For many institutions, the risk characteristics of the leveraged portfolio, such as high reliance on enterprise value, concentrations, adverse risk-rating trends or portfolio performance, will dictate more frequent reviews.

Distributions

Asset sales, participations, syndication, and other means of distribution are critical elements in the rapid growth of leveraged financing. [Lead and purchasing institutions are expected] to adopt formal policies and procedures addressing the distribution and acquisition of leveraged-financing transactions. The policies should include—

- procedures for defining, managing, and accounting for distribution fails;
- identification of any sales made with recourse and procedures for fully reflecting the risk of any such sales;
- a process to ensure that purchasers are provided with timely, current financial information;
- a process to determine the portion of a transaction to be held in the portfolio and the portion to be held for sale;
- limits on the length of time transactions can be held in the held-for-sale account and policies for handling items that exceed those limits;
- prompt recognition of losses in market value for loans classified as held-for-sale; and
- procedural safeguards to prevent conflicts of interest for both bank and affiliated securities firms.

Participations Purchased

Institutions purchasing participations and assignments in leveraged finance must make a thorough, independent evaluation of the transaction and the risks involved before committing any funds. They should apply the same standards of prudence, credit assessment and approval criteria, and "in-house" limits that would be employed if the purchasing organization were originating the loan. At a minimum, policies should include requirements for—

- obtaining and independently analyzing full credit information both before the participa-

tion is purchased and on a timely basis thereafter;
- obtaining from the lead lender copies of all executed and proposed loan documents, legal opinions, title insurance policies, UCC searches, and other relevant documents;
- carefully monitoring the borrower's performance throughout the life of the loan; and
- establishing appropriate risk-management guidelines as described in this [statement.]

Process To Identify Potential Conflicts

Examiners should determine whether an institution's board of directors and management have established policies for leveraged finance that minimize the risks posed by potential legal issues and conflicts of interest.

Conflicts of Interest

When a banking company plays multiple roles in leveraged finance, the interests of different customers or the divisions of the institution may conflict. For example, a lender may be reluctant to employ an aggressive collection strategy with a problem borrower because of the potential impact on the value of the organization's equity interest. A lender may also be pressured to provide financial or other privileged client information that could benefit an affiliated equity investor. Institutions should develop appropriate policies to address potential conflicts of interest. Institutions should also track aggregate totals for borrowers and sponsors to which it has both a lending and equity relationship. Appropriate limits should be established for such relationships.

Securities Laws

Equity interests and certain debt instruments used in leveraged lending may constitute "securities" for the purposes of federal securities laws. When securities are involved, institutions should ensure compliance with applicable securities law requirements, including disclosure and regulatory requirements.[2] Institutions should also establish procedures to restrict the internal dissemination of material nonpublic information about leveraged-finance transactions.

Compliance Function

The legal and regulatory issues raised by leveraged transactions are numerous and complex. To ensure that potential conflicts are avoided and laws and regulations are adhered to, an independent compliance function should review all leveraged-financing activity.

* * * * *

EXAMINATION RISK-RATING GUIDANCE FOR LEVERAGED FINANCING

When evaluating individual borrowers, examiners should pay particular attention to—

- the overall performance and profitability of a borrower and its industry over time, including periods of economic or financial adversity;
- the history and stability of a borrower's market share, earnings, and cash flow, particularly over the most recent business cycle and last economic downturn; and
- the relationship between a borrowing company's projected cash flow and debt-service requirements and the resulting margin of debt-service coverage.

Cash Flow/Debt-Service Coverage

Particular attention should be paid to the adequacy of the borrower's cash flow and the reasonableness of projections. Before entering into a leveraged-financing transaction, bankers should conduct an independent, realistic assessment of the borrower's ability to achieve the projected cash flow under varying economic and interest-rate scenarios. This assessment should take into account the potential effects of an economic downturn or other adverse business

2. Institutions should also ensure that their acquired equity positions are consistent with equity ownership restrictions imposed by federal and state laws, such as the Bank Holding Company Act and the Federal Reserve Act. Institutions need to take special care to aggregate all the equity positions held throughout the entire organization, including those held in all banking and nonbanking subsidiaries. [footnote added]

conditions on the borrower's cash flow and collateral values. Normally bankers and examiners should adversely rate a credit if material questions exist as to the borrower's ability to achieve the projected necessary cash flows, or if orderly repayment of the debt is in doubt. Credits with only minimal cash flow for debt service are usually subject to an adverse rating.

Enterprise Value

Many leveraged-financing transactions rely on ''enterprise value'' as a secondary source of repayment. Most commonly, enterprise value is based on a ''going concern'' assumption and derived from some multiple of the expected income or cash flow of the firm. The methodology and assumptions underlying the valuation should be clearly disclosed, well supported, and understood by appropriate decision makers and risk-oversight units. Examiners should ensure that the valuation approach is appropriate for the company's industry and condition.

Enterprise value is often viewed as a secondary source of repayment and as such would be relied upon under stressful conditions. In such cases the assumptions used for key variables such as cash flow, earnings, and sale multiples should reflect those adverse conditions. These variables can have a high degree of uncertainty—sales and cash-flow projections may not be achieved; comparable sales may not be available; changes can occur in a firm's competitive position, industry outlook, or the economic environment. Because of these uncertainties, changes in the value of a firm's assets need to be tested under a range of stress scenarios, including business conditions more adverse than the base-case scenario. Stress testing of enterprise values and their underlying assumptions should be conducted upon origination of the loan and periodically thereafter incorporating the actual performance of the borrower and any adjustments to projections. The bank should in all cases perform its own discounted-cash-flow analysis to validate ''enterprise value'' implied by proxy measures such as multiples of cash flow, earnings or sales.

Finally, it must be recognized that valuations derived with even the most rigorous valuation procedures are imprecise and may not be realized when needed by an institution. Therefore, institutions relying on enterprise value or illiquid and hard-to-value collateral must have lending policies that provide for appropriate loan-to-value ratios, discount rates and collateral margins.

Deal Sponsors

Deal sponsors can be an important source of financial support for a borrower that fails to achieve cash-flow projections. However, support from this source should only be considered positively in a risk-rating decision when the sponsor has a history of demonstrated support as well as the economic incentive, capacity, and stated intent to continue to support the transaction. Even with capacity and a history of support, a sponsor's potential contributions should not mitigate criticism unless there is clear reason to believe it is in the best interests of the sponsor to continue that support or unless there is a formal guarantee.

1. To obtain assurances that the institution maintains sound lending standards.
2. To ensure that the institution's risk-management structure provides for appropriate underwriting, pricing, monitoring, and controls over leveraged-financing transactions.
3. To assess whether the institution uses comprehensive credit-analysis processes, whether frequent and continuous monitoring exists, and whether detailed portfolio reports are prepared and used to better understand and manage the inherent risk in leveraged-finance portfolios.
4. To ensure the institution uses sound valuation methodologies, conducts ongoing stress testing, and monitors enterprise values for leveraged-financing transactions.
5. To determine whether the institution's leveraged-financed loans are risk-rated and how enterprise values are evaluated in the risk-rating process.

1. Ascertain that the institution has established procedures for determining which credits should be regarded as constituting ''leveraged financing.''
2. Determine that the institution regularly reviews its leveraged-financing credits for their risk-rating accuracy, accrual status, recognition of impairment through specific allocations, and charge-offs.
3. Ascertain whether an institution's board of directors and management have established policies for leveraged financing that minimize the risks of potential legal issues and conflicts of interest.
4. When reviewing leveraged-financing credits, give particular attention to—
   - the overall performance and profitability of a borrower and its industry over time, including periods of economic or financial adversity;
   - the history and stability of a borrower's market share, earnings, and cash flow, particularly over the most recent business cycle and last economic downturn; and
   - the relationship between a borrowing company's projected cash flow and debt-service requirements, the resulting margin of debt-service coverage, and actual performance.
5. Determine if the institution's leveraged-finance rating systems incorporate both the probability of default and a realistic assessment of likely loss amounts in a troubled situation.
6. When a borrower's condition or future prospects have significantly weakened, consider whether the leveraged-finance loans will likely merit an adverse rating based on the existence of well-defined weaknesses. If such weaknesses appear to be of a lasting nature and it is probable that a lender will be unable to collect all principal and interest owed, the loan should be placed on nonaccrual.[1]
7. Determine whether the valuation approach used for the leverage financing is appropriate for the company's industry and condition.
8. When reviewing leveraged loans that are collateral-dependent, determine whether the loans are well protected by pledged assets or whether enterprise values are well supported.

1. These loans should also be reviewed for impairment in accordance with Financial Accounting Standard No. 114 (FAS 114), ''Accounting by Creditors for Impairment of a Loan.''

INTRODUCTION

Leasing is a recognized form of financing for fixed assets that provides a lessee (the customer) the right to use depreciable assets without tying up working capital. Leasing frequently offers the lessee greater flexibility than traditional bank term-loan financing. Leasing also provides the lessor (the owner of the asset) with a generally higher rate of return than lending, but this is in exchange for assuming greater risk or investing more resources in marketing and deal structuring. The higher risk inherent in a typical lease transaction is due to the higher advance to collateral value; a longer payment period; and, in some cases, the lessor's dependence on the sale of the leased property to recover a portion of the initial investment. In most instances, some or all of the higher rate of return for the lessor is derived from the tax benefits of equipment ownership.

While leases differ from loans in some respects, they are similar from a credit viewpoint because the basic considerations are cash flow, repayment capacity, credit history, management, and projections of future operations. Additional considerations are the type of property being leased and its marketability in the event of default or termination of the lease. However, these latter considerations do not radically alter how an examiner evaluates collateral for a lease. The assumption is that the lessee/borrower will generate sufficient funds to liquidate the lease/debt. Leases are generally structured so that the bank recovers the full cost of the equipment plus an interest factor over the course of the lease term. Sale of the leased property/collateral remains a secondary source of repayment and, except for the estimated residual value at the expiration of the lease, will not, in most cases, become a factor in liquidating the advance.

In general, leasing activities of state member banks are governed by federal tax law and, in some instances, applicable state law. The leasing of personal or real property or acting as agent, broker, or adviser in leasing such property is considered a "closely related nonbanking activity" and is therefore permitted under section 225.28(b)(3) of Regulation Y by a bank holding company (BHC) or subsidiary thereof, in accordance with certain requirements. While not specifically applicable to banks, these criteria provide useful guidelines for reviewing the appropriateness and prudence of bank leasing activities. Any substantial departure from these criteria must be judged in light of safety-and-soundness implications.

A BHC can act as an agent, broker, or adviser in leasing such property only if—

- the lease is on a nonoperating basis[1] and
- the initial term of the lease is at least 90 days.

For leases involving real property—

- the effect of the transaction at the inception of the initial lease must be to yield a return that will compensate the lessor for not less than the lessor's full investment in the property plus the estimated total cost of financing the property over the term of the lease, such return to be derived from rental payments, estimated tax benefits, and the estimated residual value of the property at the expiration of the initial lease; and
- the estimated residual value cannot exceed 25 percent of the acquisition cost of the property to the lessor.

Examiners should ensure that the bank's policies and procedures appropriately govern its direct-lease-financing activities and that bank management adheres to established policies and procedures. Examiners should also ensure that the bank's audit and loan-review functions adequately encompass the leasing activity.

1. With respect to the "nonoperating basis" requirement, a BHC may not, directly or indirectly, engage in operating, servicing, maintaining, or repairing leased property during the term of the lease. For automobile leasing, this requirement means that a BHC may not, directly or indirectly, (1) provide servicing, repair, or maintenance of the leased vehicle during the lease term; (2) purchase parts and accessories in bulk or for an individual vehicle after the lessee has taken delivery of the vehicle; (3) provide the loan of an automobile during servicing of the leased vehicle; (4) purchase insurance for the lessee; or (5) provide for the renewal of the vehicle's license merely as a service to the lessee when the lessee could renew the license without authorization from the lessor. The BHC can arrange for a third party to provide these services or products.

ACCOUNTING FOR LEASES

Since leasing activity became prominent within the last few decades, lessors have employed a number of different methods to account for their investments in leases. Financial Accounting Standards Board (FASB) Statement No. 13, ''Accounting for Leases,'' effective January 1, 1977, was intended to bring uniformity to lease accounting.[2] Pursuant to the guidance, a lease is generally structured as a direct financing lease and reported as such on the institution's accounting records. A direct financing lease is a type of capital lease[3] that transfers substantially all the benefits and risks inherent in the ownership of the leased property to the lessee. In addition, collection of the minimum lease payments must be reasonably predictable, and no important uncertainties may exist regarding costs to be incurred by the lessor under the terms of the lease. Although minor variations in accounting methods are still found, most investment-in-leases accounts will be equal to—

- the sum of the minimum lease payments to be received from the lessee, plus
- the unguaranteed residual value (estimated fair market value) of the property at the end of the lease term, reduced by
- the amount of unearned and deferred income to be recognized over the life of the lease.

For the purpose of illustration, assume that property costing $120,000 is leased for a period of 96 months at $1,605 per month, and the estimated residual value (ERV) of the property is $24,000. In this example, income is recognized monthly according to the sum of the months' digits method. The investment in this lease is calculated below, followed by an explanation of each component of the net investment.

Cost	$120,000
Unearned income	34,080
Rentals receivable (96 × $1,605)	154,080
Est. residual value	24,000
Gross investment	178,080
Less:	
Unearned income	34,080
Unearned income (ERV)	24,000
Net investment	120,000

Rentals Receivable

This account is established in the amount of total rental payments to be received from the lessee. The amount by which the rentals receivable ($154,080) exceeds the cost of the property ($120,000) is the functional equivalent of interest and represents a portion of the income to be recognized over the life of the lease. In the example below, the cost of the property is temporarily charged to a fixed-asset account, then transferred to rentals receivable.

2. Other Financial Accounting Standards Board releases dealing with leasing are FASB Statements 22, 23, 27, 28, 29, 76, 77, 91, 94, 98, and 109; FASB Interpretations 19, 21, 23, 24, 26, and 27; and FASB Technical Bulletins 79-10, 79-12, 79-13, 79-14, 79-15, 79-16, 85-3, 86-2, and 88-1.

3. FASB Statement No. 13, paragraph 7, outlines in detail certain criteria that a lease must meet for it to be classified as a capital lease. (See also the call report instructions.)

Fixed assets	$120,000	
Cash		120,000
To record purchase or property for lease		
Rentals receivable	154,080	
Fixed assets		120,000
Unearned income		34,080
To record amount due from lessee		

Throughout the lease term, the rentals-receivable account is periodically reduced by the full amount of each rental payment received.

Cash	$1,605	
Rentals receivable		1,605
To record receipt of monthly payment		

Estimated Residual Value

The estimated residual value represents the proceeds the lessor expects to realize at the end of the lease term from the sale or re-leasing of the property. Exactly as its title states, this account represents only an estimate of future value and does not represent current market value or depreciated book value. The residual value at the end of the lease term is considered to be income, and the corresponding credit for this asset account is posted to unearned income.

The balance of the ERV account does not normally change significantly during the lease term. The unguaranteed residual value should be reviewed at least annually to determine whether a decline, other than a temporary one, has occurred in its estimated value. If a decline is not temporary, the accounting for the lease transaction should be revised using the new estimate, and the resulting loss should be recognized in the period that the change is made. Upward adjustments or increases in the residual value are not recognized.

After the end of the term, the residual value account is eliminated from the books upon sale, re-lease, or other disposition of the property. If the amount of proceeds received differs from the recorded residual value, the difference will be recognized as either a gain or loss, whichever is appropriate.

Est. residual value	$24,000	
Unearned income		24,000
To record ERV of leased property		
Cash	26,000	
Est. residual value		24,000
Gain on sale		2,000
To record sale of property		

Any portion of the ERV guaranteed by a party unrelated to the lessor would be deducted from the ERV account and added to rentals receivable.

Unearned Income

This liability account has a credit balance and is netted against the total of rentals receivable and the ERV for balance-sheet presentation. Its component parts are the ‘‘interest’’ income equal to the excess of rentals receivable over the cost of the property and the income to be realized from disposition of the property at the end of the lease term. Each of these components is recognized as income throughout the life of the lease by periodic transfers to earned income. Unearned income is amortized to income over the lease term to produce a constant periodic rate of return on the net investment in the lease. Any other method, such as the sum-of-the-months'-digits method, may be used if the results obtained are not materially different from those that would result from the interest method described in the preceding sentence and if the resulting impact does not overstate income during the current period. Loan-origination fees and initial direct costs, such as commissions and fees that are incurred by the lessor in negotiating and consummating the lease, are offset against each other, and the resulting net amount is deferred and recognized over the lease term. The practice of recognizing a portion of the unearned income at the inception of the lease to offset initial direct costs is no longer acceptable.

Depreciation

For certain leases, the lessor is entitled to claim depreciation for tax purposes. However, for financial statement purposes, no depreciation for leased property will appear on the income statement and no accumulated depreciation will appear on the balance sheet. If the lessor is entitled to the benefits of depreciation, then, for tax purposes only, depreciation will be calculated and will reduce the lessor's tax liability.

The lessor's entitlement to depreciation tax benefits is a function of the type of lease arrangement negotiated. When the lessor retains title to the asset and owns the asset at the expiration of the lease, the lessor may take depreciation into account for tax purposes. These characteristics are typical of a "true," "net," or "capital" lease, terms often used interchangeably in the industry. In a "financing" lease, the lessee rather than the lessor acquires title to the property at the expiration of the lease and is entitled to depreciation tax benefits. Accordingly, the lessor will charge the lessee a higher periodic lease payment (for a higher "rate of return") to offset its loss of depreciation tax benefits.

Balance-Sheet Presentation

Lease receivables are to be reported on the balance sheet as the single amount "net investment" (see below). If the lessor has established an allowance for possible lease losses, this amount is included in the total allowance for loan and lease losses and represents a deduction from the net investment. Footnotes to the balance sheet should disclose the components of the net investment, as follows:

Rentals receivable	$154,080
Est. residual value	24,000
Gross investment	178,080
Less:	
Unearned income	58,080
Net investment	$120,000

For call report purposes, lease financing receivables are reported net of unearned income as part of an institution's total loans.

Classification

If it is deemed appropriate to classify a lease, the amount at which the lease would be classified is the net investment. For example, assume that 94 of the 96 payments have been received on the above lease, that income has been recognized monthly according to the sum-of-the-months'-digits method, and that the lease is now considered a loss. Its balance on the books is $27,173, as follows:

Rentals receivable	$ 3,210
Est. residual value	24,000
Gross investment	27,210
Less:	
Unearned income	22
Unearned income (ERV)	15
Net investment	27,173

Classification of the $27,173 balance of this lease involves classifying $3,188 of the unrecovered portion of the cost of the property ($3,210 less $22 unearned income) plus $23,985 of income that has already been recognized in anticipation of receiving the ERV ($24,000 less $15 not yet recognized). In short, the calculation is $3,188 + $23,985 = $27,173.

Charging off the ERV included in the net investment treats the lease as if the underlying property has no value and, in effect, reverses the unearned income that has been recognized in anticipation of selling the leased property at its recorded ERV. Accordingly, if the property does have value, the $27,173 classified should be reduced by the net amount that the lessor could realize by selling the property.

Delinquency

It is appropriate for the examination report to state the percentage of delinquency in the lease portfolio. The percentage is calculated by dividing the aggregate rentals receivable on delinquent leases (less the "interest" components of their unearned income accounts) by the total of rentals receivable on all leases (less the "interest" components of their unearned income accounts). ERVs would not be included in the delinquent amounts since they do not represent obligations of the lessees.

If the lease obligation in the previously described classification example was the only delinquent obligation in a portfolio of leases with component accounts as shown below, the rate of delinquency in the portfolio would be 3.4 percent.

Rentals receivable	$ 94,411
Est. residual value	705,882
Gross investment	800,293
Less:	
Unearned income	647
Unearned income (ERV)	441
Net investment	$799,205

$$\frac{\$3{,}210 - 22}{\$94{,}411 - 647} = 3.4\%$$

Termination of a Lease

The termination of a lease is recognized in the income of the period in which the termination occurs by eliminating the remaining net investment from the lessor's account. The lease property is then recorded as an asset using the lower of the original cost, present fair value, or present carrying amount.

LEVERAGED LEASES

Leveraged leasing is a specialized form of financing and should only be pursued by banks with the appropriate expertise. Part of the examiner's duty is to determine that the personnel who structure and follow leveraged leases are highly qualified in that area and have a current working knowledge of applicable tax laws and regulations.

A leveraged lease transaction is complex in terms of size, the number of parties involved, legal involvement, and, of course, the unique advantages to all parties. Legal expenses and administrative costs associated with leveraged leasing limit its use to financing large capital-equipment projects. By tailoring the tax effects to the needs of the parties involved, the structure of a leveraged lease permits multiple tax benefits and maximum investment return. The lessor is in search of a tax shelter to offset income generated from other sources, while the lessee bargains for lower rental charges in exchange for the tax advantage the lessor receives. The result of this trade-off ideally produces an attractive rate of return on the lessor's invested dollars, while the lessee conserves working capital and obtains financing at a cost substantially below the lessee's usual borrowing rate.

In a leveraged lease, the lessor purchases and becomes owner of the equipment by providing only a percentage (usually 20 to 40 percent) of the capital needed. The rest of the purchase price is borrowed by the lessor from long-term lenders on a nonrecourse basis. The borrowings are secured by a first lien on the equipment, an assignment of the lease, and an assignment of the lease payments.

If the purchase price of the equipment is large, there may be several equity owners and debtholders involved. In this case, an owner trustee may be named to hold title to the equipment and to represent the equity owners. An indenture trustee may be named to hold the mortgage on the property for the benefit of the debtholders.

The lessor (equity holder), as the owner, is allowed to take accelerated depreciation based on the total cost of the equipment. The lessor might also receive a small portion of the rental payments, but the desired yield is obtained from the timing of depreciation. The effect gives the lessor a return through the small rentals and allows the lessor to retain the residual value rights to the equipment at the end of the lease period.

The bank should consider its present and anticipated future tax position, its future money rates, and the residual value of the property. The return on the bank's investment in leveraged leases depends largely on these factors. A slight change can precipitate significant changes in the bank's position. Anticipated proceeds from the sale or re-leasing of the property at the conclusion of the lease term (the residual value) is an important element of the return and should be estimated carefully. It will, in most cases, exceed 25 percent of the purchase price because of certain tax requirements. The bank should continually evaluate the property for misuse, obsolescence, or market decline, all of which can rapidly deteriorate the value of the property before the lease term expires. In these cases, the lessee may default, often with expensive consequences for the lessors.

The examiner should remember that a portion of the bank's recapture of its investment in leased property is often predicated on the inherent tax benefits. Accordingly, a decline in the bank's ability to use these tax benefits could reduce or eliminate the profitability of the venture.

The complexity of leveraged leasing should motivate the examiner to carefully scrutinize each indenture and all parties concerned before any analysis begins. The examiner should approach each lease from the standpoint of the creditworthiness of the lessee and the continuous assessment of the value of the leased property. If the lessee defaults, the loan participant is in a position to foreclose and leave the bank without a way to recapture the carrying value of its investment. Therefore, the general rule is that a bank should not enter into a leveraged lease transaction with any party to which it would not normally extend unsecured credit.

The lessor's net investment in a leveraged lease shall be recorded in a manner similar to that for a direct financing lease, but net of the principal and interest on the nonrecourse debt. The components of the net investment, including related deferred taxes, should be fully disclosed in the footnotes to the lessor's financial statements when leveraged leasing is a significant part of a bank's business activities. (See appendix E of FASB 13 for an example of how to account for a leveraged lease.)

1. To determine if lease policies, practices, procedures, objectives, and internal controls are adequate.
2. To determine if bank officers are operating in conformance with the established guidelines.
3. To evaluate the adequacy of collateral, credit quality, and collectibility.
4. To determine the scope and adequacy of the audit function.
5. To determine compliance with applicable laws and regulations.
6. To initiate corrective action when policies, practices, procedures, objectives, or internal controls are deficient or when violations of laws or regulations have been noted.

1. If selected for implementation, complete or update the Direct Financing Leases section of the Internal Control Questionnaire.
2. Based on the evaluation of internal controls and the work performed by internal/external auditors, determine the scope of the examination.
3. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examination procedures. Also, obtain a listing of any deficiencies noted in the latest review done by internal/external auditors from the examiner assigned ''Internal Control'' and determine if corrections have been accomplished.
4. The following information should be available at the start of the examination:
   a. trial balance of all leases and outstanding credits
   b. listing of accounts on which payments are delinquent 30 days or more or on which payments are otherwise not being made according to schedule
   c. listing of available lines of credit
   d. minutes of board and executive meetings since the date of the previous examination
5. Using an appropriate sampling technique, select leases for review.
6. Obtain liability and other information on common borrowers from examiners assigned cash items, overdrafts, and other loan areas and together decide who will review the borrowing relationship.
7. For leases selected for review, analyze the creditworthiness of the lessees. Consideration is given to the figures derived from the lessee's financial statements, as well as to cash flow, trends and projections of growth in sales and income, and the qualifications of management. Delinquency on a lease obligation is potentially more serious than delinquency on a conventional loan because, if the property under lease is necessary for the lessee's continued production of income, as is frequently the case, the lessee's financial condition will be seriously deteriorated before the lessee is willing to risk losing the property by default.
8. For those leases which might result in loss to the lessor or for which financial information was not adequate to make such a determination, transcribe the following information to line cards:
   a. name and line of business of lessee
   b. name of guarantor(s)
   c. original date of the lease contract
   d. original amount of the rentals receivable
   e. ERV of the property
   f. amount of ITC to be realized
   g. book value of the investment in the lease as of the examination date
   h. cost of the property
   i. description and location of the property
   j. amount and frequency of rental payments
   k. original amount, term, rate, and schedule of amortization of any nonrecourse debt associated with the lease
   l. lessor's percentage of equity participation in the lease obligation, if applicable
   m. summary financial data indicating the creditworthiness of the lessee and guarantors, if applicable
9. Before the conclusion of the examination, discuss with management all classified leases. Inadequate or negative cash flow and unfavorable trends reflected in financial statements of the lessee are usually indicative of a substandard lease. Leases classified doubtful typically include those on which payments are delinquent for an extended period and those on which the lessor's recovery of investment is dependent upon an event of unknown probability, such as a pending lawsuit or insurance claim. A loss classification results from the lessee's inability or refusal to continue making payments.
10. Prepare write-ups to support the classifications. The write-up should include the lessee's type of business, present financial status, circumstances that led to the classification, the probability that the terms of the lease can be met, and the amount of protection afforded by sale or release of the underlying property.
11. Review a sample of the lessor's computations of lease yields to determine whether the lessor will recover the cost of purchasing and the after-tax cost of financing the

property during the initial term of the lease or 40 years, whichever is less.

Shown below are the amounts which may be applied against the purchase and financing costs in calculating recovery.

a. Total of lease payments and ERV, reduced by the estimated taxes to be paid on unearned income. The amount of the ERV used in this calculation may not exceed 20 percent of acquisition cost, though it is permissible for the ERV to be carried on the books in an amount exceeding 20 percent of cost.
b. ITC to be realized by the lessor.
c. Tax benefits resulting from depreciation charges, equal to total allowable depreciation times the lessor's marginal tax rate. Depreciation for tax purposes is calculated on the basis of total original cost ignoring ERV. However, over time, accumulated depreciation may not exceed original cost less ERV.
d. For personal property leases of seven years or less, any additional amount provided by an unconditional guarantee of the lessor's full recovery of investment plus financing cost. The guarantee can be made by a lessee, an independent third party, or manufacturer deemed creditworthy by the lessor. In determining full-payout compliance, the guarantee may only account for up to 60 percent of the acquisition cost of the property.

The following example of a payout calculation assumes a marginal tax rate of 46 percent and depreciation of the full cost of the property for tax purposes:

Total lease payments		$154,080
ERV		24,000
ITC (tax benefit)		12,000
Depreciation—tax benefit (46% × 120,000)		55,200
Subtotal		$245,280
Less taxes on unearned income:		
(“interest”)	$34,080	
(ERV)	24,000	
	46% × $58,080	26,717
		$218,563

After deducting the $120,000 cost of the property from the net cash flow provided by the lease, after-tax funds of $98,563 are available to cover the cost of financing the property. Dividing this amount by the assumed marginal tax rate of 46 percent indicates that the equivalent amount in pre-tax funds is $214,267. If this $214,267 were paid as interest over a 96-month period to finance the acquisition of property costing $120,000, the annual rate of interest (internal rate of return) would be 32.0 percent (see compound interest chart). No further calculation need be made since this high percentage based on funds available to cover finance costs would exceed by far the lessor's likely approximate pre-tax cost of funds. However, in those instances in which the percentage calculated is believed to closely approximate the cost of funds, the lessor should be asked to explain the manner by which its recovery of cost is assured.

If this example were a personal property lease with a term of seven years or less, any qualified guarantee up to 60 percent of acquisition cost could have been considered as an addition to the funds available to provide the lessor with full payout.

As mentioned in the introduction to this section, an exception to the full-payout requirement is made for leases to those governmental entities that are prohibited from entering into leases for periods exceeding one year. In the case of leases to government entities, the lessor should demonstrate that the lease is expected to be continually renewed until the cost is fully recovered.

12. Review records to determine that the lease transaction constitutes a valid lease for tax purposes. If the agreement is ruled by the IRS to be a “conditional sale,” the lessor would not be entitled to depreciation charges or the ITC, and the lessee would be required to deduct depreciation charges rather than lease payments from taxable income. It is preferable that the lessor obtain a private ruling from the IRS to make certain that it qualifies as the original user of the property and is therefore entitled to the previously mentioned tax benefits. Circumstances that the IRS considers as evidence of a conditional sale rather than a lease are as follows:
    a. portions of the rental payments are made

applicable to an equity interest of the lessee in the property
    b. the lessee acquires title to the property after making a specified number of payments
    c. the payments made by the lessee for a short period of use constitute an unusually large percentage of the purchase price of the property
    d. the total rental payments to be received exceed the current fair rental value of the property, indicating that the payments include an element other than rent
    e. the lessee has an option to purchase the property at a price that is nominal in relation to the value of the property or to the total amount of rental payments
    f. a portion of each rental payment is readily identifiable as the equivalent of interest
13. Ascertain whether title to the property rests with the lessor and that the lessor has taken steps to protect its ownership rights. Evidence of filing under the Uniform Commercial Code, where appropriate, should be found in the documentation file. Aircraft should be registered with the FAA, interstate vehicles with the ICC, and ships with the Coast Guard.
14. Check for cancellation or other provisions in the contract that could jeopardize the full-payout status of the lease. There is no need to take exception to a cancellation provision that provides for payment by the lessee of an amount that allows the lessor to fully recover its investment in the property.
15. Check that insurance coverage on leased property is provided by the lessee in compliance with all insurance provisions of the contract in an amount sufficient to protect against loss from property damage. Public liability insurance should also be provided to protect against loss from lawsuits that could arise from situations such as the crash of leased aircraft.
16. Review the lessee's duties under the contract with respect to repairs and taxes. Determine whether the lessor has instituted procedures to check that the lessee's required duties are being performed.
17. Review the status of all property acquired for lease purposes but which is not now under lease. Determine the reason for the ''off-lease'' status of the property, ascertain the realizable value of the property, and investigate whether the off-lease property will be sold or re-leased within the required two-year period.
18. Investigate the lessor's procedures for periodic review of the reasonableness of the estimated residual value. The estimate should be reviewed at least annually and reduced in amount on the books if the value has declined on a presumably permanent basis.
19. Review past operations of the lessee company to determine if projections of income and ERV have been realistic in light of actual experience.
20. Review the minutes of the meetings of the board and executive committees to determine whether purchases of property and delinquent leases are reported to the board.
21. Determine if the bank has entered into leases with companies owned or controlled by any director or officer. Compare the rates and terms on such leases to the rates and terms offered on leases to companies of similar credit standing.
22. Check for lease concentrations to any one lessee or industry and prepare a comment for the examination report if any concentration is considered unwarranted.
23. Determine whether the bank has established limits for the maximum amount of ''credit'' to be extended to a single lessee. If these limits have been established, investigate whether the bank adheres to them. If they have not been established, inquire as to the bank's policy on this matter.
24. Check for action taken on matters criticized in the most recent audit reports and the previous examination report. Determine if leases classified ''loss'' were removed from the books.
25. Discuss with appropriate officer(s) and prepare summaries in appropriate report form of—
    a. delinquent leases, including those considered ''A'' paper;
    b. violations of laws and regulations;
    c. leases not supported by current and complete financial information;
    d. leases on which documentation is deficient;
    e. equipment deficiencies revealed in inspection reports;
    f. off-lease equipment;
    g. concentrations of leases;
    h. classified leases; and

i. leases to major shareholders, employees, officers, directors, and/or their interests.

26. Update workpapers with any information that will facilitate future examinations.

Review the bank's internal controls, policies, practices, and procedures for making and servicing direct lease financing. The bank's system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flow charts, copies of forms used, and other pertinent information. Items marked with an asterisk require substantiation by observation or testing.

POLICIES AND OBJECTIVES

1. Has the board of directors, consistent with its duties and responsibilities, adopted written direct lease financing policies that—
   a. establish procedures for reviewing direct lease financing applications,
   b. define qualified property, and
   c. establish minimum standards for documentation?
2. Are direct lease financing policies reviewed at least annually to determine if they are compatible with changing market conditions?

RECORDS

*3. Is the preparation and posting of subsidiary direct lease financing records performed or reviewed by persons who do not also—
   a. issue official checks and drafts or
   b. handle cash?

*4. Are the subsidiary direct lease financing records reconciled, at least monthly, with the appropriate general ledger accounts, and are reconciling items investigated by persons who do not also handle cash?

5. Are delinquent account collection requests and past-due notices checked to the trial balances that are used in reconciling subsidiary records of direct lease receivables to general ledger accounts, and are they handled only by persons who do not also handle cash?

6. Are inquiries about lease balances received and investigated by persons who do not also handle cash or pass adjustments?

*7. Are documents supporting recorded credit adjustments checked or tested subsequently by persons who do not also handle cash or initiate transactions (if so, explain briefly)?

INTEREST AND/OR RENT

*8. Is the preparation and posting of interest and/or rent records performed or reviewed by persons who do not also—
   a. issue official checks and drafts or
   b. handle cash?

DEPRECIATION (OPERATING LEASES)

9. Is the preparation and posting of periodic depreciation records performed or reviewed by persons who do not also have sole custody of property?

10. Do the bank's procedures require that depreciation expense be charged at least quarterly?

*11. Are the subsidiary depreciation records balanced, at least quarterly, to the appropriate general ledger controls by persons who do not also have sole custody of property?

OTHER

*12. Are periodic property inventory reports prepared by the lessee or trustee?

13. Do reports clearly indicate the condition and location of the leased property?

14. When inspection of the equipment leased is either infrequent or not feasible, has the bank taken measures to protect its equipment and prevent its misuse?

15. At lease termination, are outside appraisals made of property before bids are accepted?

16. Are review procedures in effect to maintain the necessary insurance coverage on all leased assets regardless of whether the cost of this insurance is to be borne by the bank or the lessee?

17. Does the bank have insurance coverage against its potential public liability risk as owner/lessor of the property?

18. Are safeguards in effect to prevent the possibility of conflict of interest or self-dealing in selecting the seller, servicer, insurer, or purchaser for the equipment leased?
19. Are separate files maintained for each lease transaction?
20. Does each file supporting the acquisition and disposal of assets reflect the review and written approval of an officer other than the person who actually controlled the disbursement and receipt of funds?
21. Are all leases required to be supported by current credit information?
22. Do modifications of terms require the approval of the board or committee that initially approved the lease?
23. If commitments are issued contingent upon receipt of certain satisfactory information, has authority to reject or accept such information been vested in someone other than the account officer?
24. Is residual value substantiated by periodic appraisals?
25. Are reports listing past-due leases and/or those receiving special attention submitted to the board for review at their regular meetings?

CONCLUSION

26. Is the foregoing information considered an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly and indicate any additional examination procedures deemed necessary.
27. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

INTRODUCTION

This section applies to most types of loans found in a consumer loan department. Consumer credit, also referred to as retail credit, is defined as credit extended to individuals for household, family, and other personal expenditures, rather than credit extended for use in a business or for home purchases. Consumer credit loans are loans not ordinarily maintained by either the commercial or real estate loan departments. Consumer loans frequently make up the largest number of loans originated and serviced by the bank, but their dollar volume may be significantly less than for other types of loans. Consumer credit loans may be secured or unsecured and are usually structured with short- or medium-term maturities. Broadly defined, consumer credit includes all forms of *closed-end credit (installment credit)* and *open-end credit (revolving credit),* such as check credit and credit card plans. Consumer credit also includes loans secured by an individual's personal residence, such as home equity and home-improvement loans. Home equity loans are discussed in ''Real Estate Loans,'' section 2090.1.

The examiner should determine the adequacy of the consumer credit department's overall policies, procedures, and credit quality. The examiner's goal should not be limited to identifying current portfolio problems but should include identifying potential problems that may result from liberal lending policies, unfavorable trends, potentially imprudent concentrations, or nonadherence to established policies. Banks lacking written policies, or failing to implement or follow established policies effectively, should be criticized in the report of examination.

TYPES OF CONSUMER CREDIT

Installment Loans

Many traditional forms of installment credit have standard monthly payments and fixed repayment schedules of one to five years. These loans are made with either fixed or variable interest rates that are based on specific indices. Installment loans fill a variety of needs, such as financing the purchase of an automobile or household appliance, financing home improvement, or consolidating debt. These loans may be unsecured or secured by an assignment of title, as in an automobile loan, or by money in a bank account.

A bank's installment loan portfolio usually consists of a large number of small loans, each scheduled to be amortized over a specific period. Most installment loans are made for consumer purchases; however, amortizing commercial loans are sometimes placed in the installment loan portfolio to facilitate their servicing. In addition, the installment loan portfolio can consist of both loans made by the bank and loans purchased from retail merchants who originated the loans to finance the sale of goods to their customers.

Indirect Installment Loans

Indirect installment loans are also known as dealer loans, sales-finance contracts, or dealer paper. In this type of consumer credit, the bank purchases, sometimes at a discount, loans originated by retailers of consumer goods, such as a car dealer. This type of lending is called indirect lending because the dealer's customer indirectly becomes a customer of the bank.

The sales-finance contracts purchased from dealers of consumer goods are generally closed-end installment loans with a fixed rate of interest. These loans are purchased in one of three ways depending on the dealer and the circumstances of purchase:

- *Without recourse.* The bank is responsible for collecting the account, curing the delinquency, or applying the deficiency against dealer reserves or holdback accounts. The majority of sales-finance contracts with dealers are without recourse.
- *Limited recourse.* The dealer will repurchase the loan, cure the default, or replace the loan only under certain circumstances in accordance with the terms of the agreement between the bank and the dealer.
- *With recourse.* The dealer is required to repurchase the loan from the bank on demand, typically within 90 to 120 days of default.

In the case of recourse and limited recourse loans, legal lending limitations need to be considered.

Sales-finance contracts purchased without recourse from dealers should be based on the individual's creditworthiness, *not* on the financial strength of the dealership itself. The contracts purchased should comply with the bank's loan policy for similar consumer loans. Exceptions to the bank's policies and procedures should be documented in the credit file and have the appropriate level of approval. For sales-finance contracts purchased with recourse that do not meet the bank's normal credit criteria and are purchased on the basis of the added strength of the dealer, the bank should document the minimum criteria for such loans and the specific bank-approved financial covenants with which the dealer must comply.

Check Credit

Check credit is defined, for the purpose of this manual, as the granting of unsecured, interest-bearing, revolving lines of credit to individuals or businesses. Banks provide check-credit services through overdraft protection, cash reserves, and special drafts.

The most common product is overdraft protection, whereby a transfer is made from a preestablished line of credit to a customer's deposit account when a check is presented that would cause the account to be overdrawn. Transfers normally are made in specific increments, up to a maximum line of credit approved by the bank.

In a cash reserve system, the customer must request that the bank transfer funds from a preestablished line of credit to his or her deposit account. To avoid overdrawing the account, the customer must request the transfer before negotiating a check against the account.

In a special draft system, the customer negotiates a special check drawn directly against a preestablished line of credit. In this method, deposit accounts are not affected.

In all three systems, the bank periodically provides its check-credit customers with a statement of account activity. Required minimum payments are computed as a fraction of the balance in the account on the cycle date and may be made by automatic charges to the deposit account.

Delinquencies are often experienced when an account is at or near the customer's maximum credit line. Examiners should verify that the following reports are generated for and reviewed by bank management, and examiners should also analyze them as part of the examination process:

- aging of delinquent accounts
- accounts on which payments are made (either on this account or other loans) by drawing on reserves
- accounts with steady usage

Many banks offer check-credit plans to small businesses; these plans may have a higher than normal degree of risk unless they are offered under very stringent controls. In these situations, the examiner's review should be based on the same factors and criteria used for the review of unsecured commercial loans.

Credit Card Plans

Most bank credit card plans are similar. The bank solicits retail merchants, service organizations, and others who agree to accept a credit card in lieu of cash for sales or services performed. The bank assumes the credit risk and charges the nonrecourse sales draft to the individual customer's credit card account. The bank sends monthly statements to the customer, who may elect to pay the entire amount or to pay in monthly installments, with an additional percentage charge on the outstanding balance each month. A cardholder may also obtain cash advances, which accrue interest from the transaction date, from the bank or automated teller machines.

A bank can be involved in a credit card plan in various ways. Also, the terminology used to describe the manner in which a bank is involved in a credit card plan may vary. The examiner first needs to determine the type of credit card plan that the bank has and then ascertain the degree of risk that the plan poses to the bank.

Both the bank's customers and the bank itself can generate potential risk in the credit card department. On the customer side, the risk is generally divided into two categories: the misuse of credit and the misuse of the credit card. The potential for credit misuse is reduced by careful screening of cardholders before cards are issued and by monitoring individual accounts for abuse. Credit card misuse may be reduced by establishing controls to prevent the following abuses:

- employees or others from intercepting the card before delivery to the cardholder

- merchants from obtaining control of cards
- fraudulent use of lost or stolen cards

Because credit cards may be easily misused by the cardholders and others who may obtain the cards, strict adherence to appropriate internal controls and operating procedures is essential in any credit card department. The examiner should determine if adequate controls and procedures exist.

Account Management, Risk Management, and Loss Allowance

Credit card lending programs can generate risk through inappropriate account-management, risk-management, and loss-allowance practices. Banks should have and follow prudent policies for credit-line management, over-limit practices, minimum payments, negative amortization, workout and forbearance practices, and recovery practices. In addition, banks should follow generally accepted accounting principles (GAAP), existing interagency policies, and call report instructions for income-recognition and loss-allowance practices. In arriving at an overall assessment of the adequacy of a bank's account-management practices for its credit card lending business, examiners should incorporate the risk profile of the bank, the quality of management reporting, and the adequacy of the bank's charge-off policies and loss-allowance methodologies. (See SR-03-01 and the FFIEC January 8, 2003, interagency guidance on credit card lending.)

Credit-line management. Banks should carefully consider the repayment capacity of borrowers when assigning initial credit lines or significantly increasing borrowers' existing credit lines. When a bank inadequately analyzes the repayment capacity of a borrower, practices such as liberal line-increase programs and multiple card strategies can increase the risk profile of a borrower quickly and result in rapid and significant portfolio deterioration.

Credit-line assignments should be managed conservatively using proven credit criteria. Support for credit-line management should include documentation and analysis of decision factors such as a borrower's repayment history, risk scores, behavior scores, or other relevant criteria.

Banks can significantly increase their credit exposure by offering customers additional cards, including store-specific private-label cards and affinity-relationship cards, without considering their entire relationship with a customer. In extreme cases, some banks may grant additional cards to borrowers who are already experiencing payment problems on their existing cards. Banks that offer multiple credit lines should have sufficient internal controls and management information systems (MIS) to aggregate related exposures and analyze performance before they offer additional credit lines to customers.

Over-limit practices. Account-management practices that do not adequately control authorization and provide for timely repayment of over-limit amounts may significantly increase the credit-risk profile of a bank's portfolio. While prudent over-limit practices are important for all credit card accounts, such practices are especially important for subprime accounts. Liberal over-limit tolerances and inadequate repayment requirements in subprime accounts can magnify the high risk exposure of the lending bank, and deficient reporting and loss-allowance methodologies can understate the credit risk.

All banks should carefully manage their over-limit practices and focus on reasonable control and timely repayment of amounts that exceed established credit limits. A bank's MIS should be sufficient to enable its management to identify, measure, manage, and control the unique risks associated with over-limit accounts. Over-limit authorization on open-end accounts, particularly those that are subprime, should be restricted and subject to appropriate policies and controls. The bank's objective should be to ensure that the borrower remains within prudent established credit limits that increase the likelihood of responsible credit management.

Minimum payment and negative amortization. Competitive pressures and a desire to preserve outstanding balances can lead to a bank's easing of minimum-payment requirements, which in turn can increase credit risk and mask portfolio quality. These problems are exacerbated when minimum payments consistently fall short of covering all finance charges and fees assessed during the billing cycle and when the outstanding balance continues to build (known as "negative amortization"). In these cases, the lending bank is recording uncollected income by capitalizing the unpaid finance charges and fees into the account balance the customer owes. The pitfalls of negative amortization are magnified when subprime accounts are involved—and are even more damaging when the condition is prolonged by programmatic, recurring over-limit fees and other charges that are primarily intended to increase recorded income for the lending bank rather than enhance the borrowers' performance or their access to credit.

The Federal Reserve expects lending banks to require minimum payments that will amortize the current balance over a reasonable period of time, consistent with the unsecured, consumer-oriented nature of the underlying debt and the borrower's documented creditworthiness. Examiners should criticize prolonged practices involving negative amortization and inappropriate fees, as well as other practices that inordinately compound or protract consumer debt and disguise portfolio performance and quality, all of which raise safety-and-soundness concerns.

Workout and forbearance practices. Banks should properly manage workout programs.[1] Areas of concern involve liberal repayment terms with extended amortizations, high charge-off rates, moving accounts from one workout program to another, multiple re-agings, and poor MIS to monitor program performance. Examiners should criticize management and require appropriate corrective action when workout programs are not managed properly. Such actions may include adversely classifying entire segments of portfolios, placing loans on nonaccrual, increasing loss allowances to adequate levels, and accelerating charge-offs to appropriate time frames.

Workout programs should be designed to maximize principal reduction and should generally strive to have borrowers repay credit card debt within 60 months. Repayment terms for workout programs should be consistent with these time frames; exceptions should be clearly documented and supported by compelling evidence that less conservative terms and conditions are warranted. To meet the appropriate time frames, banks may need to substantially reduce or eliminate interest rates and fees on credit card debt so that more of the payment is applied to reducing the principal.

In lieu of workout programs, banks sometimes negotiate settlement agreements with borrowers who are unable to service their unsecured open-end credit. In a settlement arrangement, the bank forgives a portion of the amount owed. In exchange, the borrower agrees to pay the remaining balance either in a lump-sum payment or by amortizing the balance over several months.

Income-recognition and loss-allowance practices. Most banks use historical net charge-off rates, which are based on a migration analysis of the roll rates[2] to charge-off, as the starting point for determining appropriate loss allowances. Banks then typically adjust the historical charge-offs to reflect current trends and conditions and other factors.

Banks should evaluate the collectibility of accrued interest and fees on credit card accounts because a portion of accrued interest and fees is generally not collectible.[3] Although regulatory reporting instructions do not require consumer credit card loans to be placed on nonaccrual on the basis of their delinquency status, all banks should employ appropriate methods to ensure that income is accurately measured. Such methods may include providing loss allowances for uncollectible fees and finance charges or placing delinquent and impaired receivables on nonaccrual status. Banks must account for the owned portion of accrued interest and fees, including related estimated losses, separately from the retained interest in accrued interest and fees from credit card receivables that have been securitized.

A bank's allowance for loan and lease losses (ALLL) should be adequate to absorb credit losses that are probable and estimable on all loans. While some banks provide for an ALLL on all loans, others may only provide for an

1. A workout is a former open-end credit card account in which credit availability has been closed and the balance owed has been placed on a fixed (dollar or percentage) repayment schedule in accordance with modified, concessionary terms and conditions. Generally, the repayment terms require amortization or liquidation of the balance owed over a defined payment period. Such arrangements are typically used when a customer is either unwilling or unable to repay the open-end credit card account in accordance with the original terms but shows the willingness and ability to repay the loan in accordance with modified terms and conditions.

Workout programs generally do not include temporary-hardship programs that help borrowers overcome temporary financial difficulties. However, temporary-hardship programs longer than 12 months, including renewals, should be considered workout programs.

2. Roll rate is the percentage of balances, or accounts, that move from one delinquency stage to the next delinquency stage.

3. AICPA Statement of Position 01-6, *Accounting by Certain Entities (Including Entities with Trade Receivables) That Lend to or Finance the Activities of Others,* provides guidance on accounting for delinquency fees.

ALLL on loans that are delinquent. This last practice may result in an inadequate ALLL. Banks should ensure that their loan-impairment analysis and ALLL methodology, including the analysis of roll rates, consider the losses inherent in both delinquent and nondelinquent loans.

A bank's allowance methodologies should always fully recognize the losses inherent in over-limit portfolio segments. For example, if a bank requires borrowers to pay monthly over-limit and other fees in addition to the minimum monthly payment amount, roll rates and estimated losses may be higher than indicated in the overall portfolio migration analysis. Accordingly, banks should ensure that their allowance methodology addresses the incremental losses that may be inherent in over-limit accounts.

A bank's allowances should appropriately provide for the inherent probable loss in workout programs, particularly when a program has liberal repayment periods with little progress in reducing principal. Accounts in workout programs should be segregated for performance-measurement, impairment-analysis, and monitoring purposes. When multiple workout programs with different performance characteristics exist, a bank should track each program separately and establish and maintain adequate allowances for each program. Generally, the allowance allocation should equal the estimated loss in each program based on historical experience as adjusted for current conditions and trends. These adjustments should take into account changes in economic conditions, the volume and mix of loans in each program, the terms and conditions of each program, and loan collection activities.

Banks should ensure that they establish and maintain adequate loss allowances for credit card accounts that are subject to settlement arrangements. In addition, the FFIEC Uniform Retail Credit Classification and Account Management Policy states that "actual credit losses on individual retail loans should be recorded when the bank becomes aware of the loss." In general, the amount of debt forgiven in a settlement arrangement should be classified as loss and charged off immediately. Immediate charge-off, in some circumstances, however, may be impractical. In such cases, banks may treat amounts forgiven in settlement arrangements as specific allowances.[4] Upon receipt of the final settlement payment, banks should charge off deficiency balances within 30 days.

Recovery practices. After a credit card loan is charged off, banks must properly report any subsequent collections on the loan.[5] Typically, banks report some or all of such collections on charged-off credit card loans as recoveries to the ALLL. If the total amount a bank credits to the ALLL as the recovery on an individual credit card loan (which may include principal, interest, and fees) exceeds the amount previously charged off against the ALLL on that loan (which may have been limited to principal), then the bank's net charge-off experience—an important indicator of the credit quality and performance of its portfolio—will be understated. Banks must ensure that the total amount credited to the ALLL as recoveries on a loan (which may include amounts representing principal, interest, and fees) is limited to the amount previously charged off against the ALLL on that loan. Any amounts collected in excess of this limit should be recognized as income.

Re-aging of credit card receivables. The examiner should review the bank's credit card receivables to determine if re-aging occurs. Re-aging refers to the removal of a delinquent account from normal collection activity after the borrower has demonstrated over time that he or she is capable of fulfilling contractual obligations without the intervention of the bank's collection department. The bank may use re-aging when a customer makes regular and consecutive payments over a period of time that maintain the account at a consistent delinquency level or reduce the delinquency level with minimal collection effort. Re-aging, in effect, changes the delinquency-payment status of a credit card receivable from a past-due to a current status. The examiner should determine if the bank re-ages its accounts on an exception basis or as a regular practice. The bank should document those accounts that have been re-aged, obtain appropriate approval, and ensure that re-aging is done in conformance with internal policies and procedures. (See "Bank Classification and Charge-Off Policy" later in this section and SR-00-8 for further guidance.)

4. For regulatory reporting purposes, banks should report the creation of a specific allowance as a charge-off in Schedule RI-B of the call report.

5. AICPA Statement of Position 01-6 provides recognition guidance for recoveries of previously charged-off loans.

Exceptions to examiner guidance. From time to time, banks with well-managed programs may authorize, and provide a basis for granting, limited exceptions to the FFIEC Uniform Retail Credit Classification and Account Management Policy. The basis for granting exceptions to the policy should be identified and described in the bank's policies and procedures. Such policies and procedures should address the types of exceptions allowed and the circumstances for permitting them. The volume of accounts granted exceptions should be small and well controlled, and the performance of these accounts should be closely monitored. Examiners will evaluate whether a bank uses its exceptions prudently. Examiners should criticize management and require corrective action when exceptions are not used prudently, are not well managed, result in improper reporting, or mask delinquencies and losses.

LOAN POLICY

A written consumer credit policy provides bank management with the framework to underwrite and administer the risk inherent in lending money while establishing a mechanism for the board of directors or senior management to monitor compliance. The policy should establish the authority, rules, and guidelines to operate and administer the bank's consumer loan portfolio effectively; that is, the policy should help manage risk while ensuring profitability. The policy should set basic standards and procedures clearly and concisely. The policy's guidelines should be derived from a careful review of internal and external factors that affect the bank. To avoid any discriminatory policies or practices, the policy should include guidelines on the various consumer credit laws and regulations.

The composition of the loan portfolio will differ considerably among banks because lending activities are influenced by many factors, including the type of institution, management's objectives and philosophies on diversification and risk, the availability of funds, and credit demand. An effective lending policy and commensurate procedures are integral components of the lending process. The bank's consumer credit policy should accomplish the following:

- define standards, rules, and guidelines for the credit-evaluation process, with the following specific goals:
  - — establish minimum and maximum loan maturities
  - — establish minimum levels of creditworthiness
  - — create consistency within the bank's underwriting process
  - — ensure uniformity in how the bank's consumer credit products are offered to borrowers
- provide a degree of flexibility, which allows credit officers and management to use their knowledge, skills, and experience
- provide specific guidelines for determining the creditworthiness of applicants; these guidelines might include the following:
  - — minimum income levels
  - — maximum debt-to-income ratios
  - — job or income stability
  - — payment history on previous obligations
  - — the type and value of collateral
  - — maximum loan-to-value ratios on various types of collateral
  - — a minimum score on a credit scoring system
- provide guidelines for the level and type of documentation to be maintained, including—
  - — a signed application
  - — the identity of the borrower and his or her occupation
  - — documentation of the borrower's financial capacity
  - — a credit bureau report
  - — the purpose of all loans granted to the borrower, the sources of repayment, and the repayment programs
  - — documentation of the collateral, its value, and the source of the valuation
  - — documents perfecting the lien on the collateral
  - — verification worksheets and supporting documentation
  - — a credit scoring worksheet, if applicable
  - — the sales contract and related security agreements, if applicable
  - — evidence of insurance coverage, if applicable
  - — any other documentation received or prepared in conjunction with the credit request
- define procedures for handling delinquent consumer credit loans and the subsequent charge-off and possible re-aging of those loans

The consumer credit policy should also provide guidelines for granting loans that do not conform to the bank's written lending policy or procedures. The policy should require that the reason for the exception be detailed in writing, submitted for approval to a designated authority, and documented in the loan file. Credit exceptions should be reviewed by the appropriate bank committee. The frequency of exceptions granted may indicate a lessening of underwriting standards or a need to adjust the policy to allow flexibility within safe and sound parameters. The examiner should assess the exceptions and make recommendations accordingly.

Obtaining and maintaining complete and accurate information on every consumer credit applicant is essential to approving credit in a safe and sound manner. The loan policy should establish what information will be required from the borrower during the application process and what, if any, subsequent information the borrower will be required to submit while the credit remains outstanding. Credit files should be maintained on all borrowers, regardless of the credit amount, with the exception of the latitude provided by the March 30, 1993, Interagency Policy Statement on Documentation of Loans. Each borrower's credit file should include the names of all other borrowers who are part of the same borrowing relationship, or the bank should have some other system for informing the reader of a credit file that the borrower is part of a more extensive credit relationship. A current credit file should provide the loan officer, loan committee, and internal and external reviewers with all information necessary to (1) analyze the credit before it is granted and (2) monitor the credit during its life.

Documentation requirements will vary according to the type of loan, borrower, and collateral. For example, the bank may not require a financial statement from a borrower whose loans are fully secured by certificates of deposit issued by the bank. For most consumer credit loans, the borrower's financial information is collected only at the time of the loan application.

OPERATIONAL RISK

The management of the consumer credit function and the accompanying internal controls is of primary importance to the safe, sound, and profitable operation of a bank. In evaluating controls for consumer credit administration, the examiner should review (1) the bank's adherence to policies and procedures and (2) the operational controls over recordkeeping, payments, and collateral records to ensure that risks are controlled properly. (See "Loan Portfolio Management," section 2040.1, for an overview of the various types of risk that the bank should be aware of and the controls it should implement to effectively manage risk.) Risks that are inherent to the consumer credit function and that require internal controls include, but are not limited to, the following:

- *Insurance.* All insurance policies on file should name the bank as loss payee. The bank should maintain a tickler system to monitor the expiration of insurance policies. In addition, the bank should implement procedures to ensure single-interest insurance coverage is obtained in case the borrower's insurance is canceled or expires.
- *Security agreements.* The bank should implement procedures to ensure that lien searches are performed and that liens are perfected by appropriate filings.
- *Indirect installment loans.* The bank should implement procedures to reduce the risk that can occur in this area. These procedures should ensure the following:
  - — payments are made directly to the bank and not through the dealer
  - — dealer lines are reaffirmed at least annually
  - — selling prices as listed by the dealer are accurate
  - — credit checks on the borrowers are performed independently of the dealer
  - — overdrafts are prohibited in the dealer reserve and holdback accounts
  - — past-due accounts are monitored in aggregate per dealer to assess the quality of loans received from each individual dealer

CREDIT SCORING SYSTEM

Credit scoring is a method for predicting how much repayment risk consumer credit borrowers present. Credit scoring systems are developed using application or credit bureau data on consumers whose performance has already been categorized as creditworthy or noncreditworthy. Items of information that help predict acceptable performance are identified and assigned point values relative to their overall importance. These values are then totaled to calculate an overall credit score.

The credit score is used to approve credit, and frequently allows a bank to avoid the costly and time-consuming process of individual underwriting. Management determines a minimum score, which is sometimes called the cutoff score. Borrowers whose credit scores are not within the approved cutoff-score range for the type of loan requested do not meet the bank's minimum underwriting criteria. However, the bank may override a borrower's unacceptable credit score when other mitigating factors are present that may not have been included in the credit score. Exceptions to the bank's credit scoring system should be documented.

A number of banks have developed and implemented credit scoring systems as part of the approval process for consumer credit; other banks use traditional methods that rely on a credit officer's subjective evaluation of an applicant's creditworthiness. Credit scoring systems are replacing credit officers' subjective evaluation of borrowers' creditworthiness in more and more banks, particularly in larger institutions. Credit scoring systems are divided into two categories: (1) empirically derived, demonstrably and statistically sound credit systems and (2) judgmental systems.

Empirically derived credit scoring systems are generally defined as systems that evaluate creditworthiness by assigning points to various attributes of the applicant and, perhaps, to attributes of the credit requested. The points assigned are derived from a statistical analysis of recent creditworthy and noncreditworthy applicants of the bank. An empirically derived credit scoring system is statistically sound when it meets the following requirements:

- The data used to develop the system are derived from an empirical comparison of sample groups or from the population of creditworthy and noncreditworthy applicants who applied for credit within a reasonably recent period of time.
- The system is developed to evaluate the creditworthiness of applicants in order to serve the legitimate business interests of the bank using the system.
- The system is developed and validated using statistical principles and methodology.
- The bank periodically reevaluates the predictive ability of the system by using statistical principles and methodologies and adjusts the system as necessary.

An empirically derived credit scoring system may take the age of an applicant into account as a predictive variable, provided that the age of an elderly applicant is not assigned a negative factor or value. In a judgmental system, which relies on a credit officer's personal evaluation of a potential borrower's creditworthiness, a creditor may not take age directly into account. However, the applicant's age may be related to other information that the creditor considers in evaluating creditworthiness. For example, a creditor may consider the applicant's occupation and length of time to retirement to ascertain whether the applicant's income (including retirement income) will support the extension of credit to maturity. Consumer credit regulations allow any system of evaluating creditworthiness to favor an applicant who is 62 or older.

If the bank has a credit scoring system, the examiner should review the items or customer attributes that are included in it. In general, credit scoring systems are built on an experiential or historical database. Credit scoring methods analyze the experiences of individuals who have been previously granted credit and divide them into creditworthy and noncreditworthy accounts for purposes of predicting future extensions of consumer credit.

A successful credit scoring system provides a standardized way of measuring the inherent risk of the borrower. An important measure of any credit scoring system is its definition of risk and the care with which explanatory variables are defined, data are collected, and the system is tested. The standardized risk measurement should be fundamentally sound, be based on historical data, measure the risk of default (or loss), and produce consistent results across time for a wide range of borrowers. The bank should further investigate potential borrowers who do not meet the credit scoring criteria.

Some banks may use more than one type of credit scoring methodology in their underwriting and account-management practices. The following are three examples of credit scoring systems:

- *Credit bureau scoring.* The bank uses a consumer's credit bureau information in a scoring formula. The scoring model is developed by the various credit bureaus, using the reported experience of all credit grantors with whom the applicant has or has had a relationship.
- *Custom-application scoring.* The bank uses both a consumer's application and credit

bureau data in a scoring formula. This scoring model is developed using only information on the bank's applicants and borrowers.
- *Behavioral scoring.* The bank uses a formula that includes a borrower's repayment history, account utilization, and length of time with the bank to calculate a risk score for revolving accounts.

Applicants who fail the scoring process may still be judgmentally reviewed if additional information exists that may not have been included in the scoring formula. In addition, if an applicant passes the scoring process, but other information indicates that the loan should not be made, the applicant can be denied but the reason for the credit denial should be documented.

BANK CLASSIFICATION AND CHARGE-OFF POLICY

Consumer credit loans, based on their volume and size, are generally classified using criteria that are different from the classification of other types of loans. The examiner should use the Uniform Retail-Credit Classification and Account-Management Policy[6] when determining consumer credit classifications. (See the appendix to this section.)

A bank should have procedures detailing when consumer credit loans become watch list or problem credits. In addition, the bank should have charge-off procedures for consumer credit loans. The examiner should review the bank's policies and procedures for adequacy and compliance.

Identification of unfavorable trends must include the review of past-due percentages and income and loss trends in the consumer credit department, which management should monitor closely. Unfortunately, in banks that lack a well-enforced charge-off program, loss ratios are often meaningless for periods of less than a year. As a result, bank management may not become aware of downward trends until year-end or examiner-initiated charge-offs are made. Recognition and implementation of any necessary corrective action are thus delayed.

The examiner should determine whether the bank has adopted a well-enforced charge-off procedure. If so, his or her review should be limited to ascertaining that exceptions meet established guidelines. If the bank is properly charging off delinquent consumer credit loans in the normal course of business under a policy that generally conforms to that of the Federal Reserve System, no specific request for charge-off should be necessary. When the bank has not established a program to ensure the timely charge-off of delinquent accounts, such a program should be recommended in the examination report. If material misstatements in the FFIEC Consolidated Reports of Condition and Income (call reports) for previous quarters have resulted from management's failure to charge off loans, management should be instructed to amend the call reports for each affected quarter. The following loans are subject to the uniform classification policy:

- All loans to individuals for household, family, and other personal expenditures as defined in the call reports.
- Mobile home paper, except when applicable state laws define the purchase of a mobile home as the purchase of real property and the loan is secured by the purchased mobile home as evidenced by a mortgage or similar document.
- Federal Housing Authority (FHA) title 1 loans. These loans are also subject to the following classification criteria:
  - — Uninsured portions should be charged off when claims have been filed.
  - — When claims have not been filed, uninsured delinquent portions should be classified in accordance with the delinquent installment loan classification policy.
  - — The portion covered by valid insurance is not subject to classification.

The uniform classification policy includes consumer credit loans. Small, delinquent consumer credit loans may be listed for classification purposes in the report of examination without detailed comments. Larger classified consumer loans might need to be supported with detailed comments. When no specific procedures have been established, or when adherence

6. The 1980 Federal Financial Institutions Examination Council (FFIEC) policy was revised and issued in February 1999 and June 2000. The June 2000 policy replaces the 1980 policy and its February 1999 revision. Reporting on the FFIEC call report, based on the revised policy, is not required until December 31, 2000. In addition to discussing the revised policy statement, SR-00-8 advises examiners to consider the methodology used for aging retail loans. In accordance with the FFIEC call report instructions, banks and their consumer finance subsidiaries are required to use the contractual method, which ages loans based on the status of contractual payments.

to the established procedures is not evident, the examiner should make every effort to encourage the bank to adopt and follow acceptable procedures.

REPOSSESSED PROPERTY

Repossessed property should be booked at its fair value, less cost to sell, on the date the bank obtains clear title and possession of the property. Any outstanding loan balance in excess of the fair value of the property, less selling costs, should be charged off. Periodic repricing should be performed, and appropriate accounting entries should be made when necessary. Generally, repossessed property should be disposed of within 90 days of obtaining possession, unless legal requirements stipulate a longer period.

VIOLATIONS OF LAW

The consumer credit department is particularly susceptible to violations of the various consumer credit laws and regulations. These types of violations may result in serious financial penalties and loss of public esteem. Therefore, the examiner must be aware of any violations discovered during the consumer compliance examination and ensure that corrective action has been effected. All examiners should be familiar with the various consumer credit laws and regulations and be alert to potential violations.

APPENDIX—RETAIL-CREDIT CLASSIFICATION POLICY

The Uniform Retail Credit Classification and Account Management Policy issued by the FFIEC and approved by the Federal Reserve Board is reproduced below. The Board has clarified certain provisions of this policy. In this text, the Board's revisions are in brackets.

The Uniform Retail Credit Classification and Account Management Policy[1] establishes standards for the classification and treatment of retail credit in financial institutions. Retail credit consists of open- and closed-end credit extended to individuals for household, family, and other personal expenditures, and includes consumer loans and credit cards. For purposes of this policy, retail-credit also includes loans to individuals secured by their personal residence, including first mortgage, home equity, and home-improvement loans. Because a retail-credit portfolio generally consists of a large number of relatively small-balance loans, evaluating the quality of the retail-credit portfolio on a loan-by-loan basis is inefficient and burdensome for the institution being examined and for examiners.

Actual credit losses on individual retail credits should be recorded when the institution becomes aware of the loss, but in no case should the charge-off exceed the time frames stated in this policy. This policy does not preclude an institution from adopting a more conservative internal policy. Based on collection experience, when a portfolio's history reflects high losses and low recoveries, more conservative standards are appropriate and necessary.

The quality of retail credit is best indicated by the repayment performance of individual borrowers. Therefore, in general, retail credit should be classified based on the following criteria:

- Open- and closed-end retail loans past due 90 cumulative days from the contractual due date should be classified substandard.
- Closed-end retail loans that become past due 120 cumulative days and open-end retail loans that become past due 180 cumulative days from the contractual due date should be classified loss and charged off.[2] In lieu of charging off the entire loan balance, loans with non–real estate collateral may be written down to the value of the collateral, less cost to sell, if repossession of collateral is assured and in process.
- One- to four-family residential real estate loans and home equity loans that are past due 90 days or more with loan-to-value ratios

1. [For the Federal Reserve's classification guidelines, see section 2060.1, "Classification of Credits."]

2. For operational purposes, whenever a charge-off is necessary under this policy, it should be taken no later than the end of the month in which the applicable time period elapses. Any full payment received after the 120- or 180-day charge-off threshold, but before month-end charge-off, may be considered in determining whether the charge-off remains appropriate.

OTS regulation 12 CFR 560.160(b) allows savings institutions to establish adequate (specific) valuation allowances for assets classified loss in lieu of charge- offs.

Open-end retail accounts that are placed on a fixed repayment schedule should follow the charge-off time frame for closed-end loans.

greater than 60 percent should be classified substandard. Properly secured residential real estate loans with loan-to-value ratios equal to or less than 60 percent are generally not classified based solely on delinquency status. Home equity loans to the same borrower at the same institution as the senior mortgage loan with a combined loan-to-value ratio equal to or less than 60 percent need not be classified. However, home equity loans where the institution does not hold the senior mortgage, that are past due 90 days or more should be classified substandard, even if the loan-to-value ratio is equal to, or less than, 60 percent.

- For open- and closed-end loans secured by residential real estate, a current assessment of value should be made no later than 180 days past due. Any outstanding loan balance in excess of the value of the property, less cost to sell, should be classified loss and charged off.
- Loans in bankruptcy should be classified loss and charged off within 60 days of receipt of notification of filing from the bankruptcy court or within the time frames specified in this classification policy, whichever is shorter, unless the institution can clearly demonstrate and document that repayment is likely to occur. Loans with collateral may be written down to the value of the collateral, less cost to sell. Any loan balance not charged off should be classified substandard until the borrower re-establishes the ability and willingness to repay for a period of at least six months.
- Fraudulent loans should be classified loss and charged off no later than 90 days of discovery or within the time frames adopted in this classification policy, whichever is shorter.
- Loans of deceased persons should be classified loss and charged off when the loss is determined or within the time frames adopted in this classification policy, whichever is shorter.

Other Considerations for Classification

If an institution can clearly document that a past-due loan is well secured and in the process of collection, such that collection will occur regardless of delinquency status, then the loan need not be classified. A well-secured loan is collateralized by a perfected security interest in, or pledges of, real or personal property, including securities with an estimable value, less cost to sell, sufficient to recover the recorded investment in the loan, as well as a reasonable return on that amount. ‘‘In the process of collection’’ means that either a collection effort or legal action is proceeding and is reasonably expected to result in recovery of the loan balance or its restoration to a current status, generally within the next 90 days.

Partial Payments on Open- and Closed-End Credit

Institutions should use one of two methods to recognize partial payments. A payment equivalent to 90 percent or more of the contractual payment may be considered a full payment in computing past-due status. Alternatively, the institution may aggregate payments and give credit for any partial payment received. For example, if a regular installment payment is $300 and the borrower makes payments of only $150 per month for a six-month period, [the institution could aggregate the payments received ($150 × six payments, or $900). It could then give credit for three full months ($300 × three payments) and thus treat the loan as] three full months past due. An institution may use either or both methods in its portfolio, but may not use both methods simultaneously with a single loan.

Re-aging, Extensions, Deferrals, Renewals, and Rewrites

Re-aging of open-end accounts, and extensions, deferrals, renewals, and rewrites of closed-end loans[3] can be used to help borrowers overcome

3. These terms are defined as follows. *Re-age*: Returning a delinquent, open-end account to current status without collecting [at the time of aging] the total amount of principal, interest, and fees that are contractually due. *Extension*: Extending monthly payments on a closed-end loan and rolling back the maturity by the number of months extended. The account is shown current upon granting the extension. If extension fees are assessed, they should be collected at the time of the extension and not added to the balance of the loan. *Deferral*: Deferring a contractually due payment on a closed-end loan without affecting the other terms, including maturity [or the due date for subsequently scheduled payments] of the loan. The account is shown current upon granting the deferral. *Renewal*: Underwriting a matured, closed-end loan generally at its outstanding principal amount and on similar terms. *Rewrite*: Underwriting an existing loan by significantly chang-

temporary financial difficulties, such as loss of job, medical emergency, or change in family circumstances like loss of a family member. A permissive policy on re-agings, extensions, deferrals, renewals, or rewrites can cloud the true performance and delinquency status of the portfolio. However, prudent use is acceptable when it is based on a renewed willingness and ability to repay the loan, and when it is structured and controlled in accordance with sound internal policies.

Management should ensure that comprehensive and effective risk management and internal controls are established and maintained so that re-ages, extensions, deferrals, renewals, and rewrites can be adequately controlled and monitored by management and verified by examiners. The decision to re-age, extend, defer, renew, or rewrite a loan, like any other modification of contractual terms, should be supported in the institution's management information systems. Adequate management information systems usually identify and document any loan that is re-aged, extended, deferred, renewed, or rewritten, including the number of times such action has been taken. Documentation normally shows that the institution's personnel communicated with the borrower, the borrower agreed to pay the loan in full, and the borrower has the ability to repay the loan. To be effective, management information systems should also monitor and track the volume and performance of loans that have been re-aged, extended, deferred, renewed, or rewritten and/or placed in a workout program.

Open-End Accounts

Institutions that re-age open-end accounts should establish a reasonable written policy and adhere to it. To be considered for re-aging, an account should exhibit the following:

- The borrower has demonstrated a renewed willingness and ability to repay the loan.
- The account has existed for at least nine months.
- The borrower has made at least three consecutive minimum monthly payments or the equivalent cumulative amount. Funds may not be advanced by the institution for this purpose.

ing its terms, including payment amounts, interest rates, amortization schedules, or its final maturity.

Open-end accounts should not be re-aged more than once within any twelve-month period and no more than twice within any five-year period. Institutions may adopt a more conservative re-aging standard; for example, some institutions allow only one re-aging in the lifetime of an open-end account. Additionally, an over-limit account may be re-aged at its outstanding balance (including the over-limit balance, interest, and fees), provided that no new credit is extended to the borrower until the balance falls below the predelinquency credit limit.

Institutions may re-age an account after it enters a workout program, including internal and third-party debt-counseling services, but only after receipt of at least three consecutive minimum monthly payments or the equivalent cumulative amount, as agreed upon under the workout or debt-management program. Re-aging for workout purposes is limited to once in a five-year period and is in addition to the once-in-twelve-months/twice-in-five-years limitation described above. To be effective, management information systems should track the principal reductions and charge-off history of loans in workout programs by type of program.

Closed-End Loans

Institutions should adopt and adhere to explicit standards that control the use of extensions, deferrals, renewals, and rewrites of closed-end loans. The standards should exhibit the following:

- The borrower should show a renewed willingness and ability to repay the loan.
- The standards should limit the number and frequency of extensions, deferrals, renewals, and rewrites.
- Additional advances to finance unpaid interest and fees should be prohibited.

Management should ensure that comprehensive and effective risk management, reporting, and internal controls are established and maintained to support the collection process and to ensure timely recognition of losses. To be effective, management information systems should track the subsequent principal reductions and charge-off history of loans that have been granted an extension, deferral, renewal, or rewrite.

Examination Considerations

Examiners should ensure that institutions adhere to this policy. Nevertheless, there may be instances that warrant exceptions to the general classification policy. Loans need not be classified if the institution can document clearly that repayment will occur irrespective of delinquency status. Examples might include loans well secured by marketable collateral and in the process of collection, loans for which claims are filed against solvent estates, and loans supported by valid insurance claims.

The Uniform Retail Credit Classification and Account Management Policy does not preclude examiners from classifying individual retail-credit loans that exhibit signs of credit weakness regardless of delinquency status. Similarly, an examiner may also classify retail portfolios, or segments thereof, where underwriting standards are weak and present unreasonable credit risk, and may criticize account-management practices that are deficient.

In addition to reviewing loan classifications, the examiner should ensure that the institution's allowance for loan and lease losses provides adequate coverage for probable losses inherent in the portfolio. Sound risk- and account-management systems, including a prudent retail-credit lending policy, measures to ensure and monitor adherence to stated policy, and detailed operating procedures, should also be implemented. Internal controls should be in place to ensure that the policy is followed. Institutions that lack sound policies or fail to implement or effectively adhere to established policies will be subject to criticism.

Issued by the FFIEC on June 12, 2000.

1. To determine the quality and adequacy of operations (including the adequacy of lending policies, practices, procedures, internal controls, and management information systems) for consumer credit and credit card plans.
2. To determine if bank officers and employees are operating in conformance with the established guidelines.
3. To evaluate the consumer credit portfolio for credit quality, performance, adequate collateral, and collectibility.
4. To determine the scope and adequacy of the audit and loan-review function.
5. To determine the level of risk inherent in a bank's consumer credit and credit card lending departments and what actions management has taken to identify, measure, control, and monitor the level and types of risks.
6. To determine that the goals and objectives of specific credit card plans are being achieved and that the plans are profitable.
7. To determine compliance with the board of directors' and senior management's policies and procedures and with applicable laws and regulations.
8. To initiate corrective action when policies, procedures, practices, or internal controls are deficient or when violations of law or regulations have been noted.

GENERAL CONSUMER CREDIT

1. If selected for implementation, complete or update the installment loan section of the internal control questionnaire.
2. Based on the evaluation of internal controls and the work performed by internal or external auditors, determine the scope of the examination.
3. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examination procedures. Obtain a listing of any deficiencies noted in the latest review done by internal or external auditors. If applicable, also determine if the latest consumer compliance examination disclosed any violation of laws or regulations. Determine if corrective action has been taken.
4. Request that the bank supply the following:
   a. a listing of all dealers who have indirect paper, fleet leasing, or discounted lease lines, along with respective codes
   b. an indirect paper or a fleet-leasing or discounted fleet-leasing report by code, along with the respective delinquency report for all loans overdue 30 days or more
   c. a listing of dealer reserves, holdback accounts, or both showing the dealer, account number, and balance
   d. the latest month-end extension and renewal reports
   e. a schedule of all loans with irregular or balloon payments or both
   f. a schedule of all loans with more than five prepaid installments
   g. a listing of loans generated by brokers or finders
   h. a listing of current repossessions, including the name of the borrower, a description of the item, the date of repossession, the date title was acquired, and the balance
   i. a copy of each monthly charge-off report submitted to the board since the preceding examination (If reports do not include all the information necessary to prepare the form for charge-off of installments between examinations, request a listing of that information for each charge-off.)
   j. management reports prepared by department personnel and that are not forwarded in their entirety to the board of directors or its committee
   k. a listing of the amount of recoveries on charged-off installment loans, by month, since the preceding examination
   l. a listing of all outstanding loans that have been assigned to an attorney for collection
   m. an identification of all columns and codes on the computer printout
5. Obtain a trial balance of installment loans. Use of the bank's latest trial balance is acceptable. If exact figures are required, update the trial from the daily transaction journals. Using the trial balance—
   a. agree or reconcile balances to department controls and the general ledger and
   b. review reconciling items for reasonableness.
6. Using an appropriate technique, select borrowers for examination.
7. Using an appropriate technique, select indirect dealers, fleet-leasing, and indirect lease lines from indirect dealer or leasing reports. Transcribe the following onto consumer finance indirect line cards:
   a. the amount and number of contracts, indicating whether they are with or without recourse
   b. the amount and number of contracts past due 30–89 days, 90–119 days, and more than 120 days
   c. the balance in dealer reserve or holdback accounts or both
8. Obtain the following schedules from the bank or the appropriate examiner if they are applicable to this area:
   a. past-due loans (obtain separate schedules by branch, if available)
   b. loans transferred, either in whole or in part, to another lending institution as a result of a sale, participation, or asset swap since the previous examination
   c. loans acquired from another lending institution as a result of a purchase, participation, or asset swap since the previous examination
   d. loan commitments and other contingent liabilities
   e. extensions of credit to employees, offi-

cers, directors, principal shareholders, and their interests, specifying which officers are considered executive officers
f. correspondent banks' extensions of credit to executive officers, directors, and principal shareholders and their interests
g. a list of correspondent banks
h. miscellaneous loan debit and credit suspense accounts
i. loans considered "problem loans" by management
j. each officer's current lending authority
k. the current structure of interest rates
l. any useful information obtained from the review of the minutes of the loan and discount committee or any similar committee
m. reports furnished to the loan and discount committee or any similar committee
n. reports furnished to the board of directors
o. loans classified during the preceding examination
p. the extent and nature of loans serviced

9. Review the information received and perform the following for—
   a. Loans transferred, either in whole or in part, to or from another lending institution as a result of a participation, sale or purchase, or asset swap:
      • Participations only:
        — Test participation certificates and records and determine that the parties share in the risks and contractual payments on a pro rata basis.
        — Determine that the bank exercises similar controls and procedures over loans serviced for others as for loans in its own portfolio.
      • Procedures pertaining to *all* transfers:
        — Investigate any situations in which loans were transferred immediately before the date of examination to determine if any were transferred to avoid possible criticism during the examination.
        — Determine whether any of the loans transferred were either nonperforming at the time of transfer or classified at the previous examination.
        — Determine that low-quality loans transferred to or from the bank are properly reflected on its books at fair value (while fair value may be difficult to determine, it should at a minimum reflect both the rate of return being earned on such loans as well as an appropriate risk premium).
        — Determine that low-quality loans transferred to the parent holding company or a nonbank affiliate are properly reflected at fair value on the books of both the bank and its affiliate.
        — If low-quality loans were transferred to or from another lending institution for which the Federal Reserve is not the primary regulator, prepare a memorandum to be submitted to the Reserve Bank supervisory personnel. The Reserve Bank will then inform the local office of the primary federal regulator of the other institution involved in the transfer. The memorandum should include the following information, as applicable:
          (1) name of originating institution
          (2) name of receiving institution
          (3) type of transfer (i.e., participation, purchase/sale, swap)
          (4) date of transfer
          (5) total number of loans transferred
          (6) total dollar amount of loans transferred
          (7) status of the loans when transferred (e.g., nonperforming, classified, etc.)
          (8) any other information that would be helpful to the other regulator
   b. Miscellaneous loan debit and credit suspense accounts:
      • Discuss with management any large or old items.
      • Perform additional procedures as considered appropriate.
   c. For loan commitments and other contingent liabilities, if the borrower has been advised of the commitment and it exceeds the cutoff alone or in combination with any outstanding debt, prepare a line card for subsequent analysis and review.
   d. For loans classified during the previous examination; determine the disposition of loans so classified by—
      • obtaining current balances and their

payment status, or the date the loan was repaid and source of payment;
- investigating any situations in which all or part of the funds for the repayment came from the proceeds of another loan at the bank or were a result of a participation, sale, or swap with another lending institution; and
- referring to step 9a of this section for the appropriate examination procedures, determine if repayment was a result of a participation, sale, or swap.

e. Select loans that require in-depth review based on information derived from the above schedules.

10. Consult with the examiner responsible for the asset/liability management analysis to determine the appropriate maturity breakdown of loans needed for the analysis. If requested, compile the information using bank records or other appropriate sources. See section 6000.1, ''Instructions for the Report of Examination,'' for considerations to be taken into account when compiling maturity information for the gap analysis.
11. Obtain liability and other information on common borrowers from examiners assigned to overdrafts, lease financing, and other loan areas, and together decide who will review the borrowing relationship.
12. Obtain the credit files of all direct nonconsumer borrowers, indirect dealers, and fleet-leasing and discounted leasing lines for which line cards have been developed. Transcribe and analyze the following as appropriate:
   a. the purpose of the loan
   b. collateral information, including its value and the bank's right to hold and negotiate it
   c. the source of repayment
   d. ancillary information, including the type of business, its officers, and its affiliation
   e. fiscal and interim financial exhibits
   f. guarantors and the amount of any guarantee
   g. personal statements of borrowers, endorsers, or guarantors
   h. external credit checks and bureau reports
   i. loan officer's credit memoranda
   j. subordination agreements
   k. a corporate resolution to borrow or guarantee
   l. provisions of the loan agreement or master lease agreement
   m. the type of dealer endorsement:
      - full recourse
      - limited recourse
      - nonrecourse
   n. dealer repurchase agreements
   o. reserve and holdback requirements
   p. the amount of insurance coverage
13. Check the central liability file on borrowers indebted above the cutoff or borrowers displaying credit weakness who are suspected of having additional liability in other loan areas.
14. Transcribe significant liability and other information on officers, principals, and affiliations of borrowers on which line cards have been developed. Cross-reference, if appropriate.
15. Review a listing of loans generated by brokers or finders:
   a. Check the quality of the paper being acquired.
   b. Determine that sufficient financial data have been obtained to support the credits.
   c. Evaluate performance.
16. Review the current past-due (delinquent) loan list and determine that loans are aged based on the contractual method, which ages a loan based on its contractual repayment terms, as required by the call report instructions. Discuss with management selected delinquent loans from the listings of delinquent loans and repossessed collateral.
17. Determine if management has a general policy for the timely classification and charge-off of past-due loans and ascertain whether the policy is adhered to. Determine if loan-classification practices follow the board of directors' respective policies. Ascertain whether those policies comply with the provisions of the FFIEC's Uniform Retail Credit Classification and Account Management Policy and with Federal Reserve policy. Review with management individual accounts that have not been charged off in line with these policies.
18. Review voluntary charge-offs made since the preceding examination and, on a test basis, review files on borrowers and ascertain the correctness of the charge-off.
19. Review any reports being submitted on delinquent and defaulted loans guaranteed by government agencies:
   a. Determine that management is informed

accurately and is complying with the reporting requirements.

b. Determine that claims are being promptly filed after default.

CREDIT CARD LENDING

The examiner's analysis of operating policies and procedures is key to the examination of credit card banks and credit card operations. Credit card lending is characterized by a high volume of accounts, homogeneous loan pools, and small-dollar balances. A concentrated review of individual accounts, therefore, may not be practical. Examination procedures should focus on evaluating policies, procedures, and internal controls in conjunction with performing other selected functions. The goal is not confined to identifying current portfolio problems. The examination process should include an investigation of potential problems that may result from ineffective policies, unfavorable trends, lending concentrations, or nonadherence to policies. The following examination procedures should be performed.

1. Review UBPR data to determine the volume of credit card activity.
2. Determine if management has recently offered or plans to offer new products or if management plans to enter new market niches or expand the credit card portfolio significantly (new offerings may include affinity cards, co-branded cards, secured cards, or purchasing cards).
3. Determine whether the bank is engaged or plans to engage in subprime credit card lending. If subprime lending exists or is planned, perform the subprime-lending examination procedures in section 2133.3.
4. Review correspondence that the bank has received or exchanged with credit card networks (i.e.,Visa, MasterCard). These agencies perform periodic reviews of their members.

Policy Considerations

1. Review the credit card policy. Policy guidelines should include the following items:
   a. adequate screening of account applicants
   b. standards for approving accounts and determining credit-line size
   c. minimum standards for documentation
   d. internal controls to prevent and detect fraud, such as—
      - review procedures, including frequent review of delinquent accounts;
      - delinquency notification and collection procedures;
      - criteria for freezing accounts and charging off balances;
      - criteria for curing and re-aging delinquent accounts;
      - controls to avoid reissuances of expired cards to obligors who have unsatisfactory credit histories;
      - approvals of and controls over over-limits and overrides; and
      - cardholder information security controls
   e. due diligence before engaging the service of a third party, as well as the ongoing management of credit card operations

Audit

1. Review the adequacy of the audit function regarding credit card operations.
   a. Determine if the audit program identifies contraventions of internal policy, credit card network (i.e., Visa, MasterCard) regulations, and written contracts.
   b. Determine if audit procedures include reviewing the accuracy and integrity of the bank's system for reporting the past-due status of credit card loans, over-limit accounts, and other management information systems.
   c. Determine if audit procedures include reviewing computer-driven models.
   d. Determine if independent tests of automated procedures are performed (for example, a sample of automatically re-aged accounts may be independently reviewed to test the integrity of automated systems).
   e. Determine whether audit procedures include a review of credit card processing operations. Ascertain if the product control file governing credit card processing was reviewed and whether it revealed any significant internal-control weaknesses such as a lack of segregation

of duties and access controls. Determine whether management is aware of the risks and if the audit staff has the expertise to adequately evaluate procedures and suggest controls commensurate with the risks.

f. Determine if audit procedures include a review of the services provided by outside vendors (services such as telemarketing, data processing, and direct mail). Ascertain if the audit procedures included a review of the performance of the vendors and documentation of the relationships.

2. Determine if management has reviewed and appropriately responded to audit findings regarding credit card operations.

Fraud

1. Evaluate management's strategy for controlling fraud, including whether the strategies frequently emphasize review of credit card applications to prevent fraudulent accounts from being booked or whether neural networks are used to identify fraudulent transactions. Common controls include the following items:
   a. methods of preventing application fraud, such as name and address verification, duplicate-application detection, Social Security number verification, etc.
   b. physical aspects of cards such as holograms and enriched information on the magnetic stripe
   c. adequate staffing and training of the fraud detection department
   d. computer systems to identify suspicious activity
   e. procedures for issuing cards to prevent their interception and activation
   f. procedures for handling returned cards, statements, PINs, checks, and lost and stolen cards
   g. investigation and documentation of cases of suspected fraud
   h. freezing accounts with suspicious activity
   i. procedures for filing Suspicious Activity Reports (SARs)
   j. procedures for access to and alteration of customer information
   k. controls over cardholder payments, account-balance records, and chargeback administration
   l. account authorization procedures
2. Determine whether management receives adequate fraud-monitoring reports, such as—
   a. out-of-pattern-purchase or sequence-of-purchase reports that identify suspicious transactions that do not fit an individual cardholder's established purchasing pattern or
   b. suspicious-purchasing-pattern reports that identify certain types of purchases, such as electronics or jewelry, that can correlate with fraudulent activity.
3. Review consumer complaint correspondence from cardholders that is on file with the bank or primary federal regulator for irregularities or patterns of activity.

Account Solicitation

1. Determine management's general approach to account solicitations (a variety of approaches and combination of approaches can exist). Solicitations may be for preapproved or non-preapproved accounts. The latter are usually solicited through mass mailings, telemarketing, or counter displays.
2. Determine the extent to which outside contractors are used in marketing programs (for example, outsourced mass-mailing and telemarketing operations).
3. Review management's product and marketing program, including the goals of the program, the basis of the marketing approach, and product pricing. Ascertain whether adequate supporting evidence exists to indicate (1) that management has a marketing program and a product that appeal to the bank's targeted markets and (2) that the projected product and marketing program results will be obtained.
4. Determine how management identifies markets for new solicitations and evaluates expected performance.
   a. Identify the analytical procedures (for example, response rates, usage rates, credit score distributions, and future delinquency and loss rates) management uses to project the results of a particular solicitation.

b. Determine how management verifies projections before proceeding with a full-scale solicitation program (test marketing).

5. Determine if management monitors solicitation results for each major account segment and if management incorporates the findings into future solicitations.
6. Determine if management monitors and responds to trends in adverse selection (such as when a disproportionate number of respondents that are poor credit risks answer an offer, which may result in a larger-than-projected percentage of riskier accounts being including in the solicitation-response pool).
7. Review affinity and co-branding relationships, and determine if the bank has control over the approval and acceptance of such accounts. (In co-branding, a third-party relationship exists between a broad base of cardholders and a jointly sponsored credit card. Usually, the sponsors are the bank and a retail merchant for the affinity and co-branding relationships. These cards have some type of value-added feature such as cash rebates or discounts on merchandise.)
8. Review new-product offerings and the adequacy of management's market identification, testing, and ongoing monitoring of new products. Ascertain if management monitored and controlled key new-product concerns, including whether—
   a. the amount of historical and test-sample data available to analyze the product or solicitation was adequate;
   b. the speed at which the new product was introduced was compatible with the internal controls for credit authorizations; and
   c. the size of solicitations introduced was adequately controlled, considering operational and managerial capabilities.
9. Determine if management had any problems with the wording of solicitations or applications and if any imprecise offer terms contributed to asset-quality and earnings problems. Ascertain if there were errors such as the following:
   a. no expiration date on the offer
   b. an absence of wording giving management discretion in setting credit lines
   c. insufficient information requirements on applications
10. Review balance-transfer policies and monitoring practices, and determine if balance transfers generally resulted in higher credit exposures and a tendency to distort financial condition and performance ratios due to the immediate booking of relatively large balances.
11. Review teaser interest-rate practices and determine if controls are adequate to prevent teaser rates from disguising a borrower's repayment capacity and from resulting in higher attrition when the teaser rates expire.

Predictive Models

1. Review the integrated models management uses to identify and select prospective customers. (Management usually uses two distinct credit card predictive models. The first model, the credit-scoring model, is used in the initial application process. The second model, a behavioral model, is used in the management of existing accounts. These models use a credit scorecard, which is a table of characteristics, attributes, and scores that enable a credit grantor to calculate default risk. Information derived from these models assists management with quantifying and minimizing credit risk and fraud losses.)

Credit Scoring

1. Determine the nature and extent that credit scores are used in the underwriting process.
2. Determine the degree of reliance placed on credit bureau score "good" and "bad" odds charts. Ascertain if management develops and calibrates its own good and bad odds chart with a sufficient quantity and quality of historical account data (a customized odds chart is more predictive than a credit bureau odds chart).
3. Determine if a single- or dual-score model is used. (A single-score model uses credit bureau scores; a dual-score matrix calculates a score based on the combination of a custom score, usually based on credit application data, and a credit bureau score. For the more complex operations, management should be using the more sophisticated dual-scoring model.)

Behavior-Scoring System

1. Determine whether management has implemented a behavior-scoring system to manage existing accounts. (The score is derived from a cardholder's payment and usage behavior with the credit cardholder's issuing bank. A cardholder's historical performance with a particular bank is typically the best indicator of future performance with that bank. Behavior scores are frequently supplemented with credit bureau scores to enhance their predictive value.)
2. Ascertain if management continually refines existing, or if it considers new, predictive models.
   a. Determine whether a champions and challengers system is used. (Such a system involves continual portfolio analysis and identification of predictive characteristics. Based on this analysis, existing models are revised and enhanced. The revised challenger model is then compared with the existing champion model. If the challenger is more predictive, it is adopted. This procedure is an ongoing system of refinement.)
   b. Determine if management has adopted or is considering new predictive models (for example, revenue, revolving, bankruptcy, and payment-predictor models).

Validation

1. If credit scoring is used, determine if management is validating scores by comparing account-quality rankings of accepted applications with those predicted by the system (when the rank orderings remain substantially the same, the scoring system remains valid).
   a. Review the statistical techniques used to validate each model used, and determine whether common statistical techniques are being used, such as the K/S test, the chi square, the goodness-of-fit test, divergence statistics, and the population stability test.
   b. Determine if high and low override controls are in place and if they are detailed on exception reports (overrides can skew a statistical population and distort analysis).

Portfolio Analysis

1. Review and analyze the bank's customized credit card reports, which usually include performance and industry peer-group analysis data (be alert to the possibility that the data may have been distorted by niche marketing, specialized card products, or extensive affiliate support).
2. Determine if management is segmenting portfolios (such as by geographic or demographic distribution, affinity relationship (cardholders belonging to a particular union, corporation, professional association, etc.), product type (premium or standard cards), or credit bureau scores). Consider the particular characteristics of each segment for delinquency, profitability, future marketing programs, ALLL calculations, and other purposes.
3. Determine whether geographic, customer-base, card-type, or other concentrations exist, and identify the unique risks posed by any of these portfolio segments or concentrations. Evaluate their degree of risk and consider mitigating factors.
4. Review how management uses portfolio information to identify developing trends, make strategic decisions, and detect potential problems.
   a. Determine how management reports identify the number and volume of workout and re-aged credits.[1]
   b. Evaluate the portfolio information that management reviews, such as asset-quality ratios and vintage analysis (an analysis of the account performance of homogeneous loans booked at a similar time using the same credit and pricing criteria).
5. Determine if cash advances are monitored and authorization procedures are in place

1. A workout is a former open-end credit card account in which credit availability has been closed and in which the balance owed has been placed on a fixed (dollar or percentage) repayment schedule in accordance with modified, concessionary terms and conditions. Generally, the repayment terms require amortization or liquidation of the balance owed over a defined payment period. Such arrangements are typically used when a customer is either unwilling or unable to repay the open-end credit card account in accordance with the original terms but shows the willingness and ability to repay the loan in accordance with modified terms and conditions. In a re-aged credit account, the bank changes the delinquency status of an account without the full collection of its delinquent payments.

(cardholders with excessive debt may obtain cash advances to pay other debts).

6. Review the level and trend of the following portfolio ratios:
   a. average balance of delinquent accounts (by 30-day time frames) to average balance of nondelinquent accounts
   b. lagged delinquency rate and nine-month net charge-offs to lag rates
   c. net charge-off rate and lagged net charge-off rate
   d. re-aged accounts and partial-payment plans to total active accounts and to average total loans
   e. total past-due loans to gross loans
   f. noncurrent loans to gross loans
7. Consider indicators of possible deterioration in asset quality and criticize prolonged practices that result in negative amortization (that is, when minimum payments consistently fall short of covering all finance charges and fees assessed during the billing cycle and when the outstanding balance continues to increase), inappropriate fees, and other practices that inordinately compound or protract consumer debt and disguise portfolio performance and quality. Be alert to other indicators and practices that can reflect a deterioration of asset quality, such as—
   a. rapid growth that may indicate a lowering of underwriting standards;
   b. lower minimum-payment requirements and extended principal-payment cycles, which may result in negative amortization and may also indicate less creditworthy accounts;
   c. a heightened ratio of total accounts being charged off to the number of accounts or a high average balance of accounts that may indicate a lax policy toward the number and level of credit lines granted to cardholders;
   d. lower payment rates combined with higher average balances, which may indicate that borrowers are having trouble paying their debt;
   e. an inordinately high ratio of income earned not collected on loans to total loans when compared with the percentage of total past-due loans to gross loans, which may indicate frequent re-agings, inadequate collection procedures, or a failure to charge off credit card receivables on a timely basis; and
   f. the average age of accounts, which may indicate that loss rates will rise for unseasoned accounts (loss rates are usually low for new offerings and peak at 18 to 24 months after issue).
8. Evaluate management's practices for cure programs, such as re-aging, loan extensions, deferrals, fixed payment, and forgiveness.
9. Develop an overall assessment of the adequacy of a bank's account-management practices for its credit card lending business, incorporating the risk profile of the bank, the quality of management reporting, and the adequacy of the bank's charge-off policies and loss-allowance methodologies.
10. Evaluate whether the bank clearly documents in its policies and procedures the basis for using the exceptions to the FFIEC Uniform Retail Credit Classification and Account Management Policy and whether the bank documents the types of exceptions used and the circumstances giving rise to their use. Determine if the bank prudently limits the use of exceptions. If it does not, criticize the bank's management and require corrective action when the exceptions are not well managed, result in improper reporting, or mask delinquencies and losses.
11. Criticize management and recommend appropriate supervisory corrective action when workout programs are not managed properly (characteristics of improperly managed workout programs include workout programs that do not strive to have the borrowers repay credit card debt within 60 months, the existence of liberal repayment terms with extended amortizations, high charge-off rates, accounts being moved from one workout program to another, multiple re-agings, and poor MIS to monitor program performance).
12. Determine that the bank complies with the FFIEC Uniform Retail Credit Classification and Account Management Policy.
13. Determine whether management monitors and analyzes the performance of each workout program (whether the program achieves the objective of improving the borrower's subsequent performance, the effect of the program on delinquency ratios, etc.)
14. Assess the current and potential impact the workout programs have on reported performance and profitability, including their ALLL implications.
15. Determine if third parties purchase or fund

loan payments to cure loan delinquencies and, if so, assess the impact.

16. Determine whether management developed contingent strategies to deal with rising delinquency levels, which are generally the first sign of account deterioration. Strategies could include the following issues:
    a. reviewing accounts more frequently
    b. decreasing the size of credit lines
    c. freezing or closing accounts
    d. increasing collection efforts
17. Ascertain the bank's compliance with its credit card policies and procedures by reviewing a sample of the bank's credit card loans that were originated since the prior examination.
18. Determine the level of classifications for credit card loans:
    a. Review a sample of loans to ascertain the accuracy and integrity of the bank's system for reporting past-due status.
    b. Verify that the bank's classification and charge-off procedures adhere to, at a minimum, the guidance of the FFIEC Uniform Retail Credit Classification and Account Management Policy.

Allowance for Loan and Lease Losses

1. Ascertain whether an allowance for loan and lease losses (ALLL) policy exists for credit card loans and if adequate ALLL analytical procedures are in place. Roll-rate analysis (analysis of the migration of an account from one billing cycle to the next), which is generally performed for each portfolio segment, is the industry standard. However, some banks use the following additional or alternative methods:
    a. delinquency analysis using a set percentage of loans over 60 days delinquent
    b. exposure analysis that projects net charge-off rates to each 30-day period of delinquency
    c. charge-off projections based on vintage analysis
    d. a historical rolling average based on charge-off rates for the last six months
    e. analysis based on external economic forecasting services
2. Review ALLL-calculation techniques for reasonableness (variables such as aggregating seasoned and unseasoned portfolios can significantly distort the calculation of required reserves).
3. Determine if ALLL calculations are comprehensive and if they consider the following factors:
    a. contingent liabilities, or the risk associated with undisbursed funds
    b. bankrupt and deceased cardholders (such losses are usually not predicted by a simple roll-rate analysis)
    c. economic conditions, such as unemployment and bankruptcy rates, that can significantly affect asset quality
    d. the number and volume of workout and re-aged credits
4. Determine if the ALLL methodologies adequately provide for the use of cure programs, settlement arrangements,[2] workout programs, existing over-the limit portfolio segments, any resulting estimable probable losses on those accounts, and any other credit card loan accounts.
5. Review the accounting practices for crediting recoveries on credit card loans. Determine that the total amount credited to the ALLL as recoveries on individual credit card loans is limited to the amounts previously charged off against the ALLL for the credit card loan. Any excess recovery amount must be recognized as income.
6. Verify that fraud losses are not charged to the ALLL or included in ALLL calculations and that the losses are recorded as a non-interest expense.

Asset Securitization

Perform the following examination procedures when the bank has securitized its credit card receivables (removed designated credit card receivables from its balance sheet to a special-purpose vehicle (SPV) while the bank retains its account ownership).

1. Determine if the credit card loan delinquency and loss rates are similar for both the owned portfolio and the securitized portfolio. (Slightly higher delinquency and net charge-off ratios on securitized assets

2. In a settlement arrangement, the bank forgives a portion of the amount owed. In exchange, the borrower agrees to pay the remaining balance either in a lump-sum payment or by amortizing the balance over several months.

will be prevalent if the bank is experiencing high growth and possesses a significant portion of unseasoned accounts.) When the delinquency and loss rates deviate significantly, determine if management is prioritizing credit card receivables for securitization by selecting credit card accounts that have either a high credit quality or superior past credit history. For example, in the following two ratios, the resulting percentages on a managed and owned basis should approximate one another: (1) noncurrent loans to gross loans and (2) total past-due loans to gross loans.

2. Determine the on- and off-balance-sheet effects of asset securitization. (For example, what is the on- and off-balance-sheet effect of removing seasoned accounts?) (A performance analysis is important because the level of a credit card bank's earnings and capital is largely dependent on the quality of its average total assets under management and not merely on the owned credit card portfolio.)

Third Parties

1. Determine whether any credit card–related activities are outsourced. If so, complete the third parties review located in the Subprime Lending Loan Reference. Third parties may include brokers, marketing firms, collection or servicing firms, correspondents, affinity partners, and information systems firms.
2. Determine whether the bank shares a BIN (bank identification number) with a third party. (Sharing of BINs can create financial liability. A bank sharing a BIN should have a process to identify, monitor, and control the risks associated with BIN sharing. Certain Visa and MasterCard members are assigned BINs (represented by a series of numbers on the credit card) for clearing and settlement of their credit card activities. Members that are licensed specific BINs may allow other members to deposit and receive transactions through those BINs. However, the BIN licensee (holder of the BIN) has primary responsibility for transactions processed through its BIN. In addition, users of a BIN other than the BIN licensee (BIN holder) may share responsibility for transactions processed under that BIN if the licensee fails to meet its membership obligations.)

BANK POLICIES AND PROCEDURES AND STATUTORY AND REGULATORY REQUIREMENTS

1. Determine compliance with laws, regulations, and Federal Reserve Board policies pertaining to lending by performing the following steps.
   a. *Lending limits:*
      - Determine the bank's lending limits as prescribed by state law.
      - Determine advances or combinations of advances whose aggregate balances are above the limit.

   b. *Sections 23A and 23B of the Federal Reserve Act (12 USC 371c and 371c-1) and the Federal Reserve's Regulation W—Transactions with Affiliates:*
      - Obtain a listing of loans and other extensions of credit to affiliates.
      - Test-check the listing against the bank's customer liability records to determine the list's accuracy and completeness.
      - Obtain a listing of other covered transactions with affiliates (i.e., purchase of an investment or securities issued by an affiliate; purchase of loans or other credit-related assets, including assets subject to an agreement to repurchase from an affiliate; the issuance of a guarantee, acceptance, or letter of credit, including an endorsement or standby letter of credit, on behalf of an affiliate; or acceptance of affiliate's securities as collateral for a loan to any person).
      - Determine the volume of transactions with third parties when the proceeds were used or transferred for the benefit of any affiliate.
      - Ensure that covered transactions with affiliates do not exceed the limits of section 23A.
      - Ensure that covered transactions with affiliates meet the collateral requirements of section 23A.
      - Determine that low-quality loans or other assets have not been purchased from an affiliate.

- Determine that all transactions with affiliates are on market terms and conditions that are consistent with safe and sound banking practices.
- Determine that the transactions were conducted on terms and conditions that reflect pricing that is generally available to unaffiliated parties.

c. *18 USC 215—Commission or Gift for Procuring Loan:*
- While examining the installment loan area, determine the existence of any possible cases in which a bank officer, director, employee, agent, or attorney may have received anything of value for procuring or endeavoring to procure any extension of credit.
- Investigate any such suspected situation.

d. *Federal Election Campaign Act (2 USC 441b)—Political Contributions:*
- While examining the installment loan area, determine the existence of any loans in connection with any election to any political office.
- Review each such credit to determine whether it is made in accordance with applicable banking laws and regulations and in the ordinary course of business.

e. *12 USC 1972—Tie-In Provisions.* While reviewing credit and collateral files (especially loan agreements), determine whether any extension of credit is conditioned upon the customer's—
- obtaining additional credit, property, or services from the bank, other than a loan, discount, deposit, or trust service;
- obtaining additional credit, property, or service from the bank's parent holding company or the parent's other subsidiaries;
- providing an additional credit, property, or service to the bank, other than those related to and usually provided in connection with a loan, discount, deposit, or trust service;
- providing additional credit, property, or service to the bank's parent holding company or any of the parent's other subsidiaries; or
- not obtaining other credit, property, or service from a competitor of the bank, the bank's parent holding company, or the parent's other subsidiaries, except that the lending bank may impose conditions and requirements in a credit transaction to ensure the soundness of the credit.

f. *Insider lending activities.* The examination procedures for checking compliance with the relevant law and regulation covering insider activities and reporting requirements are as follows (the examiner should refer to the appropriate sections of the statutes for specific definitions, lending limitations, reporting requirements, and conditions indicating preferential treatment):
- *Regulation O (12 CFR 215)—Loans to Executive Officers, Directors, and Principal Shareholders and Their Interests*. While reviewing information relating to insiders received from the bank or appropriate examiner (including information on loan participations, loans purchased and sold, and loan swaps)—
  - — Test the accuracy and completeness of information about installment loans by comparing it with the trial balance or loans sampled.
  - — Review credit files on insider loans to determine that required information is available.
  - — Determine that loans to insiders do not contain terms more favorable than those afforded to other borrowers.
  - — Determine that loans to insiders do not involve more than the normal risk of repayment or present other unfavorable features.
  - — Determine that loans to insiders, as defined by the various sections of Regulation O, do not exceed the lending limits imposed by those sections.
  - — If prior approval by the bank's board was required for a loan to an insider, determine that such approval was obtained.
  - — Determine compliance with the various reporting requirements for insider loans.
  - — Determine that the bank has made provisions to comply with the public disclosure requirements for insider loans.

— Determine that the bank maintains records of such public requests and the disposition of the requests for a period of two years.
- *Title VIII of the Financial Institutions Regulatory and Interest Rate Control Act of 1978 (FIRA) (12 USC 1972(2))—Loans to Executive Officers, Directors, and Principal Shareholders of Correspondent Banks.*
  — Obtain from or request that the examiners reviewing due from banks and deposit accounts verify a list of correspondent banks provided by bank management, and ascertain the profitability of those relationships.
  — Determine that loans to insiders of correspondent banks are not made on preferential terms and that no conflict of interest appears to exist.

g. *Federal Reserve Board Policy Statement on the Disposition of Credit Life Insurance Income (67* Fed. Res. Bull. *431 (1981), FRRS 3–1556).* Test for compliance with the policy statement by determining—
- that the income generated from the sale of credit life, health, and accident insurance[3] is—
  — not distributed directly to employees, officers, directors, or principal shareholders in the form of commissions or other income for their personal profit; however, such individuals may participate in a bonus or incentive plan in an amount not exceeding, in any one year, 5 percent of the recipient's annual salary, and paid not more often than quarterly; and
  — for accounting purposes, credited to the bank's income account, the income account of an affiliate operating under the Bank Holding Company Act, or in the case of an individual shareholder, to a trust for the benefit of all shareholders.
- whether an insurance agent or agency acted as an intermediary in arranging the bank's credit life insurance coverage and what the relationship of the agent or agency is to the bank. Is the agent or agency in compliance with the provisions of this policy?
- which employees, officers, directors. and principal shareholders are licensed insurance agents.
- whether bank officers have entered into reciprocal arrangements with officers of other banks to act as agent for sale of credit life insurance and to receive commissions.
- if the credit life insurance income is credited to an entity other than the bank and whether the bank is being appropriately reimbursed for the use of its premises, personnel, and goodwill. Compute the percentage compensation paid to the bank (total credit life insurance income). Include that percentage in the confidential section of the commercial report of examination. As a general rule, a reasonable compensation would be an amount equivalent to at least 20 percent of the credited entity's *net* income (if available) attributable to the credit life insurance sales.

h. *Financial Recordkeeping and Reporting of Currency and Foreign Transactions (31 CFR 103.33)—Records to Be Retained by Financial Institutions.* Review operating procedures and credit life documentation and determine whether the bank retains records of each extension of credit over $10,000, specifying the name and address of the borrower, the amount of the credit, the nature and purpose of the loan, and the date therefor. Loans secured by an interest in real property are exempt.

2. Perform appropriate procedural steps for the separate area, concentration of credits.
3. Discuss with the appropriate officer (or officers) and prepare comments to the examiner-in-charge stating your findings on the following:
   a. delinquent loans, including breakout of "A" paper
   b. violations of laws and regulations
   c. concentration of credits
   d. classified loans
   e. loans not supported by current and complete financial information
   f. loans on which collateral documentation is deficient

3. This policy also applies to income derived from the sale of mortgage life insurance; therefore, consult with the examiner assigned real estate loans to coordinate work to avoid any duplication of efforts.

g. inadequately collateralized loans
h. extensions of credit to major stockholders, employees, officers, directors, and/or their interests
i. Small Business Administration or other government-guaranteed delinquent or criticized loans
j. a list of installment loans requested to be charged off
k. the adequacy of written policies relating to installment loans
l. the manner in which bank officers are operating in conformance with established policy
m. adverse trends within the installment area
n. the accuracy and completeness of the schedules obtained from the bank or other examination areas
o. internal-control deficiencies or exceptions
p. recommended corrective action when policies, practices, or procedures are deficient
q. the quality of departmental management
r. other matters of significance

4. Update the workpapers with any information that will facilitate future examinations.

Review the bank's internal controls, policies, practices, and procedures for making and servicing installment loans. The bank's system should be documented completely and concisely and should include, where appropriate, narrative descriptions, flow charts, copies of forms used, and other pertinent information. In the questionnaire below, items marked with an asterisk require substantiation by observation or testing.

POLICIES

1. Has the board of directors, consistent with its duties and responsibilities, adopted written installment loan policies that establish—
   a. procedures for reviewing installment loan applications?
   b. standards for determining credit lines?
   c. minimum standards for documentation?
2. Are installment loan policies reviewed at least annually to determine if they are compatible with changing market conditions?

RECORDS

*1. Is the preparation and posting of subsidiary installment loan records performed or reviewed by persons who do not also—
   a. issue official checks or drafts?
   b. handle cash?

*2. Are the subsidiary installment loan records reconciled daily to the appropriate general ledger accounts and are reconciling items investigated by persons who do not also handle cash?

3. Are delinquent-account collection requests and past-due notices checked to the trial balances that are used in reconciling installment loan subsidiary records to general ledger accounts, and are requests and notices handled only by persons who do not also handle cash?

4. Are loan-balance inquiries received and investigated by persons who do not also handle cash?

*5. Are documents supporting recorded credit adjustments checked or tested subsequently by persons who do not also handle cash? (If not, explain why briefly.)

6. Is a daily record maintained that summarizes loan-transaction details, i.e., loans made, payments received, and interest collected, to support applicable general ledger account entries?

7. Are frequent note and liability ledger trial balances prepared and reconciled with controlling accounts by employees who do not process or record loan transactions?

8. Are two authorized signatures required to effect a status change in an individual customer's account?

9. Does operating management produce and review an exception report that encompasses extensions, renewals, or any factors that would result in a change in a customer's account status?

10. Do customer account records clearly indicate accounts that have been renewed or extended?

LOAN INTEREST

1. Is the preparation and posting of interest records performed or reviewed by persons who do not also—
   a. issue official checks or drafts?
   b. handle cash?
2. Are any independent tests of loan-interest computations made and compared to initial and subsequent borrowers' interest records by other persons who do not—
   a. issue official checks or drafts?
   b. handle cash?

COLLATERAL

1. Are multicopy, prenumbered records maintained that—
   a. detail the complete description of collateral pledged?
   b. are typed or completed in ink?
   c. are signed by the customer?
2. Are receipts issued to customers for each item of collateral deposited?
3. Are the functions of receiving and releasing collateral to borrowers and of making entries in the collateral register performed by different employees?

4. Is negotiable collateral held under joint custody?
5. Is all collateral for a single loan maintained in a separate file?
6. Are receipts obtained and filed for released collateral?
7. Is a record maintained of entry to the collateral vault?
8. Are the following controls on collateral in effect:
   a. When the bank customers' savings passbooks are held as collateral, the savings department is notified and the account is so noted on the deposit ledger.
   b. Descriptions of motor vehicles, as set forth on the certificate of title and insurance policies, are checked to the chattel mortgages or other appropriate documents granting security interest in the vehicle.
   c. An insurance maturity tickler file is maintained.
   d. Procedures are in effect to ensure single-interest insurance coverage is obtained in case regular insurance is cancelled or expires.
   e. All insurance policies on file include a loss-payable clause in favor of the bank.
   f. Filings are made on all security agreements.
   g. Supporting lien searches and property appraisals are performed when a judgment action is returned involving real property.
9. Are control records maintained that identify loans secured by junior liens on real estate?
10. Do those records indicate the current balance for loans secured by superior liens on the same property?

DEALER LOANS

1. On dealer loans, are—
   a. separate controls maintained or can they be easily generated?
   b. payments made directly to the bank and not through the dealer?
   c. coupon books, if used in connection with loans, mailed to the borrowers, instead of the dealer?
   d. monthly summaries of the total paper discounted and outstanding for each dealer prepared and reviewed?
   e. dealer lines reaffirmed at least annually?
   f. required documents on file in connection with the establishment of each dealer line?
   g. signed extension agreements obtained from dealers before extending accounts originally discounted on a repurchase agreement or other recourse basis?
   h. downpayment amounts checked to ensure they do not misrepresent the sales price?
   i. procedures in effect to prevent the dealer from making late payments?
   j. prohibitions against bringing loans current by charges to the dealer's reserve accounts in effect?
   k. selling prices, as listed by the dealer, verified?
   l. overdrafts prohibited in the dealer reserve and holdback accounts?
   m. procedures in effect to have the title application controlled by someone other than the purchaser?
   n. credit checks on borrowers performed independently of the dealer or are the dealer's credit checks independently verified?
   o. delinquencies verified directly with the customers?

DISCOUNTED LEASING PAPER

1. If the bank discounts leasing paper—
   a. are separate controls maintained or can they be easily generated?
   b. are payments made directly to the bank?
   c. are controls established or are audits of lessor's books conducted if the lessor is permitted to accept payments (if so, explain why briefly)?
   d. are monthly summaries of total paper discounted for each lessor prepared and reviewed?
   e. are lines for each lessor reaffirmed at least annually?
   f. is a master lease required and properly recorded when fleet-leasing or blanket purchase of leasing paper is handled?
   g. is the value of leased goods verified to ensure that it is not less than the amount advanced?
   h. is lease paper screened for the credit quality of the lessee?

i. are lease terms and payment amounts required to be adequate to liquidate the debt in full?

CREDIT CARD LENDING

1. Has the bank tested, analyzed, and documented line-assignment and line-increase criteria prior to broad implementation of a new credit card plan?
2. Is a borrower's repayment capacity carefully considered when the bank assigns an initial credit line or significantly increases existing credit lines?
   a. Are credit-line assignments managed conservatively using proven credit criteria?
   b. Does the bank have documentation and analyses of decision factors such as repayment history, risk scores, behavior scores, or other relevant criteria?
   c. Does the bank consider its entire relationship with a borrower when making decisions about credit-line assignments?
   d. If the bank offers multiple credit lines to borrowers, does it have sufficient controls and management information systems to aggregate related exposures and analyze borrowers' performance before offering them additional lines of credit?
3. Do the bank's policies and procedures focus on adequate control, authorizations, and the timely repayment of amounts that exceed established credit limits?
   a. Are the bank's management information systems sufficient to enable management to identify, measure, manage, and control the risks associated with over-limit accounts?
   b. Does the bank have appropriate policies and controls for over-limit authorizations on open-end accounts, particularly subprime accounts?
4. Do the bank's policies and procedures require that minimum payments on credit card accounts amortize the current balances over a reasonable period of time, consistent with the nature of the underlying debt and the borrower's documented creditworthiness? Do the bank's policies and practices foster or encourage prolonged negative amortization, inappropriate fees, and other practices that inordinately compound or protract consumer debt?
5. Are workout programs designed to maximize principal reduction, and do they strive to have borrowers repay their credit card debt within 60 months? Has the bank documented and supported, with compelling evidence, any exceptions to the 60-month time frame for workout programs? Has the bank also documented and supported any less conservative loan terms and conditions that may be warranted?
6. Has the bank established and maintained adequate loss allowances for credit card accounts subject to settlement arrangements?
   a. Does the bank classify as a loss and charge off immediately amounts of debt forgiven in settlement arrangements?
   b. Are specific allowances for such settlement accounts reported as a charge-off in Schedule RI-B of the call report?
   c. Does the bank charge off any deficiency balances within 30 days from the receipt of a final settlement payment?
7. Does the bank evaluate the collectibility of accrued interest and fees on credit card accounts and recognize and properly account for the amounts that are uncollectible?
   a. Are appropriate methods employed to ensure that income is accurately measured (such methods include providing loan-loss allowances for uncollectible fees and finance charges or placing delinquent and impaired receivables on nonaccrual status)?
   b. Is the owned portion of accrued interest and fees, including related estimated losses, accounted for separately from the retained interest in accrued interest and fees from securitized credit card receivables?
8. Does the bank's allowance for loan and lease losses (ALLL) methodology fully recognize the incremental losses that may be inherent in over-limit accounts and portfolio segments?
9. Are accounts in workout programs segregated for performance-measurement, impairment-analysis, and monitoring purposes?
   a. Are multiple workout programs with different performance characteristics tracked separately?
   b. Is the allowance allocation for each workout program equal to the estimated loss in each program, based on historical experience adjusted for current conditions and trends?

10. Is the total amount credited to the ALLL as recoveries on a loan limited to the amount previously charged off against the ALLL, and are any amounts that are collected in excess of this limit recognized as income?
11. Do the bank's policies and procedures address the types of allowed exceptions to the FFIEC Uniform Retail Credit Classification and Account Management Policy and also the circumstances permitting those exceptions?
    a. Is the volume of accounts that are granted exceptions small and well controlled?
    b. Is the performance of accounts that are granted exceptions closely monitored?
    c. Does the bank use exceptions prudently? If not, has management been criticized and has appropriate supervisory corrective action been recommended?

REPOSSESSIONS

1. Are procedures established on repossessions so that—
    a. management takes timely action to receive full advantage of any dealer endorsement or repurchase agreement?
    b. the notice of intention to sell is mailed to all parties who are liable on the account?
    c. bids are required before the sale of the item?
    d. bids are retained in the borrower's credit file?
    e. open repossessions are physically checked monthly?
    f. surplus funds received from the sale of a repossession are mailed back to the borrower in the form of a cashier's check?
    g. any deficiency balance remaining after the sale of repossession is charged off?
    h. the bill of sale is properly completed and signed by an officer?
    i. separate general ledger control is maintained?

DELINQUENT ACCOUNTS AND OPERATING REVIEW SYSTEM

1. Are collection policies established so that—
    a. a delinquent notice is sent before a loan becomes 30 days past due?
    b. collection effort is intensified when a loan becomes two payments past due?
    c. records of collection efforts are maintained in the customer's file?
    d. field or outside collectors are under the supervision of an officer and are required to submit progress reports?
    e. all collections are acknowledged on multicopy prenumbered forms?
    f. all documents that are held outside the regular files and that pertain to installment loans under collection are evidenced by a transmittal sheet and receipt?
    g. delinquency lists are generated on a timely basis (indicate the frequency)?
2. Is an operating review system in place that—
    a. determines that duties are properly segregated and that loan officers are prohibited from processing loan payments?
    b. recomputes the amount of credit life and accident and health insurance on new loans?
    c. recomputes the amount of discount on new loans?
    d. recomputes the rebates on prepaid loans?
    e. test-checks daily transactions to subsequent general ledger postings?
    f. reviews new-loan documentation?
    g. reviews all information in reports being submitted to the board of directors, or any committee thereof, for errors or omissions?
    h. conducts a periodic review of income accruals for accuracy?
    i. reviews entries to unearned discount or income accounts?
    j. reviews all charged-off loans for proper approval?
    k. periodically reconciles charged-off notes to controls?
    l. reviews dealer's reserve and holdback agreements and periodically determines the adequacy of the balances in the deposit account?
    m. periodically verifies dealer reserve balances?
    n. determines that payments are accurately and promptly posted?
    o. reviews collection or reversal of late charges?
    p. determines that extension fees are collected on all extended loans?

q. determines that discounted dealer paper is properly endorsed?
r. determines that discounted dealer paper is within established guidelines?
s. reviews compliance with laws and regulations?
t. reviews trial balance reconcilements to the general ledger?

CONCLUSION

1. Is the foregoing information an adequate basis for evaluating internal control that is, there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly and indicate any additional examination procedures deemed necessary.
2. Based on a composite evaluation (as evidenced by answers to the foregoing questions), is internal control considered adequate or inadequate?

Federally insured banks tend to avoid lending to customers with poor credit histories because of the higher risk of default and resulting loan losses. However, some lenders[1] extend their risk-selection standards to attract lower-credit-quality accounts.

Subprime lending involves extending credit to borrowers who exhibit characteristics that indicate a significantly higher risk of default than traditional bank lending customers.[2] The risk of default may be measured by traditional credit-risk measures (such as credit or repayment history or debt-to-income levels) or by alternative measures such as credit scores.

Subprime borrowers represent a broad spectrum of debtors, ranging from those who have repayment problems because of an adverse event, such as job loss or medical emergency, to those who persistently mismanage their finances and debt obligations. Subprime borrowers typically have weakened credit histories that include payment delinquencies and possibly more severe problems, such as charge-offs, judgments, and bankruptcies. They may also display reduced repayment capacity as measured by credit scores, debt-to-income ratios, or other criteria that may encompass borrowers with incomplete credit histories. Generally, subprime borrowers will display a range of one or more credit-risk characteristics, such as—

- two or more 30-day delinquencies in the last 12 months, or one or more 60-day delinquencies in the last 24 months;
- judgment, foreclosure, repossession, or charge-off in the prior 24 months;
- bankruptcy in the last five years;
- relatively high default probability as evidenced by, for example, a credit bureau risk score (FICO) of 660 or below (depending on the product or collateral), or other bureau or proprietary scores with an equivalent default-probability likelihood; or
- debt-service-to-income ratio of 50 percent or greater, or an otherwise limited ability to cover family living expenses after deducting total monthly debt-service requirements from monthly income.

1. The terms ‘‘lenders,’’ ‘‘financial institutions,’’ and ‘‘institutions’’ refer to federally insured banks and their subsidiaries.

2. For purposes of this section, loans to customers who are not subprime borrowers are referred to as ‘‘prime.’’

Subprime loans are loans to borrowers displaying one or more of these characteristics at the time of origination or purchase.

SUPERVISORY GUIDANCE FOR SUBPRIME LENDING

The subprime supervisory guidance applies to direct extensions of credit; the purchase of subprime loans from other lenders, including delinquent or credit-impaired loans purchased at a discount; the purchase of subprime automobile or other financing ‘‘paper’’ from lenders or dealers; and the purchase of loan companies that originate subprime loans.

Subprime lending does not include loans to borrowers who have had minor, temporary credit difficulties but are now current. Also, the subprime-lending guidance does not generally apply to prime loans that develop credit problems after acquisition; loans that were initially extended in subprime programs and are later upgraded, as a result of their performance, to programs targeted to prime borrowers; and community development loans, as defined in the Community Reinvestment Act (CRA) regulations, that may have some higher risk characteristics, but are otherwise mitigated by guarantees from government programs, private credit enhancements, or other appropriate risk-mitigation techniques.

Subprime lending poses unique and significant risks to banking institutions engaged in the activity. Market events have raised supervisory issues about how well subprime lenders are prepared to manage and control the risks. Subprime-lending institutions need strong risk-management practices and internal controls, as well as board-approved policies and procedures that appropriately identify, measure, monitor, and control all associated risks. Institutions considering or engaging in this type of lending should recognize the additional risks inherent in this activity and determine if these risks are acceptable and controllable, given their organization’s financial condition, asset size, level of capital support, and staff size. Well-managed subprime lenders should recognize the heightened loss characteristics in their portfolios and internally classify their delinquent accounts well before the time frames in their respective interagency supervisory policy.

Interagency guidance on subprime lending was issued on March 1, 1999, to alert examiners and financial institutions to some of the pitfalls and hazards involved in this type of lending.[3] (See SR-99-06.) Additional interagency examination guidance was issued on January 31, 2001, to further strengthen the supervision of certain institutions, primarily those institutions having subprime-lending programs with an aggregate credit exposure equaling or exceeding 25 percent of their tier 1 capital.[4] (See SR-01-04.) The aggregate exposure includes principal outstanding and committed, accrued and unpaid interest, and any retained residual interests[5] relating to securitized subprime loans. The Federal Reserve may also apply the additional guidelines to certain smaller subprime portfolios, such as those experiencing rapid growth or adverse performance trends, those administered by inexperienced management, and those with inadequate or weak controls.

Subprime loans command higher interest rates and loan fees than those offered to standard-risk borrowers. Subprime loans can be profitable, provided the price charged by the lender is sufficient to cover higher loan-loss rates and overhead costs related to underwriting, servicing, and collecting the loans. The ability to securitize and sell subprime portfolios at a profit while retaining the servicing rights makes subprime lending attractive to a larger number of institutions, further increasing the number of subprime lenders and loans. Some financial institutions have experienced losses attributable to ill-advised or poorly structured subprime-lending programs. These losses have attracted greater supervisory attention to subprime lending and the ability of an insured bank to manage the unique risks associated with this activity.

Risk Management

The following items are essential components of a well-structured risk-management program for subprime lenders.

Planning and Strategy

Before engaging in subprime lending, the board and management should ensure that proposed activities are consistent with the institution's overall business strategy and risk tolerances, and that all involved parties have properly acknowledged and addressed critical business-risk issues. These issues include the costs associated with attracting and retaining qualified personnel, investments in the technology necessary to manage a more complex portfolio, a clear solicitation and origination strategy that allows for after-the-fact assessment of underwriting performance, and the establishment of appropriate feedback and control systems. The risk-assessment process should extend beyond credit risk and appropriately incorporate operating, compliance, and legal risks. Finally, the planning process should set clear objectives for performance, including the identification and segmentation of target markets or customers, as well as set performance expectations and benchmarks for each segment and the portfolio as a whole. Institutions establishing a subprime-lending program should proceed slowly and cautiously into this activity to minimize the impact of unforeseen personnel, technology, or internal-control problems and to determine if favorable initial profitability estimates are realistic and sustainable.

Staff Expertise

Subprime lending requires specialized knowledge and skills that many financial institutions may not possess. Marketing, account-origination, and collections strategies and techniques often differ from those employed for prime credit; thus, it may not be sufficient to have the same lending staff responsible for both subprime loans and other loans. Additionally, servicing and

3. The March 1999 and January 2001 statements were adopted and issued by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision.

4. The March 1999 and January 2001 subprime-lending interagency guidance is consolidated within this section. To focus on the supervisory guidance that applies primarily to institutions having subprime-lending programs equaling or exceeding 25 percent of tier 1 capital, see the January 2001 release. The March 1999 interagency supervisory guidance applies to all subprime-lending institutions.

5. Residual interests are on-balance-sheet assets that represent interests (including beneficial interests) in transferred financial assets retained by a seller (or transferor) after a securitization or other transfer of financial assets. They are structured to absorb more than a pro rata share of credit loss related to the transferred assets through subordination provisions or other credit-enhancement techniques.

collecting subprime loans can be very labor intensive. If necessary, the institution should implement programs to train staff. The board should ensure that staff possess sufficient expertise to appropriately manage the risks in subprime lending and that staffing levels are adequate for the planned volume of subprime activity. The experience, or seasoning, of staff and loans should be taken into account as performance is assessed over time.

Lending Policy

A subprime-lending policy should be appropriate to the size and complexity of the institution's operations and should clearly state the goals of the subprime-lending program. While not exhaustive, the following lending standards should be addressed in any subprime-lending policy:

- types of products offered as well as those that are not authorized
- portfolio targets and limits for each credit grade or class
- lending and investment authority clearly stated for individual officers, supervisors, and loan committees
- a framework for pricing decisions and profitability analysis that considers all costs associated with the loan, including origination costs, administrative or servicing costs, expected charge-offs, and capital
- evaluation of collateral and appraisal standards
- well-defined and specific underwriting parameters (that is, on acceptable loan term, debt-to-income ratios, and loan-to-collateral-value ratios for each credit grade and a minimum acceptable credit score) that are consistent with any applicable supervisory guidelines[6]
- procedures for the separate tracking and monitoring of loans approved as exceptions to stated policy guidelines
- credit-file documentation requirements, such as applications, offering sheets, loan and collateral documents, financial statements, credit reports, and credit memoranda to support the loan decision
- correspondent/broker/dealer approval process, including measures to ensure that loans originated through this process meet the institution's lending standards

If the institution elects to use credit scoring (including applications scoring) for approvals or pricing, the scoring model should be based on a development population that captures the behavioral and credit characteristics of the subprime population targeted for the products offered. Because of the significant variance in characteristics between the subprime and prime populations, institutions should not rely on models developed solely for products offered to prime borrowers. Further, the model should be reviewed frequently and updated as necessary to ensure that assumptions remain valid.

Purchase Evaluation

As they evaluate expected profits, institutions that purchase subprime loans from other lenders or dealers must give due consideration to the cost of servicing these assets and to the loan losses that may be experienced. For instance, some lenders who sell subprime loans charge borrowers high up-front fees, which are usually financed into the loan. This provides incentive for originators to produce a high volume of loans with little emphasis on quality, to the detriment of a potential purchaser. Further, subprime loans, especially those purchased from outside the institution's lending area, are at special risk for fraud or misrepresentation (that is, the quality of the loan may be less than the loan documents indicate).

Institutions should perform a thorough due-diligence review before committing to purchase subprime loans. Institutions should not accept loans from originators that do not meet their underwriting criteria, and they should regularly review loans offered to ensure that loans purchased continue to meet those criteria. Deterioration in the quality of purchased loans or in the portfolio's actual performance versus expectations requires a thorough reevaluation of the lenders or dealers who originated or sold the loans, as well as a reevaluation of the institution's criteria for underwriting loans and selecting dealers and lenders. Any such deterioration may also highlight the need to modify or termi-

6. Extensions of credit secured by real estate, whether the credit is subprime or otherwise, are subject to the Interagency Guidelines for Real Estate Lending Policies, which establish supervisory loan-to-value (LTV) limits on various types of real estate loans and impose limits on an institution's aggregate investment in loans that exceed the supervisory LTV limits. (See 12 CFR 208, appendix C.)

nate the correspondent relationship or to adjust underwriting and dealer or lender selection criteria.

Loan-Administration Procedures

After the loan is made or purchased, loan-administration procedures should provide for the diligent monitoring of loan performance and establish sound collection efforts. To minimize loan losses, successful subprime lenders have historically employed stronger collection efforts, such as calling delinquent borrowers frequently, investing in technology (for example, using automatic dialing for follow-up telephone calls on delinquent accounts), assigning more experienced collection personnel to seriously delinquent accounts, moving quickly to foreclose or repossess collateral, and allowing few loan extensions. This aspect of subprime lending is very labor intensive but critical to the program's success. To a large extent, the cost of such efforts can be a tradeoff with future loss expectations, when an institution analyzes the profitability of subprime lending and assesses its appetite to expand or continue this line of business. Subprime-loan administration procedures should be in writing and at a minimum should detail—

- billing and statement procedures;
- collection procedures;
- content, format, and frequency of management reports;
- asset-classification criteria;
- methodology to evaluate the adequacy of the allowance for loan and lease losses (ALLL);
- criteria for allowing loan extensions, deferrals, and re-agings;
- foreclosure and repossession policies and procedures; and
- loss-recognition policies and procedures.

Loan Review and Monitoring

Once an institution books the loans, designated staff must perform an ongoing analysis of subprime loans, not only on an aggregate basis but also for subportfolios. Information systems should be in place to segment and stratify the institution's portfolio (for example, by originator, loan-to-value, debt-to-income ratios, or credit scores). Assigned staff should produce reports that management can use to evaluate the performance of subprime loans. The review process should focus on whether performance meets expectations. Institutions then need to consider the source and characteristics of loans that do not meet expectations and make changes in their underwriting policies and loan-administration procedures to restore performance to acceptable levels.

When evaluating actual performance against expectations, it is particularly important that management review credit scoring, pricing, and any ALLL-adequacy models. Models driven by the volume and severity of historical losses experienced during an economic expansion may have little relevance in an economic slowdown, particularly in the subprime market. Management should ensure that models used to estimate credit losses or to set pricing allow for fluctuations in the economic cycle and are adjusted to account for other unexpected events.

Consumer Protection

Institutions that originate or purchase subprime loans must take special care to avoid violating fair lending and consumer protection laws and regulations. Higher fees and interest rates combined with compensation incentives can foster predatory pricing or discriminatory "steering" of borrowers to subprime products for reasons other than the borrower's underlying creditworthiness. An adequate compliance-management program must identify, monitor, and control the consumer protection hazards associated with subprime lending.

Subprime mortgage lending may trigger the special protections of the Home Ownership and Equity Protection Act of 1994, subtitle B of title I of the Riegle Community Development and Regulatory Improvement Act of 1994. This act amended the Truth in Lending Act to provide certain consumer protections in transactions involving a class of nonpurchase, closed-end home mortgage loans. Institutions engaging in this type of lending must also be thoroughly familiar with the obligations set forth in Regulation Z (12 CFR 226.32), Regulation X (24 CFR 3500), and the Real Estate Settlement Procedures Act (RESPA) (12 USC 2601) and should adopt policies and implement practices that ensure compliance.

The Equal Credit Opportunity Act makes it unlawful for a creditor to discriminate against an applicant on a prohibited basis regarding any aspect of a credit transaction. Similarly, the Fair Housing Act prohibits discrimination in connection with residential real estate–related transactions. Loan officers and brokers must treat all similarly situated applicants equally and without regard to any prohibited-basis characteristic (for example, race, sex, or age). This is especially important with respect to how loan officers or brokers assist customers in preparing their applications or otherwise help them to qualify for loan approval.

Securitization and Sale

To increase their loan-production and -servicing income, some subprime lenders originate loans and then securitize and sell them in the asset-backed securities market. Strong demand from investors and favorable accounting rules often allow securitization pools to be sold at a gain, providing further incentive for lenders to expand their subprime-lending program. However, the securitization of subprime loans carries inherent risks, including interim credit risk and liquidity risks, which are potentially greater than those for securitizing prime loans. Accounting for the sale of subprime pools requires assumptions that can be difficult to quantify, and erroneous assumptions could lead to the significant overstatement of an institution's assets. Moreover, the practice of providing support and substituting performing loans for nonperforming loans to maintain the desired level of performance on securitized pools has the effect of masking credit-quality problems.

Institutions should recognize the volatility of the secondary market for subprime loans and the significant liquidity risk incurred when originating a large volume of loans intended for securitization and sale. Investors can quickly lose their appetite for risk in an economic downturn or when financial markets become volatile. As a result, institutions that have originated, but have not yet sold, pools of subprime loans may be forced to sell the pools at deep discounts. If an institution lacks adequate personnel, risk-management procedures, or capital support to hold subprime loans that were originally intended for sale, these loans may strain an institution's liquidity, asset quality, earnings, and capital. Consequently, institutions actively involved in the securitization and sale of subprime loans should develop a contingency plan that addresses back-up purchasers of the securities or the attendant servicing functions, alternate funding sources, and measures for raising additional capital.

Institutions should refer to the Statement of Financial Accounting Standards No. 140 (FAS 140), "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities," for guidance on accounting for these transactions. If a securitization transaction meets FAS 140 sale or servicing criteria, the seller must recognize any gain or loss on the sale of the pool immediately and carry any retained interests in the assets sold (including servicing rights or obligations and interest-only strips) at fair value. Management should ensure that the key assumptions used to value these retained interests are reasonable and well supported, both for the initial valuation and for subsequent quarterly revaluations. In particular, management should consider the appropriate discount rates, credit-loss rates, and prepayment rates associated with subprime pools when valuing these assets. Since the relative importance of each assumption varies with the underlying characteristics of the product types, management should segment securitized assets by specific pool, as well as by predominant risk and cash-flow characteristics, when making the underlying valuation assumptions. In all cases, however, institutions should take a conservative approach when developing securitization assumptions and capitalizing expected future income from subprime-lending pools. Institutions should also consult with their auditors as necessary to ensure that their accounting for securitizations is accurate.

Reevaluation

Institutions should periodically evaluate whether the subprime-lending program has met profitability, risk, and performance goals. Whenever the program falls short of original objectives, an analysis should be performed to determine the cause, and the program should be modified appropriately. If the program falls far short of the institution's expectations, management should consider terminating it. Questions that management and the board need to ask may include the following:

- Have cost and profit projections been met?
- Have projected loss estimates been accurate?

- Has the institution been called upon to provide support to enhance the quality and performance of loan pools it has securitized?
- Were the risks inherent in subprime lending properly identified, measured, monitored, and controlled?
- Has the program met the credit needs of the community that it was designed to address?

Examination Review and Analysis

The following supervisory guidance (up to the examination objectives) applies only to banks that have subprime-lending programs equaling or exceeding 25 percent of tier 1 capital and to banks that have other designated subprime programs referenced in SR-01-4.

The heightened risk levels and potential volatility in delinquency and loss rates posed by subprime-lending programs warrant examiners' increased ongoing attention. The risks inherent in subprime-lending programs call for frequent reviews. There are generally two levels of review appropriate for subprime activities:

- *Portfolio-level reviews* include assessments of underwriting standards, marketing practices, pricing, management information and control systems (quality control, audit and loan review, vendor management, compliance), portfolio performance, and the appropriate application of regulatory and internal allowance and capital policies.
- *Transaction-level testing* includes the testing of individual loans for compliance with underwriting and loan-administration guidelines; the appropriate treatment of loans under delinquency, re-aging, and cure programs; and the appropriate application of regulatory and internal allowance and capital policies.

Examiners should perform a portfolio-level review and some transaction testing at each institution engaged in subprime lending, during each regularly scheduled examination cycle. The Federal Reserve will perform regular off-site supervisory monitoring and may require subprime lenders to supply supplementary information about their subprime portfolios between examinations. The examiner's findings from transaction-level testing and portfolio-level reviews should be incorporated into the conclusions about overall asset quality, the adequacy of the ALLL and capital, and the adequacy of portfolio risk-management practices.

Transaction-Level Testing

Subprime-loan portfolios contain elevated risks, and actual subprime-lending practices often can deviate from stated policy and procedural guidance. Therefore, examiners should supplement the portfolio-level examination procedures with transaction-level testing to determine whether—

- individual loans adhere to existing policy, underwriting, risk-selection, and pricing standards;
- individual loans and portfolios are classified in accordance with the subprime-lending guidelines described in this section, or in other Federal Reserve credit-extending supervisory guidance;
- management, board, and regulatory reporting is accurate and timely;
- existing loans conform to specified account-management standards (such as over-limits, line increases, reductions, cancellations, re-scoring, or collections);
- key risk controls and control processes are adequate and functioning as intended;
- roll rates and other loss-forecasting methods used to determine ALLL levels are accurate and reliable; and
- lending practices exist that may appear unsafe, unsound, or abusive and unfair.

Adequacy of the ALLL

Examiners should assess the adequacy of the ALLL to ensure that the portion allocated to the subprime portfolio is sufficient to absorb estimated credit losses for this portfolio. Consistent with interagency policy,[7] the term "estimated credit losses" means an estimate of the amount that is not likely to be collected; that is, net charge-offs that are likely to be realized given the facts and circumstances as of the evaluation date.[8] These estimated losses should meet the

7. The Interagency Policy Statement on the Allowance for Loan and Lease Losses was issued December 21, 1993, and the ALLL methodologies and documentation standards were issued July 2, 2001.

8. Estimates of credit losses should include accrued interest and other accrued fees (for example, uncollected credit card

criteria for accrual of loss contingency, as set forth under generally accepted accounting principles (GAAP), consistent with supervisory ALLL policy.

New Entrants to the Business

In some instances, an institution (for example, a newly chartered institution or an existing institution entering the subprime-lending business) may not have sufficient previous loss experience to estimate an allowance for subprime-lending activities. In such cases, industry statistics or another institution's loss data for similar loans may be a better starting point to determine the ALLL than the institution's own data for developing loss rates. When an institution uses loss rates developed from industry statistics or from other institutions to determine its ALLL, it should demonstrate and document that the attributes of the loans in its portfolio or portfolio segment are similar to those in the other institution's (or industry's) portfolio.

Pools of Subprime Loans—Not Classified

The ALLL required for subprime loans should be sufficient to absorb at least all estimated credit losses on outstanding balances over the current operating cycle, typically 12 months. The board of directors and management are expected to ensure that the institution's process for determining an adequate level for the ALLL is based on a comprehensive and adequately documented analysis of all significant factors. The consideration factors should include historical loss experience, ratio analysis, peer-group analysis, and other quantitative analysis as a basis for the reasonableness of the ALLL. To the extent that the historical net charge-off rate is used to estimate expected credit losses, it should be adjusted for changes in trends, conditions, and other relevant factors, including business volume, underwriting, risk selection, account-management practices, and current economic or business conditions that may alter such experience. The allowance should represent a prudent, conservative estimate of losses that allows a reasonable margin for imprecision. Institutions should clearly document loss estimates and the allowance methodology in writing. This documentation should describe the analytical process used, including—

- portfolio-segmentation methods applied;
- loss-forecasting techniques and assumptions employed;
- definitions of terms used in ratios and model computations;
- relevance of the baseline loss information used;
- rationale for adjustments to historical experience; and
- a reconciliation of forecasted loss rates to actual loss rates, with significant variances explained.

Classification Guidelines for Subprime Lending

Well-managed subprime lenders should recognize the heightened loss characteristics in their portfolios and internally classify their delinquent accounts well before the time frames outlined in the retail classification policy issued by the Federal Financial Institutions Examination Council (FFIEC) on June 12, 2000. Examiners should classify subprime loans and portfolios in accordance with the guidelines in this section and other applicable Federal Reserve supervisory guidelines. Classified loans are loans that are not protected adequately by the current sound worth and paying capacity of the borrower or the collateral pledged. As such, full liquidation of the debt may be in jeopardy. Pools of classified subprime loans (to include, at a minimum, all loans past due 90 days or more) should be reviewed for impairment, and an adequate allowance should be established consistent with existing interagency policy.

Individual Loans

Examiners should not automatically classify or place loans in special mention merely because they are subprime. Rather, classifications should

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fees or uncollected late fees) that have been added to the loan balances and, as a result, are reported as part of the institution's loans on the balance sheet. An institution may include these types of estimated losses in either the ALLL or a separate valuation allowance, which would be netted against the aggregated loan balance for regulatory reporting purposes. When accrued interest and other accrued fees are not added to the loan balances and are not reported as part of loans on the balance sheet, the collectibility of these accrued amounts should nevertheless be evaluated to ensure that the institution's income is not overstated.

reflect the borrower's capacity and willingness to repay and the adequacy of collateral pledged.

Loans to borrowers that do not have the capacity to service their loans generally will be classified substandard. When repayment capacity is insufficient to support the orderly liquidation of the debt, and the collateral pledged is insufficient to mitigate risk of loss, then a more severe classification and nonaccrual is warranted. Subprime loans that are past due 90 days or more should be classified at least substandard based on a reasonable presumption that their past-due status indicates an inadequate capacity or unwillingness to repay. A more stringent classification approach may be appropriate based on the historical loss experience of a particular institution. Classification of other subprime loans as doubtful or loss will be based on examiners' analysis of the borrower's capacity to repay, and on the quality of institution underwriting and account-management practices as evidenced in the loan file or by other documentation.

In some cases, the repayment of principal, interest, and fees on some subprime loans may be overly dependent on collateral pledged. This occurs when the risk of default is so high that an abundance of collateral is taken to mitigate risk of loss in the event of default. From a safety-and-soundness perspective, institutions should be discouraged from lending solely on the basis of collateral pledged. Such loans will generally be classified substandard. Further, when the borrower does not demonstrate the capacity to service the loan from sources other than collateral pledged, the loan may be placed on nonaccrual.

Portfolios

When the portfolio review or loan sample indicates serious concerns with credit-risk selection practices, underwriting standards, or loan quality, examiners should consider classifying or criticizing the entire portfolio or segments of the portfolio. Such a decision may be appropriate in cases where risk is inordinately high or delinquency reports reflect performance problems. Some subprime-lending portfolios may pose very high risk. These may include portfolios of unsecured loans or secured, high loan-to-value loans to borrowers who clearly exhibit inadequate capacity to repay the debt in a reasonable time frame. Most such portfolios should be classified at least substandard.

Required Documentation for Cure Programs

Cure programs, including such practices as re-aging, extensions, renewals, rewrites, or other types of account restructuring, are subject to the standards outlined in the retail classification policy. In accordance with that policy, cure programs should be used *only* when the institution has substantiated the customer's renewed willingness and ability to repay. Examiners will expect institutions to maintain documentation supporting their analysis of the customer's renewed ability and willingness to repay the loan at the time it is extended, renewed, or deferred. When the institution cannot demonstrate both the willingness and ability of the customer to repay, the loan should not be renewed, extended, deferred, or rewritten, and the loan should be moved back to its pre-cure delinquency status. Documentation should include one or more of the following:

- a new verification of employment
- a recomputed debt-to-income ratio indicating sufficient improvement in the borrower's financial condition to support orderly repayment
- a refreshed credit score or updated bureau report
- a file memo evidencing discussion with the customer

When documentation of the customer's renewed willingness and ability to repay the loan is absent or deficient, management practices should be criticized.

Predatory or Abusive Lending Practices

The term ‘‘subprime’’ is often misused to refer to certain predatory or abusive lending practices. Lending practices can be designed to responsibly provide service to customers and enhance credit access for borrowers with special credit needs. Subprime lending that is appropriately underwritten, priced, and administered can serve these goals.

Some forms of subprime lending may be abusive or predatory, however. Lending practices may be designed to transfer wealth from the borrower to the lender or loan originator without a commensurate exchange of value.

This is sometimes accomplished when the lender structures a loan to a borrower who has little or no ability to repay the loan from sources other than the collateral pledged. When default occurs, the lender forecloses or otherwise takes possession of the borrower's property (generally the borrower's home or automobile). In other cases, the lender may use the threat of foreclosure or repossession to induce duress on the borrower for payment. Typically, predatory lending involves at least one, and perhaps all three, of the following elements:

- making unaffordable loans based on the assets of the borrower rather than on the borrower's ability to repay an obligation
- inducing a borrower to refinance a loan repeatedly in order to charge high points and fees each time the loan is refinanced (that is, "loan flipping")
- engaging in fraud or deception to conceal the true nature of the loan obligation or ancillary products from an unsuspecting or unsophisticated borrower

Loans to borrowers who do not demonstrate the capacity to repay the loan, as structured, from sources other than the collateral pledged are generally considered unsafe and unsound. Such lending practices should be criticized in the examination report as imprudent. Further, examiners should refer any loans with the aforementioned characteristics to Federal Reserve consumer compliance/fair lending specialists for additional review.

Capitalization

The Federal Reserve's minimum capital requirements generally apply to portfolios that exhibit substantially lower risk profiles than those that exist in subprime-loan programs. Therefore, these requirements may not be sufficient to reflect the risks associated with subprime portfolios. Subprime-lending activities can present a greater-than-normal risk for financial institutions and the deposit insurance funds; therefore, the level of capital institutions need to support this activity should be commensurate with the additional risks incurred. Each subprime lender is responsible for quantifying the amount of capital needed to offset the additional risk in subprime-lending activities, and for *fully documenting* the methodology and analysis supporting the amount specified.

The amount of additional capital necessary will vary according to the volume and type of subprime activities conducted and the adequacy of the institution's risk-management program. An institution's overall capital adequacy will be evaluated on a case-by-case basis through on-site examinations and off-site monitoring procedures, considering, among other factors, the institution's own documented analysis of the capital needed to support subprime lending. Institutions that are determined to have insufficient capital must correct the deficiency within a reasonable time frame or be subject to supervisory action. In light of the higher risks associated with this type of lending, higher minimum-capital requirements may be imposed on institutions engaging in subprime lending.

The sophistication of this analysis should be commensurate with the size, concentration level, and relative risk of the institution's subprime-lending activities and should consider the following elements:

- portfolio-growth rates
- trends in the level and volatility of expected losses
- the level of subprime-loan losses incurred over one or more economic downturns, if such data or analyses are available
- the impact of planned underwriting or marketing changes on the credit characteristics of the portfolio, including the relative levels of risk of default, loss in the event of default, and the level of classified assets
- any deterioration in the average credit quality over time due to adverse selection or retention
- the amount, quality, and liquidity of collateral securing the individual loans
- any asset, income, or funding-source concentrations
- the degree of concentration of subprime credits
- the extent to which current capitalization consists of residual assets or other potentially volatile components
- the degree of legal or reputation risk associated with the subprime business lines pursued
- the amount of capital necessary to support the institution's other risks and activities

Given the higher risk inherent in subprime-lending programs, examiners should reasonably expect, as a starting point, that an institution would hold capital against such portfolios in an amount that is *one and one-half to three times greater* than what is appropriate for non-subprime assets of a similar type. Refinements should depend on the factors analyzed above, with particular emphasis on the trends in the level and volatility of loss rates, and on the amount, quality, and liquidity of collateral securing the loans. Institutions should have capital ratios that are well above the averages for their traditional peer groups or other similarly situated institutions that are not engaged in subprime lending.

Some subprime asset pools warrant increased supervisory scrutiny and monitoring, but not necessarily additional capital. For example, well-secured loans to borrowers who are slightly below what is considered prime quality may entail minimal additional risks compared with prime loans, and they may not require additional capital if adequate controls are in place to address the additional risks. On the other hand, institutions that underwrite higher-risk subprime pools, such as unsecured loans or high loan-to-value second mortgages, may need significantly higher levels of capital, perhaps as high as 100 percent of the loans outstanding, depending on the level and volatility of risk.

Stress Testing

An institution's capital adequacy analysis should include stress testing as a tool for estimating unexpected losses in its subprime-lending pools. Institutions should project the performance of their subprime-loan pools under conservative stress-test scenarios, including an estimation of the portfolio's susceptibility to deteriorating economic, market, and business conditions. Portfolio stress testing should include "shock" testing of basic assumptions, such as delinquency rates, loss rates, and recovery rates on collateral. Stress tests should also consider other potentially adverse scenarios, such as changing attrition or prepayment rates; changing utilization rates for revolving products; changes in credit-score distribution; and changes in the capital-market demand for whole loans or asset-backed securities supported by subprime loans. These are representative examples; actual factors will vary by product, market segment, and the size and complexity of the portfolio relative to the institution's overall operations. Whether stress tests are performed manually, or through automated modeling techniques, it is expected that—

- the process is clearly documented, rational, and easily understood by the institution's board and senior management;
- the inputs are reliable and relate directly to the subject portfolios (for example, baseline loss history or default probabilities should reflect each segment of the institution's portfolio and not just a blend of prime and subprime borrowers);
- assumptions are well documented and conservative; and
- any models are subject to a comprehensive validation process.

The results of the stress-test exercises should be a documented factor in the analysis and determination of capital adequacy for the subprime portfolios.

Institutions that engage in subprime-lending programs without adequate procedures to estimate and document the level of capital necessary to support their activities should be criticized. Where capital is deemed inadequate to support the risk in subprime-lending activities, examiners should consult with their Reserve Bank supervisory official to determine the appropriate course of action. Such actions may include requiring additional capital in accordance with the Federal Reserve's capital adequacy rules, or requiring the institution to submit an acceptable capital plan in accordance with safety-and-soundness guidelines.

Subprime-Lending Examiner Responsibilities

Using the interagency guidance and any supplemental Federal Reserve guidelines, examiners should assess carefully management's ability to administer the higher risk in subprime portfolios. The examiner should judge management's ability to manage the risk involved in the subprime-lending program, in particular, the quality of the risk-management and control processes in place, and more importantly, the extent to which management is adhering to those processes. When examiners determine that risk-management practices are deficient, they should criticize management and initiate corrective action. Such actions may include formal or informal enforcement actions or a plan to achieve adequate capitalization. When a primary supervisor determines that an institution's risk-management practices are materially deficient, the primary supervisor may instruct the institution to discontinue its subprime-lending programs.

APPENDIX—QUESTIONS AND ANSWERS FOR EXAMINERS REGARDING THE EXPANDED GUIDANCE FOR SUBPRIME-LENDING PROGRAMS

To assist examiners who review subprime-lending activities, the following questions and answers were developed to provide additional guidance on the expanded interagency guidance that was issued on January 31, 2001.

Applicability of the Guidance

Question 1: Does the guidance apply to all institutions?

No. The guidance will not affect the vast majority of insured institutions engaged in traditional consumer lending. The guidance applies to institutions that *systematically* target the subprime market through *programs* that employ tailored marketing, underwriting standards, and risk selection.

The guidance does not address traditional consumer lending that has historically been the mainstay of community banking. It does not apply to institutions extending credit to subprime borrowers as part of their standard community-lending process, or making loans to subprime borrowers as an occasional exception to a prime-lending program, even if the aggregate of these loans totals more than 25 percent of tier 1 capital. Such institutions continue to be subject to the normal supervisory process.

Institutions engaging in subprime-lending programs generally have knowingly and purposefully focused on the subprime-lending markets through planned business strategies, tailored products, and explicit borrower targeting. In instances where significant exposures to subprime borrowers are identified, examiners should consider the institution's marketing program, loan products, pricing, underwriting standards and practices, and portfolio performance to determine if the institution has a program that warrants the supervision and safeguards outlined in the guidance.

Question 2: Does the guidance apply when an institution offers a product that attracts a disproportionate number of subprime borrowers, but which the institution does not explicitly identify as subprime?

A subprime program commonly features products specifically tailored to borrowers with weakened credit histories. Such products often differ substantially in pricing and terms from products offered to prime borrowers, and usually have separate and distinctly different underwriting standards. An institution offering a product that attracts a disproportionate number of borrowers with weakened credit histories likely has a subprime program whether or not the activity is called a subprime program. The guidance will apply to these programs when the resultant aggregate credit exposure is at least 25 percent of the institution's tier 1 capital.

Institutions with significant programs are expected to have the necessary risk-management and internal-control systems in place to properly identify, measure, monitor, and control the inherent risks in its subprime portfolio. Risk management and controls for these programs typically involve enhanced performance monitoring, intensive collection activities, and other loss-mitigation strategies. If an institution systematically targets the subprime market but does not segregate these loans from its prime portfolio, it is doubtful that the institution has the necessary risk-management and control systems in place to safely engage in the activity.

Subprime Characteristics

Question 3: Why does the Expanded Guidance for Subprime Lending Programs use a credit bureau risk score (FICO) of 660 as a cutoff point for subprime lending?

The guidance does not use credit scores, or any other single risk factor, as a definitive cutoff point for subprime lending. The characteristics listed are not explicit, bright-line definitions. The range of credit characteristics used to describe subprime borrowers is intended to help examiners identify lenders that are engaged in subprime-lending programs. These characteristics describe borrowers with varying, but significantly higher, probabilities of default than prime borrowers. The guidance states that ''this list is illustrative rather than exhaustive and is not meant to define specific parameters for all borrowers.''

A credit bureau score of 660 (FICO) is used only as an example to illustrate a credit score that generally indicates a higher default probability. The guidance indicates the probability of default, as evidenced by the credit score, will vary by product and collateral. The subprime guidance lists *several* characteristics that denote a higher probability of default. Examiners are directed to use these characteristics as a starting point to expand their review of lending programs targeting subprime borrowers in accordance with risk-focused examination procedures. The severity of risk may vary significantly for the different characteristics listed, as well as for the type and quality of collateral. Examiners should take this into consideration when reviewing the portfolio and determining the adequacy of loan-loss reserves and capital.

The characteristics used in the guidance are well recognized in the investment and lending industries. A number of public debt rating agencies and financial institutions, including the government-sponsored enterprises (GSEs), use similar credit characteristics to differentiate risk among borrowers. Specific examples include the following:

- Fitch defines a subprime borrower as ''...one with a credit profile worse than that of a prime A quality borrower, whose credit report would typically reveal no recent mortgage delinquencies and whose credit profile would yield a [FICO] credit score in the range above 680.'' Fitch's mortgage credit grade matrix lists the following credit-history elements for A-, the highest subprime grade: one 30-day delinquency in the last 12 months on a mortgage debt; one 30-day delinquency in the last 24 months on installment debt, or two 30-day delinquencies in the last 24 months on revolving debt; bankruptcy in past five years; charge-off or judgments exceeding $500 in the past 24 months; and/or a debt-to-income ratio of 45 percent.[1]
- Standard & Poor's subprime-mortgage underwriting guidelines define subprime A-characteristics as two or more 30-day delinquencies on mortgage and consumer credit, one 60-day delinquency on consumer credit, debt-to-income ratio of 45 percent, and no bankruptcy in the past five years. Standard & Poor's also ''...considers subprime borrowers to have a FICO credit score of 659 or below.''[2]
- Standard & Poor's has classified nonprime B auto securitization pools as having occasional delinquencies and minor charge-offs on revolving debt, static pool net losses of 3.1 percent to 7.5 percent, and FICO credit scores ranging from 620–679.[3]
- Freddie Mac has used the FICO score of 660 or below to designate higher-risk borrowers requiring more comprehensive review. Freddie Mac views a score in the 620–660 range as an indication that the ''borrower's willingness to repay debt as agreed is uncertain.'' FICO scores below 620 are placed in the ''cautious-review category,'' and Freddie Mac considers scores below 620 ''as a strong indication that the borrower's credit reputation is not acceptable...''[4]

Capital Guidance

Question 4: If an institution is engaged in subprime lending as described by the guidance, does the 1.5-to-3 times capital described in the guidance automatically apply?

No. The expanded interagency guidance on subprime lending is flexible examination guidance; the capital range does not automatically apply because the guidance is not a capital rule or regulation. Rather, the guidance describes an expectation that subprime lenders hold sufficient loan-loss reserves and capital to offset the additional risks that may exist in subprime activities. The agencies expect institutions to have methodologies and analyses in place to support and document the level of reserves and capital needed

1. Fitch IBCA, Duff & Phelps, ''Rating U.S. Residential Subprime Mortgage Securities, March 16, 2001: 2.

2. Standard & Poor's, ''U.S. Residential Subprime Mortgage Criteria,'' Structured Finance, 1999: 12, 169.

3. Standard & Poor's, ''Auto Loan Criteria and Market Overview 1998,'' Structured Finance Ratings Asset-Backed Securities, 6.

4. Freddie Mac, Single-Family Seller/Servicer Guide, chapter 37, section 37.6, ''Using FICO Scores in Underwriting,'' March 7, 2001.

for the additional risks assumed. The higher the risk, the more reserves and capital needed to support the activity. Institutions with lower-risk subprime portfolios may not need additional reserves and capital. In addition, examiners are reminded that subprime lending is only one element in the evaluation of the institution's overall capital adequacy. If the analysis shows that the institution has adequate capital for all its assets and activities, including subprime lending, there is no additional capital requirement arising from the guidance.

Examiners are instructed not to unilaterally require additional reserves and capital based on the guidance. Any determination made by an examiner that an institution's reserves or capital are deficient will be discussed with the institution's management and with each agency's appropriate supervisory office before a final decision is made.

Question 5: Are the regulatory expectations for higher capital levels consistent with capital levels supporting subprime assets outside the insured banking industry?

Yes. The regulatory expectations of higher capital maintenance are consistent with expectations in the capital markets. The 1.5-to-3-times-capital multiple is risk based, e.g., the level of additional capital varies by relative loan quality and is applied only to the subprime portfolio, not the institution's entire asset structure. This is consistent with the financial marketplace's assessment of relative risk in subprime assets outside the banking industry. For example, the amount of credit enhancement required for subprime securitization structures varies according to the level and volatility of perceived credit risk in the underlying assets. In addition, publicly traded subprime-finance companies (that are not currently suffering from adverse ratings) maintain equity-capital-to-managed-asset ratios that are 1.5 to as much as 6 times (depending on loan type and relative quality) those of finance companies that do not specialize in subprime loans.

1. To assess and evaluate the extent of subprime-lending activities; whether management has adequately planned for this activity; and whether management has developed and maintains board-approved policies and procedures, systems, and internal controls that identify, measure, monitor, and control the additional risks.
2. To ascertain whether management has established adequate subprime-lending standards that are commensurate with the risks associated with the subprime-lending program.
3. To conduct portfolio-level reviews and transaction-level testing of the subprime-lending activities, assessing the quality and performance of the subprime-loan portfolios and subprime-lending program, including its profitability, delinquency, and potential and actual loss experience.
4. To assess the adequacy of the allowance for loan and lease losses (ALLL) for the subprime-loan portfolio.

1. Determine whether the subprime-lending activities are consistent with the bank's overall business strategy and risk tolerances, and that the critical business risks have been identified and considered.
2. Assess whether the bank has the financial capacity, including capital adequacy, to conduct the high-risk activity of subprime lending safely, without any undue concentrations of credit.
3. Ascertain if management has committed the necessary resources, that is, technology and skilled personnel, to manage and control the risks associated with the volume and complexity of the subprime-lending program.
4. Determine whether the banking institution's contingency plans are adequate to address the issues of (1) alternative funding sources, (2) back-up purchasers of the securities or the attendant servicing functions, and (3) methods of raising additional capital during an economic downturn or when financial markets become volatile.
5. Determine if management has established adequate lending standards that are appropriate for the size and complexity of the banking organization's operations, and if management is maintaining proper controls over the program. (See ''Risk Management'' in section 2133.1 for the lending standards that should be included in the subprime-loan program.)
6. Review and evaluate loan-administration and loan-monitoring procedures for subprime loans originated or purchased, including—
   a. collection, repossession, and disclosure procedures;
   b. the management of the number of staff members, the level and effective use of skilled staffing, and advanced technology;
   c. the adequacy of the allowance for loan and lease losses (ALLL); and
   d. the adequacy and accuracy of models used to estimate credit losses or set pricing, making certain that the models account for economic cycles and other unexpected events.
7. Perform a portfolio-level review and conduct some transaction testing. Incorporate examination findings from the portfolio-level and transaction-level testing reviews into the conclusions about overall asset quality, the adequacy of the ALLL and capital, and the adequacy of portfolio risk-management practices.
8. Review securitization transactions for compliance with Statement of Financial Accounting Standards No. 140 (FAS 140) and this guidance, including whether the banking organization has provided any support to maintain the credit quality of loan pools it has securitized.
9. Evaluate the ALLL and regulatory capital allocated to support subprime-lending programs, including whether the total protection for subprime-asset programs and the levels for each component are adequate. Ascertain that a sound risk-management program exists that includes the ability of management to determine and quantify appropriate levels for each component.
10. Analyze the performance of the program, including its profitability, delinquency, and loss experience.
11. Consider management's response to adverse performance trends, such as higher-than-expected prepayments, delinquencies, charge-offs, customer complaints, and expenses.
12. Determine if the banking institution's subprime-lending program effectively manages the credit, market, liquidity, reputational, operational, and legal risks associated with subprime-lending operations.
13. Evaluate the documented analysis of the institution's capital needed to support its subprime-lending activities. Ascertain whether the capital levels are risk sensitive, that is, does allocated capital reflect the level and variability of loss estimates within reasonably conservative parameters? Determine if there is a direct link between the expected loss rates used to determine the required ALLL and the unexpected loss estimates used to determine capital. Document and reference each institution's subprime capital evaluation in the examination comments and conclusions regarding capital adequacy.
14. Classify loans according to the following criteria:

a. Classify as substandard loans to borrowers that do not have the capacity to service their loans.
b. Classify as at least substandard subprime loans that are 90 days or more past due based on a reasonable presumption that their past-due status indicates an inadequate capacity or unwillingness to repay.
c. Consider classifying or criticizing the entire portfolio or segments of the portfolio when the portfolio review or loan sample indicates serious concerns with credit-risk selection practices, underwriting standards, or loan quality.
d. Classify as substandard high-risk unsecured loan portfolios or secured high loan-to-value loans to borrowers who clearly exhibit inadequate capacity to repay the debt in a reasonable time frame.

15. Report as unsafe and unsound imprudent loans to borrowers who do not demonstrate the capacity to repay the loan, as structured, from sources other than the pledged collateral. Refer such loans to a consumer compliance/fair lending specialist for review.
16. Carefully assess management's ability to administer the higher risk in subprime portfolios. If risk-management practices are deficient, criticize management and reach specific agreements with senior management and the board of directors to initiate corrective action.

INTRODUCTION

Agricultural loans can be broadly defined as loans made to agricultural producers to finance the production of crops or livestock. The term ‘‘crops’’ is meant to include any of the many types of plants that produce grains, fruits, vegetables, or fibers that can be harvested. Similarly, a variety of animals is produced for profit, although cattle, swine, sheep, and poultry are by far the most common. Production cycles vary with the type of crop or livestock, from a few weeks or months to several years; in the case of an orchard crop or timber, the time from planting to harvest (from cash outlay to the generation of income) is quite lengthy. The type of crop or livestock to be produced will determine the nature of the financing needed, including its timing, collateral considerations, and repayment terms.

Repayment terms for farm loans normally correspond to anticipated cash flows. Since repayment of agricultural-related loans usually comes from the sale of crops or livestock, annual repayment terms are not uncommon. Depending on the type of operation and timing of cash income, payments may be set to come due semiannually, quarterly, or on an irregular schedule. However, many smaller farm operators also receive income from nonfarm employment, which allows them to make monthly payments on some loans.

Agricultural producers need access to land (often with buildings and other improvements) and equipment, in addition to the shorter-term operating inputs directly involved in crop or livestock production. Not all producers own land; some are tenants who pay the landowners cash rent or a portion of the crop yield. Many producers both own and rent or lease land in an effort to maximize efficiency and income. Accordingly, individual producers may need a variety of types of loans, including—

- real estate loans,
- equipment loans,
- livestock loans, and
- operating (or production) loans.

Information on each of these types of agricultural loans follows, as well as general comments on agricultural lending and the examiner’s review of agricultural loans.

AGRICULTURAL REAL ESTATE LOANS

Real estate loans are not intended as a primary focus of this manual section. However, real estate loans are a significant portion of total debt for many agricultural producers, and the examiner should consider them when evaluating other types of loans to agricultural producers. For a more thorough discussion of real estate loans, refer to section 2090.1, ‘‘Real Estate Loans.’’ Loans to finance agricultural land, together with related improvements (frequently including the producer’s residence) comprise the most common type of real estate loan made by agricultural banks. These loans are subject to the same general lending principles and legal and regulatory requirements[1] as loans on other types of real estate. Even if a bank has not made a real estate loan to the agricultural borrower, any real estate debt owed elsewhere must be considered in analyzing the borrower’s creditworthiness, along with amounts due to the bank and any other creditors. Additionally, any state laws on homestead exemptions should be noted.

Agricultural real estate loans tend to have special characteristics, particularly with regard to valuation and repayment considerations. For instance, farmland appraisers need special knowledge of soil types, topography, data on rainfall or water tables, and crop production data, as well as a knowledge of area market conditions and other extenuating information. Prevailing market values for farmland tend not to permit as high a level of cash return as those for other types of income-producing property. Values always reflect supply and demand, and, probably due to a number of factors, the demand for farmland has traditionally been relatively strong from neighboring landowners, other area farmers, nonfarmers, and absentee owners who have a strong desire to own land. A lower level of return generally dictates a lower loan-to-value ratio, although a borrower may be able to

1. In connection with the supervisory loan-to-value limits set forth in the ‘‘Interagency Guidelines for Real Estate Lending Policies,’’ farmland, ranchland, or timberland committed to ongoing management and agricultural production is considered ‘‘improved property,’’ subject to a loan-to-value limit of 85 percent. However, a bank may set a lower limit for itself and, as a matter of policy, probably will loan less than 85 percent of appraised value on farmland in most cases.

service debt at a higher level from other income sources such as less-heavily encumbered land, rented land, or nonfarm income. For example, it would not be unusual for a bank to advance 100 percent of the purchase price of land if a lien on additional land is taken to lower the overall loan-to-value ratio.

There is generally a well-established market for agricultural land. Although values fluctuate based on a variety of factors (just as they do with other types of real estate), there is normally a recognized range of values at any given time for particular land types within a general area. The examiner should gain some knowledge of current area land prices and trends through published data from local universities or private organizations, interviews with bank management, and the review of appraisal reports. This knowledge will be vital in assessing collateral values and the borrower's overall financial condition and future prospects.

An amortization period of up to 20 years is not uncommon for agricultural real estate loans by banks. Longer-term loans (up to 30 years) on farm real estate are sometimes made by commercial banks, but are more common with other lenders such as Federal Land Banks. Many banks structure real estate loans so that required payments are based on a 20- to 30-year amortization, but they write the notes with a 5- to 10-year maturity, at which time a balloon payment is due. Major improvements, such as livestock-confinement buildings or grain-handling facilities, commonly have a shorter amortization period of 10 years or less.

AGRICULTURAL MACHINERY AND EQUIPMENT LOANS

Agricultural producers often need to finance the purchase of machinery, equipment, vehicles, and implements. Typically, these loans are secured by the durable goods being financed and are amortized over an intermediate term of up to seven years. As with any equipment loan, some borrower equity should be required, the amortization period should be no longer than the expected useful life of the equipment, and scheduled payments should correlate reasonably with the timing and amount of anticipated income. In some cases, equipment loan payments may be advanced under the borrower s operating line of credit.

Loans to farmers and ranchers may include individual notes to finance the purchase of specific pieces of equipment or vehicles. However, many agricultural borrowers provide the bank with a blanket lien on all equipment and vehicles to secure any and all debts owed the bank. Frequently, borrowers have both purchase money loans on specific equipment and other loans secured by a blanket equipment lien.

Under the Uniform Commercial Code, a security interest in equipment is created with a security agreement signed by the borrower and a bank officer, and the lien is perfected by a centrally filed financing statement. Many banks file the financing statement in both the county and state in which the borrower resides *and* in the county and state in which the equipment is located. The filing is a public record that notifies lenders or other interested parties that the assets identified have been pledged, as well as to whom and when they were pledged.

Since the filing record provides vital information for potential lenders, bank management must check it before extending credit to determine whether the collateral is already pledged to another lender. In many cases, a bank might approve a loan request only if it were to be in a first lien position, but there can be exceptions. For example, a bank may agree to advance on a second lien position in a large piece of equipment in which the borrower has substantial equity or take a blanket lien on all equipment, including one or a few items of equipment pledged elsewhere (such as a purchase money lien held by an equipment dealer). As a matter of prudent lending and sound loan administration, lien searches should be performed periodically on at least larger borrowers or on those borrowers known to be or suspected of having problems or of being involved with other lenders.

Sound bank lending policies should prescribe a maximum loan-to-value ratio for equipment, as well as maximum repayment terms. The same is true for vehicles, although the loan-to-value limits on vehicles for highway use (automobiles and trucks) tend to be higher because they have a less-specialized use and are more liquid. Maximum loan-to-value limits, particularly for loans to purchase specific pieces of farm equipment, may range to more than 80 percent or even to 100 percent for strong borrowers. However, many farm lines of credit are supported in part by blanket liens on all the borrower's equipment. Typically, overall loan-to-value ratios on a line of equipment do not exceed 60 percent.

LIVESTOCK LOANS

Livestock loans vary with the animal species and the nature of the individual producer's operation, but the same general lending principles apply to virtually all types of livestock loans. The borrower should have an equity position in the livestock financed, ample feed on hand, or another underlying financial strength that will protect the lender from risks such as losses from animal diseases and deaths, rising feed costs, or market fluctuations. The size of the livestock operation should be commensurate with the borrower's physical facilities and management capability. Total debt should not overburden the borrower, and the timing and source of repayment for loans should be understood when they are originated. The term of a livestock loan normally bears a close relationship to the length of time the animals are to be held.

Feed is a necessity for livestock producers and a major expense for those involved in finishing animals for slaughter, dairy herds, or egg-laying operations. On the other hand, stocker cattle feed mainly on pasture or silage, which reduces feed costs. Some livestock producers also raise feed crops, which may improve their overall efficiency. Many producers, however, need to buy feed. In any event, the loan officer should have a firm understanding of how much feed the borrower has on hand (or will be harvesting) and how much will have to be purchased. Still, even though both borrower and banker may be experienced and capable at projecting feed costs, variables beyond their control impose some risk of increased costs. These variables might include perils such as unfavorable weather or disease affecting feed crop yields or rising feed prices or shortages brought on by other unanticipated forces.

Many banks will advance up to 100 percent of the cost of livestock if the borrower has sufficient feed on hand and a sound overall financial position. Since the animals gain weight and value as feedstocks are consumed, the bank's collateral position normally strengthens as the livestock matures toward market weight. For borrowers without adequate feedstocks on hand, advance rates may be limited to 70 to 80 percent of the purchase price.

TYPES OF LIVESTOCK OPERATIONS AND LOAN CONSIDERATIONS

Livestock producers usually specialize in particular kinds or breeds of animals or in certain phases of an animal's life cycle. This specialization may vary depending on geographic area, climate, topography, soil type, or the availability of water and feed, or on the producer's preferences, experience, or physical facilities. A producer may change his specialization from time to time based on recurring market cycles or more fundamental shifts in economic factors, such as consumer demand. Some producers are involved in more than one type of livestock operation at any given time.

The following is a brief discussion of the most common types of livestock operations, as well as the lending and loan analysis considerations for each.

Cattle

Beef Breeds

- *Cow-calf operation.* A producer has breeding stock that produces calves, which are then sold as either feeder calves or future breeding stock or are kept until the animal reaches full maturity.

  The typical cow-calf loan is for financing the breeding stock (cows and bulls) of a herd. The loan term is usually three to five years, with annual payments of principal and interest to fully amortize the loan within that term. Often, loans for this type of operation are written with one-year maturities and no predetermined amount of principal reduction at maturity. However, this kind of loan structure is more suitable for borrowers who are not highly leveraged.

  Repayment is from the annual sale of calves and cull cows (older cows or those that fail to produce offspring). Approximately 10 to 15 percent of a cow herd is culled each year; most cows are retained for seven to as many as twelve years. Bulls are typically stocked at one for each 20 to 25 cows; pregnancy rates are generally 80 to 100 percent, depending on the age and health of the cows and on feed availability.

Most calves are born in late winter and early spring, weighing around 100 pounds. Cows may be winter-fed on hay, but cows and calves graze on pastureland from spring to around October when the calves weigh 500 to 550 pounds. At this time, the calves may be sold to another producer who specializes in raising stockers. (However, in some areas, herds are managed to produce fall calves. Also, depending on feed sources and market conditions, calves may be sold at lighter weights, around 300 to 400 pounds.)

- *Stocker or backgrounding operation.* A producer in a stocker operation acquires calves weighing from 300 to 550 pounds and feeds them, primarily on pasture, until they weigh around 700 to 750 pounds, when they are sold to a finisher. Since the growth gains of young cattle are generally the most efficient phase of beef production, some stock operators prefer to buy lighter weight calves, although the lighter weights require more care and supervision to minimize death losses. Stocker operations are relatively high-risk programs that require specialized knowledge, but they can also be quite profitable.

  Backgrounding requires approximately 100 days, during which time the cattle may be fed a daily ration of silage (the entire corn or grain sorghum plant chopped into feed and stored in a silo) and grain and feed supplements, including soybean meal, minerals, salt, and vitamins. The supplements usually need to be purchased. Steers gain approximately two pounds per day, and heifers slightly less. Sometimes stocker cattle are placed on pasture, which can include dormant wheat in the winter or grass during the summer.

  Stocker cattle are typically financed with a 90- to 120-day single-advance, single-maturity note. Funds for feed purchases may be provided as part of the note proceeds, but, more commonly, the feed is raised by the producer. Loan repayment comes from the sale of the cattle when they weigh around 700 to 750 pounds. Collateral for stocker loans is typically the cattle financed and the feed. Banks usually require around a 30 percent margin in the cattle, but may require as little as 20 percent or less for financially strong borrowers.

  The profitability of a backgrounding operation is sensitive to the average daily weight gain, feed costs, weather, and purchase and sale prices of the cattle.

- *Finishing operation.* A finishing operation acquires cattle weighing approximately 700 to 750 pounds and feeds them a high-protein grain ration until they are ready for slaughter at around 1,100 to 1,200 pounds.

  Finishing usually takes around 130 to 145 days. Most finishing cattle are now custom-fed in commercial feedlots, but the producer (not the feedlot owner) usually retains ownership of the cattle. Feeder steers usually gain approximately 3.2 pounds per day, and heifers around 2.8 pounds per day. However, average daily gains vary depending on the breed, type of ration, time of year, or weather conditions.

  Finishing cattle can be risky because of fluctuations in cattle prices between purchase and sale dates. Some producers use futures contracts to lock in prices and reduce the risk, or they enter into forward contracts with a packer. Larger producers may use a ‘‘moving hedge’’ to offset the risk imposed by market cycles.[2]

  Banks normally require 20 to 30 percent initial margin in financing the purchase of feeder cattle, but may advance up to 100 percent of the feed costs. As the cattle gain weight, the bank's collateral position tends to improve. Repayment comes from sale of the cattle, with loan maturity set near the anticipated sale date.

Dairy Operations

Cows are milked for ten months each year, then rested for two months and allowed to ‘‘dry up’’ (quit producing milk by not being milked). Three months after a female dairy cow gives birth, she is rebred and calves nine months later. Cows are commonly bred through artificial insemination, which allows the producer to improve the genetics of the herd. Each year approximately one-third of the cows are culled,

2. In this strategy, the producer periodically buys a given number of lightweight feeders and at the same time sells a similar number of fat cattle. When prices are down, lower revenues from sales of cattle are offset by the benefit of lower costs to purchase replacement lightweight feeders. By the same token, when prices are up, higher purchase costs are offset by higher revenues on the slaughter cattle sold. This strategy allows the producer to prevent or substantially minimize losses due to fluctuating market prices. Otherwise, the producer might too often be in the position of only buying at high prices and only selling at low prices.

with replacement heifers usually raised on the farm. An 80 percent calf crop is common, with the males either sold soon after birth or fed for slaughter.

Milk production is measured by pounds of milk produced per cow per year. Production in the range of 13,500 to 20,500 pounds is common. Milk production variables include the quality of the cows, number of days milked each year, and amount and quality of feed. Feeding cows a higher ratio of grain to dry hay will result in higher milk production, but the higher feed costs must be weighed against the returns of higher production.

Feed is a major expense for a dairy operation. Dairy cows consume a ration of corn or grain sorghum, soybean meal, high-quality hay, silage, vitamins, and minerals. Family-oriented dairy operations usually grow most of their own feed on the farm, while larger operations purchase most of their feed and confine the cows to a dry-lot facility.

A dairy operation is heavily capital intensive because of the investment in cows, buildings, and equipment. Dairying is also labor intensive, which further adds to the cost of production.

The efficiency of a dairy operation is measured on a ‘‘per-cow’’ basis. Gross income, expenses, and net income can be divided by the number of cows to analyze trends and compare them with other dairy operations. Several other key indicators of a dairy operation's productivity include the following:

- *Pounds of milk per cow per year.* Herds averaging less than 14,000 pounds may be struggling.
- *Calving interval.* Twelve to thirteen months is favorable; if the interval lengthens, milk production and the overall efficiency of the operation will decline.
- *Calf losses.* A 10 percent or less loss on live calves born is favorable and considered an indication of good management.
- *Culling rate.* Cows should start milking when they are about two years old and should average four to five lactation periods before they are culled; if cows have to be culled prematurely, efficiency declines.

Loans to dairy operators may include longer-term financing for land and improvements; intermediate financing for the cow herd, specialized equipment, and vehicles; and operating loans to help finance the production of feed crops. Established operations may not require herd financing unless the herd is being expanded. Financing replacement cows to maintain a herd, if necessary, should be included in a shorter-term operating loan. Generally, operating loans are not a major financing activity as the dairy farmer's regular income from the sale of milk can often accommodate operating needs.

Collateral for dairy loans, in addition to real estate, typically includes the livestock, crops and feed on hand, and equipment. The collateral is usually covered with a blanket security agreement. Often, milk sale proceeds are assigned to the bank, and the milk buyer sends a monthly check directly to the bank to meet scheduled loan repayments.

Clearly, the primary source of income for the dairy farmer is the sale of milk, which is produced daily. Additional income is produced from the annual sale of calves and culled cows.

Hogs

Hog production consists of a two-stage operation: (1) ‘‘farrowing’’ (breeding sows to produce feeder pigs) and (2) ‘‘finishing’’ (fattening feeder pigs to slaughter weight). Many producers combine both enterprises and are called farrow-to-finish operations.

Hog producers range from small operators to large corporate interests. The small producers can be considered those who market less than 2,500 head per year; they can be involved either in finishing hogs or in farrow-to-finish operations. Small producers also tend to be involved in grain farming (raising their own feed) and other kinds of livestock production. The profitability and financial strength of a small producer is generally tied to the ability to market hogs frequently throughout the year, which lessens the impact of adverse market fluctuations. If the producer cannot market frequently, he or she probably needs to be involved in hedging practices. A corporate hog farm is usually a farrow-to-finish operation, with the number of sows ranging from 500 to as many as 100,000 for the largest producers.

Farrowing Operations

Hog breeding normally requires one boar for approximately 20 sows. Sows typically have two litters per year, and litter size is one of the most crucial factors in determining the success of a farrowing operation. Eight hogs per litter is a goal for most producers. Up to 25 percent of the sows will be culled each year. Some producers raise their own replacement sows, while others purchase quality breeding stock in an attempt to improve herd quality.

Pigs are farrowed (born) in confinement buildings, and after three weeks, they are moved to a nursery facility where the pigs are weaned from the sow. The capital invested in farrowing facilities varies greatly, but the trend has been toward higher investments in facilities that require less labor. However, a large investment in a single-use, costly hog facility can pose a significant risk if the farrowing operation is not profitable.

Feed costs are the largest operating expense of a farrowing operation. The feed required consists of a feed grain (corn or milo), a protein supplement, vitamins and minerals, and a pig starter (a commercial feed used in the transition from nursing to eating solid food). In a feeder pig production operation, the young pigs are typically kept until they weigh 40 to 60 pounds, which takes around two months. Feed costs are continually changing because of fluctuating grain prices, so it may be difficult to project cash flow accurately. Historical cash flow may be more useful in demonstrating the borrower's overall management capabilities.

Loans to farrowing operations may include an intermediate- to mid-term loan on the facilities (usually not for more than ten years), breeding stock loans that should be amortized over no more than four years, and operating loans. Operating loans are often in the form of revolving lines of credit to purchase feed, with repayment normally coming from the sale of hogs. The operating line should be cleaned up periodically, or the bank should establish systems to monitor advances and repayments to ensure that stale debt is not accumulating.

Collateral for a farrowing operation could include the facilities and the hogs and feed on hand. For collateral purposes, the hogs should be valued at local market prices even though the producer might have paid a premium for breeding stock. Feed should be heavily margined, as the proceeds from feed sale during a foreclosure are likely to be limited.

Loan repayment comes primarily from the sale of young feeder pigs and culled sows. The timing of scheduled repayments will vary, depending largely on the producer's breeding schedule and the anticipated sale dates for feeder pigs. Usually, sows are bred at different times so they are not all having pigs at the same time. In the case of a farrow-to-finish operation, the cycle will be longer, and repayments will be scheduled according to anticipated sale dates of the fat hogs and culled breeding stock.

Finishing Operations

Hog finishing is the process of acquiring young pigs that weigh 40 to 60 pounds, and feeding them until they reach a slaughter market weight of 220 to 240 pounds. The process takes approximately four months. The average death loss for a finishing operation is generally 4 to 5 percent of the total number of hogs started on feed.

Loans for hog finishing are usually in the form of single-payment notes that mature in approximately four months. Loan proceeds are used to purchase young pigs and may also be used to purchase feed. A bank commonly advances up to 100 percent of the purchase price of the pigs. Usually, there is a blanket security agreement in place that gives the bank a security interest in all hogs, as well as in feed and other chattels to provide additional overall support for the credit. Margin in the collateral increases as the animals gain weight. Repayment comes from the sale of fat hogs to a packing plant.

The main factors in determining a finisher's profitability are (1) the cost of the feeder pigs, (2) the cost of feeding the pigs, and (3) revenues from the sale of hogs. Costs and revenues continually change because of fluctuations in market prices for young pigs, slaughter hogs, grain, and feed. Because of the relatively short cycle of hog finishing, a number of loans may be made during one year. In analyzing hog loans, reviewing the overall profitability of the operation (taking into account depreciation on facilities and equipment, interest, and insurance) is more meaningful than reviewing the results from each individual loan advance.

Sheep

Sheep are raised for the production of meat and wool. The most common sheep enterprise is the raising of ewe (female) flocks, which produces income from the sale of both wool and lambs. Larger flocks tend to be more efficient as they can take better advantage of investments in labor-saving equipment.

Ewes give birth once a year, usually during late fall or winter. They frequently have twins, resulting in an overall lamb production per ewe of approximately 140 percent. About 20 percent of the ewes are culled each year, with replacements usually being raised from lambs. There is typically one ram for each 30 ewes in a breeding flock. The sheep and lambs graze on pasture during the summer and are fed a ration of roughage and grain during the winter.

Loans to ewe flock operators are made to purchase breeding stock and to pay operating expenses. Breeding-stock loans should be amortized over no more than five years. Repayment comes primarily from the sale of lambs and wool.

Typically, lambs are finished in commercial feedlots until they reach slaughter weight, which involves purchasing 60-pound feeder lambs and feeding them a hay-grain ration for about 90 days until they weigh approximately 120 pounds. The loan term is usually 90 to 120 days, with the sale of fat lambs to a processor being the source of repayment. Collateral consists of the lambs, which should be valued at local market prices. Margin required in the lambs, if any, will depend on feedstocks owned or on the borrower's financial strength.

Poultry

Poultry production has become a very large and highly organized agribusiness. Large corporate producers dominate the industry. However, they depend to a large extent on individual growers, with whom they contract to raise the birds almost from the day they are hatched until they are ready for slaughter. The large company supplies an independent grower with the day-old chicks, feed, and medications and provides technical support. Under the contract, the company pays the grower at a rate designed to provide an acceptable return on the grower's investment in poultry houses, equipment, and labor.

Producing breeding stock, incubating eggs, hatching chicks, and producing pullets and eggs are other aspects of the poultry industry that are highly specialized and relatively concentrated within fairly large corporate producers. Most banks will not extend loans on these types of operations, and any that do should have substantial background information on the industry in their files. The examiner should review that information and discuss the industry and the borrower's operation with the officer originating or servicing the credit.

The typical grower owns 60 to 80 acres of land and has an average of three to four poultry houses. Most growers also have other jobs and earn supplemental income from their growing operations. Broiler (or fryer) chickens generally are grown to a live market weight of approximately 4.2 pounds at 42 days of age.

Most bank loans to contract poultry growers consist of construction loans to build poultry houses and permanent financing for the houses and equipment. The houses are large but of relatively simple construction. Permanent financing is typically amortized over 10 to 15 years.

Government guarantees (Farmers Home Administration, Small Business Administration, or various state agencies) are often available to mitigate the bank's risk by guaranteeing from 85 percent to as much as 100 percent of the permanent loan. Federal guarantees have not been available for construction financing of poultry houses, so the bank generally will have to assume the full risk of the loan during the construction period.

Construction loans are generally converted into long-term loans that are repaid with the contract income a grower receives from the large corporate producer. Since feed and other supplies are typically furnished by the large producer, individual growers do not normally require operating loans.

Egg production for consumption (rather than hatching) is another aspect of the poultry industry; it is also highly organized and controlled by large producers. Facilities, feed, and labor represent the primary costs for these operations, with repayment coming primarily from the sale of eggs. Some income is also derived from the sale of "spent" hens (older hens that are no longer efficient layers). These operations are capital intensive and highly specialized. Loans to egg producers need to be carefully analyzed to determine whether they are properly structured and adequately margined. Assessment of the borrower's overall management ability, and record of profitability, industry trends, and any special risk factors is particularly important in judging loan quality.

OPERATING (PRODUCTION) LOANS

Banks (and other lenders) commonly finance the operating expenses of agricultural producers with short-term operating loans. Expenses financed may include items such as cash rent; seed; fertilizer; chemicals; irrigation; fuel; taxes; hired labor; professional fees; and, for a livestock producer, feed, feed supplements, veterinary care and medicines, and other supplies. Operating loans may take the form of single-purpose financing or line-of-credit financing. The single-purpose loan is the simplest and most basic form of financing, as it does not attempt to address the borrower's total credit requirements, and the repayment source and timing are relatively certain.

Line-of-credit financing may accommodate most of a borrower's operating needs for the production cycle. Advances are made as needed to purchase inputs or pay various expenses, with all income usually remitted to the lender to reduce the line. Depending on the type of operation, the line may seldom be fully retired because funds are advanced for a new operating year before all inventories from prior years are marketed. An operating line of credit is generally established after cash-flow projections for the year are made to anticipate credit needs and repayment capacity. While this type of financing has the advantages of convenience and accurate cash-flow monitoring (which permits comparing actual cash flow with projections), it can also have some disadvantages. The lender may be inadvertently funding or subsidizing other creditors' payments with advances on the line and, because operating cycles overlap, it may be difficult for the lender to get out of an undesirable situation.

An operating line may be revolving or nonrevolving. A revolving line replenishes itself as repayments are made, so the outstanding balance can fluctuate up and down during the approved term. There is no limit on the total amount borrowed during the term of the line, as long as the amount outstanding never exceeds the established limit. A nonrevolving line is structured so that once the approved amount is used, even though payments are made to reduce the line, the borrower must reapply and receive approval for any further advances. Revolving lines afford flexibility but have no firm disbursement or repayment plan, so they are usually reserved for borrowers with strong financial positions, proven financial management, and a history of cooperation and performance. Bank management should continually monitor operating lines and clearly document the purpose for advances and source of repayments. A clean-up period may or may not be required after harvest or completion of the operating cycle, depending on the anticipated schedule for selling farm or ranch production.

The primary source of repayment for an agricultural operating loan is revenue from agricultural production. Many farmers also receive some form of government support payments, and they may have employment off the farm or do custom work (such as harvesting) for hire. In many cases, wages or salaries generated from the nonfarm employment of a farmer's spouse will cover a significant portion of the family's living expenses, relieving the financial pressure on the farming operation. To evaluate repayment capacity, the loan officer must determine how much revenue will be generated from either current production or inventories. Revenues will need to be sufficient to cover all expenses, however, not just those funded by the loan. These could include various operating expenses, family living expenses, payments on capital debt (for real estate and equipment), and any anticipated new capital expenditures. There should also be a margin to cover incorrect assumptions about yields and prices.

Most agricultural lenders recognize the need for yearly cash-flow projections to help determine credit needs and repayment capacity. Projections of both income and expense are usually made for each month (or each quarter) of the year to anticipate the amount and timing of peak financing needs, as well as the total net cash flow for the year. Obtaining and analyzing yearly federal income tax returns (particularly Schedule F) should be strongly encouraged as a means of reviewing actual operating results. Actual data can then be compared with projections to determine variances. Reasons for the variances should be understood as a part of the credit analysis process. This analysis will help the bank decide whether to grant or deny credit and service loans.

If a borrower loses money from operations in one year and cannot fully repay the operating loan, there will be "carryover debt." In general, carryover debt should be segregated, secured with additional collateral if possible, and amortized over a reasonable term that is consistent with the borrower's repayment capacity. Consistent losses and excessive carryover debt can preclude further advances and lead to the sale of certain assets or even to full liquidation of the operation.

Collateral for a typical operating loan includes growing crops, feed and grain, livestock, and other inventories. Normally, a bank also obtains a security interest in equipment, vehicles, government payments, and other receivables to strengthen the collateral margin. For new borrowers, a lien search is recommended to determine the presence of any senior liens. Pledged assets should be valued, either by a knowledgeable bank officer or an outside appraiser, and the operation and collateral should be inspected periodically to judge conditions and values. Inspections for established borrowers are usually done at least annually. More frequent inspections are usually performed on marginal borrowers or if the borrower has a feeder livestock operation with more rapid turnover of assets.

GOVERNMENT AGRICULTURAL SUBSIDY PROGRAMS

Federal government programs have long been able to help farmers financially and, to an extent, control the overproduction of agricultural products. These programs are continually evolving, but remain important in determining many producers' income levels and profitability. In addition to establishing subsidies, the programs also set limits on the number of acres of certain crops that a producer can plant to help control crop surpluses and support price levels.

Conservation Reserve Program

The Conservation Reserve Program (CRP) is a long-term retirement program for erodible land. Landowners submit bids for a 10-year contract, stating the annual payment per acre they would accept to convert the highly erodible land to a grass cover. The maximum bid per acre has been established, and accepted bids must not exceed prevailing local rental rates for comparable land. If the bid is accepted by the local Agricultural Stabilization and Conservation Service (ASCS) office, the landowner must sow the land to grass, with the cost of planting grass shared by the landowner and the government.

During the term of the 10-year contract, the landowner cannot plant a crop on the land, allow grazing on it, or cut the grass for hay. The CRP contract is assignable, so it can be transferred to a new owner along with title to the land.

Farmers Home Administration

The Farmers Home Administration (FmHA) is a federal lending agency operating within the U.S. Department of Agriculture. The FmHA performs two main functions: (1) providing supervised credit to farmers who are unable to obtain adequate credit from commercial banks and (2) improving rural communities and enhancing rural development.

Three basic programs allow the FmHA to extend funds to farmers: (1) grants, (2) direct loans, and (3) loan guarantees. The grant program is the smallest and generally relates to rural housing and community programs, most of which are for water and waste disposal systems. The direct loan programs are for loans made by FmHA through its county and state offices to farmers. The loan guarantee program permits the FmHA to guarantee up to 90 percent of the amount of loss on a loan made and serviced by another lender.

Most FmHA loans are (1) farm-operating loans, (2) farm ownership loans, or (3) emergency farm loans. Operating loans and farm ownership loans are for operators of family farms. Eligible purposes for operating loans include capital loans for machinery and livestock, as well as annual production inputs. Farm ownership loans are available for buying land, refinancing debts, and constructing buildings. Emergency loans are designed for farmers in counties where severe production losses have resulted from a disaster or from economic emergencies.

To qualify for a loan, a borrower must (1) be unable to obtain sufficient credit elsewhere at reasonable rates and terms, (2) be a citizen of the United States, (3) be an owner or tenant operator of a farm not larger than a family farm, and (4) have sufficient training or experience to ensure a reasonable chance of success in the proposed operation.

Banks have been highly motivated to use the FmHA-guaranteed loan program as a means of mitigating risk and perhaps developing a sound customer for the future. An FmHA loan also improves the bank's liquidity, since the guaranteed portion of the loan can be sold in the secondary market.

Small Business Administration

While it is not primarily a lender to agricultural producers, the Small Business Administration (SBA) has made low-interest-rate disaster loans available to individuals, including farmers. The SBA can make or guarantee various types of agricultural loans to producers whose annual revenues do not exceed $500,000. Banks occasionally make these loans, which are supported by collateral as well as a substantial percentage guarantee by the SBA. In many rural areas, however, it is probably more convenient for a bank to work with a nearby FmHA office than with an SBA office, which may be located some distance away in a metropolitan community.

Federal Crop Insurance Corporation

The Federal Crop Insurance Corporation, which is a part of the U.S. Department of Agriculture, writes multiperil crop insurance. The premiums for this insurance are subsidized by the federal government. For further information, see the following subsection on crop insurance.

CROP INSURANCE

The Federal Crop Insurance Reform Act of 1994 combined crop insurance and disaster aid into a single, unified program. To be eligible for any price support or production adjustment program and for new contracts in the conservation reserve program or any FmHA loan, farmers must carry crop insruance coverage. The expanded crop insurance program replaces the need for disaster bills as the federal response to emergencies involving widespread crop loss.

Aside from the basic required coverage under the federal program, known as the catastrophic coverage level, banks encourage some borrowers to carry crop insurance to reduce their risk of not being repaid on farm-operating loans. Borrowers that are more highly leveraged and have minimum margin in their operating loans are most likely to be required to carry crop insurance. Two common types of crop insurance are (1) crop hail insurance sold by private insurers, which insures only against hail damage, and (2) multiperil crop insurance written by the Federal Crop Insurance Corporation. As its name implies, multiperil crop insurance insures against drought, rain, hail, fire, wind, frost, winterkill, disease, and insect losses.

The federal government subsidizes the multiperil crop insurance premium by paying most of its administrative, actuarial, underwriting, and selling expenses. By subsidizing premiums and encouraging more producers to purchase the insurance, the government hopes to reduce the dependency on crop disaster payments when natural disasters occur. However, this program has not been particularly popular with farmers because they would have to suffer a high level of losses on all planted acres to receive any significant proceeds from the insurance. By diversifying their crops and planting in fields that are separated by significant distances, many farmers are willing to risk planting without crop insurance.

EVALUATING AGRICULTURAL MANAGEMENT

A crucial factor in loan analysis for banks, as well as for examiners, is an evaluation of the management capabilities of the agricultural producer. Cash earnings from an operation provide the primary source of repayment for most agricultural loans, so it is important to evaluate the borrower's ability to manage a profitable operation. The three kinds of management that agricultural lenders most often analyze are production, marketing, and financial management.

Production Management

A lender should first assess the borrower's technical ability as a producer of crops or livestock. This is primarily an objective measure because it consists of comparing an operation's output against industry and area norms. An operator whose production levels are consistently below average will probably have difficulty meeting debt-service requirements and may not be able to stay in business. There may be justifiable reasons for occasional years of below-average production, but lenders should be cautious of operators who consistently perform poorly.

Another factor to consider is the producer's ability to successfully cope with the inherent variability of agricultural production. Adverse weather, disease, and pest infestations are all production risks that continually affect crops and livestock. Some producers diversify the commodities they produce to reduce their dependency on one crop or type of livestock.

Marketing Management

Good marketing management enables the producer to reduce price risk exposure. Volatile markets have convinced most producers and lenders that sound marketing is crucial for an ongoing agricultural operation, and almost every producer needs a marketing plan designed to control price risk. Aside from helping to ensure profitability, the plan can be incorporated in formulating a more reliable statement of projected cash flow, which helps both the lender and producer anticipate financing needs.

Some of the techniques that producers use to manage price risk exposure are forward contracting, hedging, purchasing options, and using government programs. See the subsection "Marketing Farm Products" for details.

Financial Management

A producer should have the ability and willingness to understand, maintain, and use financial records. The importance of sound financial records began to be more fully appreciated in the 1980s when agricultural loan losses rose, and many agricultural producers and banks failed. During that time, the primary emphasis for many agricultural lenders shifted from collateral-based lending to cash-flow lending. While collateral may afford ultimate protection for the lender under a liquidation scenario, cash flow allows for repayment of debt in the normal course of business.

In addition to recordkeeping, financial management also encompasses how a producer uses his or her assets and liabilities. Maintaining financial reserves in the form of current assets is one means by which a producer can be prepared to overcome short-run adversity. The reserves need not necessarily be cash; they might be in the form of stored grain or other nonperishable produce or they could be earning assets such as livestock, which is readily marketable. Controlled, reasonable equipment purchases are another indication of good financial management. Overspending on equipment may be indicated if the borrower's equipment list includes many items that are new, especially costly, duplicative, or unneeded for the types of operations being conducted. The presence of sizable nonbank equipment debt on the borrower's financial statement can, in some cases, also reflect overspending.

MARKETING FARM PRODUCTS

Marketing considerations have become more important for many producers as they attempt to maximize returns. Rather than merely selling crops or livestock at prevailing market prices when the production cycle is complete, some producers attempt to lock in a price through the use of forward contracts or futures or options trading. Some producers of nonperishables may simply study market action and cycles and keep harvested crops in storage, waiting for higher prices. Some livestock producers may buy and sell throughout the year to help even out the effects of market fluctuations. Both the bank lending officer and the borrower need to have a clear understanding of the marketing plan, including its potential costs, benefits, and risks.

The following comments briefly describe some of the basic tools producers use as alternatives to the cash market to manage price risk.

- *Forward contracting*. The producer contracts with a buyer to sell farm products at a fixed price in advance of the actual marketing date. These contracts are simple to use if willing buyers can be found, but carry some risk of the buyer's defaulting, particularly if market prices decline significantly before the contract matures. This risk may be mitigated to some extent by requiring the buyer to provide security in the form of a 10 to 15 percent margin to help ensure that the buyer honors the contract.
- *Minimum-price forward contract*. This is a relatively new type of forward pricing that may be available to some producers. It establishes a floor but not a ceiling for the price the producer will receive for his commodities, so

it protects against price declines but permits the producer to garner additional profits if the market rises.

- *Basis contracting*. This is a variation on forward contracting, whereby the price the producer receives is not fixed when the contract is drawn, but will be determined by the futures market price plus or minus some agreed-on difference (basis). For example, cattle for September delivery might be priced at the September futures price (as of a date to be selected by the seller) plus 50 cents per hundredweight. Accordingly, a basis contract does not reduce risk until the price is set by the seller, so if the seller waits to set the price, he or she is still subject to all market risk. However, a basis contract can be combined with a put option (see below) to set a minimum price.
- *Hedging*. Hedging involves the use of counterbalancing transactions to substantially eliminate market risk. The type of hedge typically used by an agricultural producer is sometimes referred to as a ‘‘short hedge’’ because it involves use of the futures market to, in effect, sell short. Later, when the producer's commodities are ready for delivery, he sells them in the cash market. If the price has declined, he makes a profit on the sale of the futures contract to offset the lower price he receives in the cash market. Conversely, if the price has increased, a loss on the futures contract will be incurred to offset the gain in the cash market. Hedging is similar to fixing a price with a forward contract except that the price is said to be an ‘‘expected’’ fixed price, since the difference between the cash and futures prices may not be correctly anticipated and the resulting net price received will vary some from the expected level. Hedging can have an advantage over forward contracting because it is readily available and based on competitively determined futures prices. Since positions in the futures market require the producer to keep a cash margin with the broker, and additional margin calls may have to be met if the market goes up (after the producer has sold short), it is especially important that the bank loan officer be aware of and understand the borrower's marketing plan.
- *Put option*. Buying a put option gives the producer the right, but not the obligation, to sell a commodity at a given (strike) price any time before the put's expiration date. It protects against falling prices because the put becomes more valuable as prices fall. At the same time, a put allows the producer to benefit from rising prices, if they rise more than enough to cover the cost of the put. Puts can also be attractive because they can limit losses by establishing a minimum price at times when current prices are not profitable and the producer is reluctant to fix a low price with forward contracting or short hedging. Puts have the disadvantage of being more expensive than hedging; premiums for put options can be especially high when market prices are high.

Other more complex strategies are sometimes used that combine cash and futures instruments to minimize risk or to modify initial positions to adjust for changing market conditions, including the following.

- *Establishing minimum prices with basis contracts*. Purchasing a put option along with selling commodities on a basis contract establishes a minimum price, while allowing the producer to gain from rising prices.
- *Converting a fixed price into a minimum price*. If a producer accepts a fixed price via forward contracting and later regrets that decision, he or she may decide to purchase a call option (which becomes more valuable as prices rise). The combination of a fixed-price contract and a call option is called a ‘‘synthetic put’’ because the net effect is the same as buying a put option. The producer who has accepted an estimated fixed price via a short hedge can either lift the hedge (cover the open short sale in the futures market) or, depending on circumstances and relative costs, leave the hedge in place and purchase a call option.
- *Converting a minimum price into a fixed price*. If a put option has been used to set a minimum price at very low levels, and prices subsequently increase, the producer can either roll up the put to a higher strike price or sell futures and establish a fixed price when the market reaches an acceptable level. Buying one or a series of additional puts allows the producer to profit from a further rising market but may become expensive.

FINANCIAL AND INCOME INFORMATION FOR AGRICULTURAL PRODUCERS

The financial and income information most commonly used by agricultural lenders includes balance sheets, income tax returns, and statements of projected cash flow. Many producers do not prepare income statements on an accrual basis. Often, their only available income statement is Schedule F of the annual federal income tax return.

Balance Sheet

Balance sheets for agricultural producers usually divide assets and liabilities into three groups—current, intermediate, and long-term—based on the liquidity of assets and repayment schedules of liabilities. Current assets are those that will either be depleted within 12 months or can easily be converted to cash without affecting the ongoing business operation. Current assets include cash, accounts receivable, livestock held for sale, inventories of crops, feed, supplies, growing crops to be harvested within 12 months, and prepaid expenses.

Intermediate assets support production and may be held for several years. Principal intermediate assets include breeding stock, equipment, and vehicles. While these assets may be relatively liquid, their sale would seriously affect the productivity of the operation.

Long-term, or fixed, assets are more permanent in nature and benefit the operation on an ongoing basis. The principal fixed asset of an agricultural operation is farm real estate, although the producer may have other long-term assets, such as investments, which may or may not be related to his or her farming or ranching operation.

Current liabilities include those which must be paid within 12 months, including amounts owed for feed, seed, supplies, interest, and taxes. The amounts of any payments due within 12 months on intermediate-term and long-term debt should also be included in current liabilities.

Intermediate liabilities are generally those due between one and ten years from the statement date, and commonly represent debt to finance equipment and vehicles. As mentioned above, the amounts of payments due on these debts within 12 months are shown as current liabilities.

Long-term liabilities usually are those that, at inception, had a maturity of more than ten years. Debt on real estate is the main type of long-term liability on the balance sheets of most agricultural producers.

The difference between total assets and total liabilities is the net worth of the producer or the equity in the producer's assets. Most producers are individual or family farmers whose balance sheets also include personal assets not directly used in the operation, as well as debts owed on those items.

It is important to remember that the amount shown on the statement for net worth is subject to question. Since it is merely the difference between the amounts shown for total assets and total liabilities, its accuracy depends on how the assets are valued and whether all liabilities are reflected. Most agricultural borrowers value assets on their balance sheets at what they assume to be "market value." However, some tend to use rather optimistic valuations, particularly on items such as equipment and real estate. Also, some borrowers tend to carry the same values forward each year for real estate or equipment, which may cast some doubt on accuracy. Examiners reviewing agricultural credits should try to determine prevailing market prices for various types of land in the bank's trade area and acquire general knowledge of equipment values. Recent published sales data on both real estate and equipment provide reliable indications of current values.

Sometimes not all liabilities are fully or properly disclosed. A form of potential liability that is often not disclosed is the amount of deferred income tax that will be due on the sale of real estate in which the borrower may have a substantial unrealized capital gain. It may not be possible to readily estimate such deferred-tax liability unless the borrower's statement shows both cost and market values. However, the examiner should keep these points in mind in analyzing the balance sheet, in an attempt to accurately assess the borrower's financial strength. Comparison with previous balance sheets, other information in the loan file, and general knowledge about values will aid the examiner in this analysis.

It is advisable to determine how the balance sheet was prepared and by whom. Many are prepared by the borrower and submitted to the bank. Others may be prepared by the borrower and lending officer working together. Presumably, the latter method would tend to ensure a more accurate presentation but, if not, it could raise questions about lending practices or the lending officer's competency. Similarly, balance sheets that do not balance (not an unusual occurrence) might indicate a lack of appropriate analysis by the lending officer.

Balance-Sheet Ratio Analysis

The following are some basic, fairly simple ratios that can indicate the financial strength of a producer.

- *Current ratio (current assets/current liabilities)*. This ratio can reflect a borrower's ability to meet current obligations without additional borrowing.
- *Quick ratio (liquid assets/current liabilities)*. This ratio compares current assets that are easily converted into cash with current obligations and reflects a borrower's ability to immediately meet current obligations.
- *Leverage ratio (total liabilities/net worth)*. This ratio shows the relationship between borrowed capital and owned capital. The higher the ratio, the greater is the reliance on borrowed capital, which means higher interest expense, potentially lower net income, and certainly less equity cushion to withstand risk and adversity. This is often called the *debt-to-worth ratio*.

Ratio Interpretation Guidelines[3]

Ratio	*Low Risk*	*Moderate Risk*	*High Risk*
Current Ratio	1.5:1	1:1–1.5:1	<1:1
Quick Ratio	1.1:1	.8:1–.5:1	<.5:1
Leverage Ratio	.75:1	1:1	1.25:1

Income Statement

Determining actual profitability for most agricultural borrowers is difficult, primarily because of the absence of complete income and expense information on an accrual basis. The most common income statement for agricultural producers is Schedule F of the federal income tax return (''Profit or Loss from Farming''), which accompanies Form 1040. It is prepared on a cash basis, showing cash income received and cash expenses paid, although the taxpayer is also permitted to deduct depreciation expense for items such as equipment, improvements to real estate, and breeding stock. Farmers may have other farm-related income reported on Form 4797, which reports sales of dairy and breeding livestock, or on Schedule D, which shows sales of real estate and equipment. Additional nonfarm income is reported on page 1 of Form 1040. All sources of income need to be considered by lenders and examiners, but for most farm borrowers, Schedule F is the primary report of income for the farming operation.

Tax returns probably provide the most accurate income and expense information for most farm operations. Some lenders attempt to convert the cash basis Schedule F to an accrual basis by adjusting for changes in inventory values, receivables, payables, and similar items, but the process requires timely, detailed financial information that often is not readily available. Instead, many lenders and examiners look at cash-basis income over a three-to-five year period to analyze trends and even out the cash-flow variances caused by differences in production and marketing cycles.

While cash income is not necessarily a good measure of farm business profits, it does help show the cash-flow situation and is useful in planning debt repayment programs and family budgets. In addition, cash income statements can be compared with projected cash flows to determine variances that need explanation or that may indicate the need for changes in the operation.

Operating Ratio Analysis

Key ratios can be calculated from income statements to aid in analysis. The most commonly used ratios measure profitability, repayment ability, and efficiency. Profitability is usually determined by return on equity and return on assets. Repayment ability can be determined by the earnings coverage ratio and debt payment ratio. The most common economic efficiency ratio used is the operating expense to revenue ratio. Although many smaller banks have not used income statements to any extent to analyze agricultural credits, this type of analysis can provide useful insights into an operator's efficiency and repayment ability.

3. These ratio interpretation guidelines are only rules of thumb and need to be viewed in conjunction with a thorough analysis of other pertinent factors, including balance-sheet composition, the nature of the operation, and an assessment of the borrower's management ability.

Return on assets is usually calculated by adding interest expense to net farm income and deducting a management fee (usually an amount for unpaid family labor), then dividing the resulting figure by average total farm assets for the year. Return on equity is usually calculated by deducting a management fee or unpaid family labor from net farm income and dividing the difference by total farm net worth.

Common ratios used to assess debt repayment ability and repayment risk are the earnings coverage ratio and the debt payment ratio. The earnings coverage ratio (also known as the cash-flow ratio) is a measure used to assess the operation's ability to repay. A strong earnings coverage ratio would be 30 percent or above. An acceptable but riskier level would be 10 to 30 percent. The debt payment ratio is used to determine risk over the term of the loan. It is calculated by dividing total annual debt payments by total revenue. As a general rule, total principal and interest payments should not exceed 25 percent of total revenue. A ratio of less than 15 percent would be relatively safe, while a 15 to 25 percent range would indicate some degree of risk.

The operating expense to revenue ratio measures the operating efficiency of the farm exclusive of debt obligations. A ratio of less than 70 percent usually reflects an efficient manager who can service larger amounts of debt. If the ratio exceeds 80 percent, repayment problems could occur if large amounts of debt are outstanding. The ratio tends to be higher for smaller operations.

The following example shows how the earnings coverage, debt payment, and operating expense to revenue ratios are determined from the income statement. This example reflects generally adequate ratios.

1. Total farm revenue	$210,000
2. PLUS: Nonfarm revenue	22,000
3. Total revenue (line 1 + line 2)	232,000
4. LESS: Farm operating expenses (excluding interest and depreciation)	153,000
5. LESS: Family living expenses and income taxes	35,000
6. Earnings available for interest and principal payments and new investments	44,000
7. LESS: Interest and principal payments	32,500
8. Remaining earnings available for risk, uncertainty, or new investments	11,500

Earnings coverage ratio = line 8 divided by line 7	35%
Debt payment ratio = line 7 divided by line 3	14%
Operating expense to revenue ratio = line 4 divided by line 1	73%

Statement of Projected Cash Flow

Projecting cash flow for an agricultural operation gives recognition to the importance of cash flow in servicing the debt of an ongoing operation. It also tends to impose some discipline on both borrower and lender by requiring a thoughtful planning process for the year in terms of anticipated income, expenses, financing needs, debt-servicing requirements, and capital expenditures. For individual or family farm operations, family living expenses should be included in the projections, as well as nonfarm income.

A cash-flow statement typically shows both the timing and amount of cash receipts and expenses. It can be either a forecasting device (statement of projected cash flow) or historical record (statement of actual cash flow). Banks and other lenders most commonly use the statement of projected cash flow because it aids in planning the borrower's credit needs, usually for the coming 12-month period.

A statement of projected cash flow shows not only how much credit is likely to be needed, but approximately when it will be needed. Perhaps most importantly, it shows whether cash income is expected to exceed expenses for the year. It also indicates the likely high point of the credit (amount and time) and the expected cash or debt position at the end of the year. The projected cash-flow statement represents a kind of budget that provides benchmarks against which actual performance can be compared. Significant variances call for explanations and may prompt certain actions to improve future operating results. Historical statements of actual cash flow have value for comparative purposes and can be an excellent aid in preparing projections for the following year, although banks do not typically request them from most agricultural borrowers. They tend to rely, instead, on income tax returns for information on actual operating results.

Cash flow projections are usually made near the beginning of a calendar year, although timing can vary depending on the nature of the operation. The statement is prepared as a spreadsheet normally listing, by month, anticipated cash receipts and disbursements. For each period, the projected operating-loan balance is shown after adjusting for the amount of projected net cash flow.

AGRICULTURAL LOAN POLICIES

Not all banks make agricultural loans, but for many banks, these loans comprise a significant portion of their portfolios. Any bank making agricultural loans should have developed an adequate, formalized set of written policies to guide the lending officers and staff. Agricultural loan policies should address the same general considerations as the policies used for other loan categories, such as desirable, undesirable, or prohibited loans; collateral requirements (including evaluation guidelines); maximum loan-to-value ratios; maximum maturities; documentation requirements; and concentration limitations. Given the specialized nature of agricultural assets and the varied types of operations, the policies should be comprehensive and specifically address the types of agricultural loans the bank intends to make.

Some banks may have general policies, supplemented by separate procedures or practices. Regardless of the individual bank's terminology or the way in which the material is organized, it is important that the bank's board of directors ensure that appropriate written guidance is provided for management in the agricultural lending area. The policies should help ensure that loans are made on a sound basis and provide a framework for identifying, addressing, and resolving problems that arise. Loan grading, either by the loan officers, a separate loan review function, or both is desirable, as well as a general plan for actions to be taken on loans with unsatisfactory grades. The policies should also address collection and charge-off considerations. Agricultural loan policies should be reviewed by the bank's board of directors and modified when deemed necessary. For more detailed guidance on bank loan policy, refer to section 2040.1, ''Loan Portfolio Management.''

AGRICULTURAL LOAN DOCUMENTATION

Loan documentation establishes the bank's legal position as creditor and secured party and evidences the borrower's ownership of and actual existence of collateral. Some documents, such as an insurance policy, give some evidence of collateral values and ensure that tangible collateral is protected. A number of documents play a supporting role, as they provide information that is vital in assessing a borrower s creditworthiness and in demonstrating the borrower's financial capacity to regulatory authorities, auditors, loan reviewers, senior management, and the board of directors. The documents also help management to service and grade the credit, determine the nature and extent of any problems, and formulate plans to resolve them by strengthening the bank's position or averting losses.

Absence of complete and current loan documentation is a weakness in the lending function and can pose a significant threat to the bank's safety and soundness. Some documentation exceptions are noted during virtually every examination, largely due to inadvertent oversights or unavoidable delays in obtaining original or updated documents. However, an unusually large volume of exceptions can be an important indication of weak and deteriorating loan quality. Excessive exceptions reflect unfavorably on management and indicate a need for management to either formulate stronger loan policies and procedures or to emphasize adherence to established guidance.

Many banks use a standard checklist to help ensure that all applicable documents are obtained when a loan is made. Most banks also have either an automated or manual ''tickler'' system to identify when updated documents are needed, such as current financial statements, tax returns, UCC-1 filings, collateral inspections, and evidence of insurance. Because of the large volume of required documents, many of which need to be updated at least annually, it is imperative that bank management be firmly committed to a sound loan documentation program. The program should establish responsibility for obtaining documents, monitoring compliance, and providing follow-up to help ensure that all required documents are obtained in a timely manner.

Not every document is applicable to each agricultural loan. Examiners need to assess which documents are appropriate for a given loan depending on its individual circumstances. There should be little disagreement between examiners and bank management about the basic documents needed. Basic documentation requirements are usually listed in the bank's loan policies or procedures. The need for certain supporting documents may be a matter of judgment, particularly in regard to frequency of updating documents. In most cases, however, bankers and examiners tend to agree on items that are to be considered documentation exceptions. Refer to section 2080.1, "Commercial and Industrial Loans," for further guidance on loan documentation. Following is a list of the types of documents a bank should have in connection with agricultural loans:

- promissory note
- security agreement
- financing statement
- real estate mortgage or deed of trust
- other collateral assignments, as appropriate (such as assignments of third-party notes, mortgages or deeds of trust, life insurance policies, deposit accounts, securities, or other contracts)
- subordination agreements (for example, a prior lienholder may subordinate its lien position to a bank to induce the bank to make a loan)
- appraisals
- hazard insurance policy or certificate of coverage
- cash-flow projections, usually prepared annually
- income tax returns
- financial statements (balance sheets) for the borrower, cosigner, or guarantor
- collateral inspection reports by the bank
- bill of sale for livestock or equipment
- worksheet for each note (showing the purpose, timing, and source of repayment; collateral; total existing bank debt; analysis)
- overall credit analysis (particularly on large or troubled loans)
- loan officer memos and comments
- correspondence

LOAN ADMINISTRATION AND SERVICING

In addition to making agricultural loans, analyzing creditworthiness, setting loan terms, obtaining collateral, and assembling required documentation, management needs to administer the portfolio of outstanding loans. They need to monitor borrowers' performance relative to agreed-upon terms, collateral margins, financial and income data, cash flow, crop prospects, and market trends that may affect borrower performance. If problems arise, bankers need to formulate and implement plans to protect the bank's position.

Farm and Livestock Inspections

A physical inspection of the farming operation is usually performed by bank management before advancing any substantial funds to a new borrower. Subsequent inspections, particularly for larger or more marginal borrowers and for readily moveable collateral, should be performed periodically. Inspections may be performed by the loan officer or by another bank officer or employee with agricultural experience. The inspector usually prepares a fairly detailed report listing farm assets (livestock, equipment, grain and feed on hand, and growing crops) and at least brief comments on the condition of assets and crop prospects. Often, a listing of machinery, equipment, and vehicles is prepared from the bank's records ahead of time to aid in the inspection process; any additions, deletions, or exceptions noted should be shown on the report. Livestock are listed by type, showing numbers, sex, and approximate weight. Values for all items should be shown on the report, based on current market prices. The report may note the number of acres the potential borrower owns and rents, as well as the approximate value of real estate owned. A real estate evaluation might be performed as part of a farm inspection, but a full appraisal, if required, would almost always be performed separately, usually by another individual.

Farm inspections are usually performed annually, unless the borrower has a livestock feeding operation or some other type of operation that involves frequent turnover of assets. Generally, it is desirable to inspect feeder operations approximately every six months or more frequently if deemed necessary. The absence of a current inspection report, especially for larger or troubled borrowers, may be considered a loan-documentation exception.

UNSOUND AGRICULTURAL LENDING PRACTICES

Following is a list of common unsound lending practices, some of which are general and apply to all types of loans while others relate more specifically to agricultural loans. This list includes the most common shortcomings. Depending on the extent of the unsound practices, the examiner should incorporate specific recommendations for improvement into the examination report or formal supervisory action where appropriate.

- absence of or failure to follow sound lending policies and procedures
- failure to require adequate performance on debt
- failure to monitor the borrower's performance and position, commonly evidenced by the—
  - —lack of periodic collateral inspections
  - —absence of current income and financial information
  - —failure to consider the borrower's total debt-service requirements
  - —presence of additional operating debt at another bank; or
  - —absence of a lien search to verify the bank's position in collateral
- inappropriate loan structuring, such as—
  - —untimely or inappropriate repayment schedules
  - —failure to identify or segregate carryover operating debt
- unwillingness to say ''no'' to a financially stressed borrower, which could be an indication of—
  - —overlending (building loan volume without regard to quality or long-term effects on the borrower and the bank)
  - —failure to consider borrower's management capabilities
  - —failure to analyze or project costs of production
  - —failure to observe market trends.
- lending for speculative purposes
- lending outside of the bank's normal trade area
- lending on new or unproven types of operations or operations in which bank management has little or no experience

TROUBLED AGRICULTURAL LOANS

Aside from readily identifiable problem loans such as past-due loans, loans on nonaccrual status, loans on the bank's watch list or those that were previously classified, or loans to borrowers who have filed for bankruptcy, the following characteristics may indicate existing or potential problems. Examiners should keep in mind both current conditions and trends.

- undermargined collateral position
- unusually high leverage
- marginal liquidity
- heavy investment in equipment, vehicles, or real estate
- need for unplanned credit advances
- deficiencies or problems revealed in the collateral inspection
- unfavorable financial trends (especially increasing debt-to-worth ratio or declining collateral margins)
- lack of performance (renewals without appropriate performance)
- capitalizing interest on debt
- charge-offs
- inability to meet scheduled debt payments
- tax problems
- reluctance of borrower to provide current, complete, and accurate financial information
- notification of insurance cancellation for failure to pay premium
- evidence of legal action against the borrower
- overdependence on guarantors
- overdependence on anticipated inheritance

CHAPTER 12 BANKRUPTCY

Chapter 12 bankruptcy for family farmers became effective in November 1986. It was designed specifically for the family-farm debtor and permits family farmers to reorganize farm debt so that the amount of the debt approximates the value of the collateral. Only a ''family farmer with regular annual income'' (which can be a partnership or corporate structure) may file a chapter 12 bankruptcy. To be eligible, a debtor must meet *all* of the following tests:

- have a farming operation
- have no more than $1.5 million in total debts
- derive at least 80 percent of total debts (exclud-

ing debt on the principal residence) from the farming operation

- derive more than 50 percent of the family's income from the farming operation during the year immediately preceding the filing

The family farmer will have regular annual income if the court finds the annual income to be sufficiently stable and regular to enable the farmer to make payments under the chapter 12 plan.

Under chapter 12, there is no requirement for accelerated payment of arrearage as there is with chapter 13. Instead, the farmer/debtor can commence making plan-required payments from the start of the chapter 12 bankruptcy. Also, a farmer/debtor will have the ability to modify a promissory note and continue payments on it beyond the life of the chapter 12 plan if the court approves the modification; in such cases, the creditor cannot object.

A secured creditor will be "adequately protected" during the chapter 12 bankruptcy if it receives cash payments to offset any decrease in the value of collateral and, in the case of farmland, if the creditor is paid a reasonable rental fee based on the earning capacity of the property. Also, chapter 12 does not allow the creditor to recover "lost opportunity costs," so the creditor will not be entitled to interest and other gains that would have been received by the creditor had bankruptcy not been filed. Elimination of the lost-opportunity-cost provision makes it more difficult for creditors to obtain a lift of stay on the grounds that there is not adequate protection.

Before confirming the chapter 12 plan, a court may permit a farmer to sell pledged assets without the consent of the secured creditor, although proceeds from the sale must go to the secured creditor. Creditors may bid at the sale, and collateral that is not sold will be subject to current evaluation in determining what amounts will be claimed by secured creditors under the plan. There is no time limit on the duration of a chapter 12 plan, except for a three-year limit (or five years with court approval) on unsecured debts.

If a chapter 12 debtor voluntarily dismisses the case, he is prohibited from refiling for 180 days. The law also provides for a dismissal from chapter 12, or a conversion to chapter 7, when the debtor commits fraud. Any other provisions of chapter 12 that are not discussed here are generally similar to those in chapter 11 and chapter 13 bankruptcy proceedings.

WORKING OUT PROBLEM AGRICULTURAL LOANS

When significant problems arise in agricultural credits, bank management resolves the problems in a timely manner to protect and strengthen the bank's condition. A sound and accurate loan-grading system, supported by a competent internal loan review program, will help to ensure timely identification of problems. Regulatory examinations provide an independent assessment, which may identify additional problems that management has not recognized. Once problems are identified, the following considerations are important in a workout program:

- identify the source of the problem
- establish a workout plan designed to strengthen the borrower and to minimize loss to the bank
- set at least a tentative timetable for the workout
- reach agreement with the borrower on the plan, if possible
- monitor progress frequently

Alternative actions in a workout plan might include—

- reducing the bank's exposure in outstanding debt by—
  - —obtaining additional collateral,
  - —obtaining financial assistance through sound cosigners, guarantors, or government guarantees,
  - —encouraging the borrower to modify his operations, or
  - —restructuring the credit to reduce the interest rate or payments
- advancing more funds to—
  - —refinance existing nonbank debt on more favorable terms or
  - —improve the bank's overall collateral position (for example, take out a small balance to a senior lender to put the bank in a first lien position)
- reducing or eliminating outstanding bank debt by—
  - —selling assets, which can range from a partial sale to reduce debt burden and improve chances for survival to a complete liquidation;

—refinancing a portion of bank debt (such as real estate) elsewhere if more favorable rates or terms are available; or
—recognizing a loss by partial or complete charge-off of the credit.

EXAMINER REVIEW OF AGRICULTURAL LOANS

A review of agricultural loans during an examination will follow the same basic guidelines employed in reviewing commercial or real estate loans. Certain practices, types of collateral, and documents may be unique to agricultural loans, and credit analysis will be somewhat specialized. However, the objectives of assessing credit quality based on the borrower's financial strength, cash flow, collateral, history of performance, and indications of management capabilities are much the same as for other loan types.

Sample size and sampling techniques will vary with the planned scope of the examination and size of the bank and its agricultural loan portfolio. As a minimum, the examination scope would usually include past-due and nonaccrual loans, watch-list loans, previously classified loans, insider loans, and some portion of other loans. See section 2080.1, ''Commercial Loans,'' for details regarding this topic.

Classification of agricultural loans should be made using the same criteria established for other types of loans. See section 2060.1, ''Classification of Credits,'' for regulatory definitions of substandard, doubtful, and loss classifications, as well as the special mention category and guidance on classifying loans.

1. To determine if lending policies, practices, procedures, and internal controls for agricultural loans are adequate.
2. To determine if bank officers are operating in conformance with the established guidelines.
3. To evaluate the agricultural loan portfolio for credit quality, performance, collectibility, and collateral sufficiency.
4. To determine the scope and adequacy of the audit function.
5. To determine compliance with applicable laws and regulations.
6. To initiate corrective action when policies, practices, procedures, objectives, or internal controls are deficient or when violations of laws or regulations have been noted.

INTRODUCTION

This section is intended to provide guidance to examiners reviewing small, noncomplex production loans, usually to small independent oil and/or gas operators. The examination of a loan to a small oil or gas operator is considerably different from the examination of most commercial loans, and is similar in some respects to examinations of real estate loans. The only asset that many small independent operators have is oil or gas in the ground or both. Loans to operators are based solely on the predicted cash-flow value of the oil or gas production. Therefore, a production loan is a loan secured by interests in oil and/or gas production properties. Cash flow generated from the future sale of encumbered oil and/or gas reserves is the primary, and in some cases, the only credible source of repayment. Therefore, production payments are usually assigned to the bank, and the liquidation value of collateral is expected to be sufficient to pay off the loan at any time. In considering this or any type of secured loan, the banker will determine or judge the character, capacity, credit history, and other credit factors related to the borrower. Also, the bank must determine that the operator of the properties is capable and dependable.

Because cash flow generated from the future sale of oil or gas is the justification or basis for production lending, only proved-producing reserves are acceptable collateral for a bank because they provide sufficiently predictable cash flow for debt service. For this reason, loan values are predicated primarily on reserves that are proved-developed-producing properties.

DEFINITIONS OF RESERVES

Reserves are classified into one of three categories: proved, probable, or possible, with proved divided into three subcategories.

Proved Reserves

- *Proved-developed-producing.* These wells have been drilled and completed, and are producing oil or gas.
- *Proved-developed-nonproducing.* These are generally proved-developed reserves behind the casing of existing wells or at minor depths below the present bottom of such wells that are expected to be produced through these wells in the predictable future. The development cost of this type of reserves should be relatively small compared with the cost of a new well.
- *Proved-undeveloped.* These are reserves that are proved resources to be recovered from new wells on undrilled acreage or from existing wells requiring a relatively major expenditure for recompletion.

Probable Reserves

- *Probable reserves.* These reserves might include those expected to be producing from existing or planned wells in areas anticipated to be economically beneficial, based on geological or seismic data.

Possible Reserves

- *Possible reserves.* These reserves include those whose existence may be inferred from geological considerations, including potential reserves from planned waterfloods or other recovery techniques that have not been proved.

EVALUATION OF RESERVES

When a lender decides to proceed with financing secured by oil or gas reserves, an engineering report will be obtained. The initial step to determining the loan value of the collateral or assessing the creditworthiness of a production loan is an analysis of the engineering report. Banks that make production loans will usually have a petroleum engineer on staff or contract with an engineering consultant firm to provide an engineer's report on the properties to be pledged. Basically, the engineering report consists of determining reserves and production forecasts and then applying the pricing and costs to arrive at the net lease operating income available for debt service. This report is comparable to a real estate appraisal in its importance and function.

The following table is a very simple presentation compared with the typical evaluation of oil and gas properties in an engineer's report. Typically, most reports will detail five or more years with the last row including all remaining years. Production is usually broken down into categories of oil and gas, and sometimes the number of wells is detailed. Expenses may be divided into major components such as operating costs; production and ad valorem taxes; depreciation, depletion, and write-off of intangibles; general and administration expenses; and taxes on income. Also, if the owner expects to make capital improvements from income, a column may be added for that factor. Some reports include the pro forma amount and terms of the loan to aid the analysis.

Engineering reports must be generated by a fully qualified petroleum engineer. The lender must have complete confidence in the engineer's ability and intellectual honesty, as well as in the quality of the data and its susceptibility to analysis. The integrity of engineering data that depict future cash stream is critical to the initial lending decision and equally important to an examiner in the assessment of credit quality. In summary, an acceptable engineering report must be an independent, detailed analysis of the reserves prepared by a competent engineer. The examiner should carefully review the following three elements.

Pricing

The value assigned to production and expenses must be realistic. Operating costs are based on what similar operations in similar areas have been or, in the case of producing reserves, on historical performance, which may be escalated at some reasonable percentage each year. The report should consider increases and decreases in price as well as cost inflation over the "life of the properties." The future price of oil is a judgment factor and should be based on conservative pricing and can include some reasonable escalation each year. This information can be obtained from a number of reliable sources, and the examiner should determine the source to judge the reliability of report information. The prices used for gas are usually contract prices plus escalation-clause rates. Special care is necessary in evaluating gas contracts, including their reasonableness in light of current conditions and the ability and willingness of the purchasers to honor the contracts. In some instances, certain purchasers have broken contracts or exercised "market-out" clauses to cease complying with long-term purchase commitments. The Securities and Exchange Commission requires reserves with renegotiable contracts or under market-out clauses to value the reserves at spot prices at the date of renegotiation or immediately, in the case of market-out clauses.

TABLE 1
ENGINEER'S REPORT—EVALUATION OF OIL AND GAS PROPERTIES

Year	*Production $18 per Barrel (bbl)*	*Future Income*	*Operating and Other Expenses*	*Future Net Income*	*Present Worth (PW) Future Income @10%*	*PW Future Net Income @10%*
1	5,000	$ 90,000	$10,000	$ 80,000	$ 85,800[1]	$ 76,300
2	4,000	72,000	8,000	64,000	62,400	55,500
3	3,000	54,000	7,000	47,000	42,600	37,000
4	2,000	36,000	6,000	30,000	25,800	21,500
5	1,000	18,000	5,000	13,000	11,700	8,500
Total	15,000	$270,000	$36,000	$234,000	$228,300	$198,800

1. For present-worth calculations, usually ½ year is used for the first period, 1½ for the second period, and 2½ for the third period, and so on.

Present Worth

Present worth is used to recast future income into the equivalent dollar value today; it should reflect current market interest rates. The present worth of future net revenues is used to help determine the maximum amount that can be loaned.

Timing

Preferably, the report should be no more than six months old. A report that is up to 12 months old may be acceptable in some cases; however, it should not be more than 12 months old. Change is the most important factor in determining the adequacy and timeliness of reports. Recent significant price fluctuations or changes in interest rates may require the examiner to adjust the valuation of the reserves to reflect current conditions.

The engineer is responsible for ensuring that the evaluation includes only proved-developed-producing reserves, unless otherwise directed by the lender. In some cases, the lender might give value to a property or well that is proved-developed-nonproducing if it has been drilled and completed, but is not producing because sales facilities or a gas pipeline hookup has not been completed. The lender would, however, deduct a safety factor by cutting back the reserves assumed to be dedicated to that well because the margin of error increases. However, the lender will not generally loan against proved-undeveloped, probable, or possible reserves because of the speculative nature of those categories. Their inclusion as collateral is usually as an abundance of caution with little or no value assigned to them.

A judgment has to be made on the probable accuracy of predictions of future revenues. The engineer evaluates geologic conditions such as sand continuity, faulting, spacing, the number of wells, the diversity of properties, well productivity, the pressure production history, and overall data quality, as well as the degree of confidence the engineers have in their own numbers. Estimates based on well-established production performance are given the most credibility. Lesser weight is given to estimates derived from more speculative methods such as volumetrics, analogy with similar reservoirs, or a computer simulation of new producing zones. The examiner should carefully review the narrative portion of the engineer's report to help determine its usefulness. It will detail what data were available, how they were used, the methods of analysis, and whether a field inspection was made, including individual well tests. This section of the report should inform the examiner of the true condition of the well and reserves. It is possible for the projected cash flow to portray one picture while the narrative portrays an entirely different one.

Generally, a bank will loan up to 50 percent of the net present value of proved-developed-producing reserves; however, a lower percentage may be needed depending on a number of factors. If the reserves are in an area that is highly faulted, or if seismic work and drilling indicated that a zone is contiguous from one well to the next and the porosity and permeability of the pay-zone rock are very similar, then a smaller percentage will be used. To avoid the possibility that any individual, unforeseen event will have a significant effect on the total projection, a wide spread of properties is preferable. This applies not only to a concentration of value in any one well, but also to a concentration in one reservoir, field, or producing area. Generally, a safety factor of not less than 2:1 will be used on proved-producing properties, but on long-life and high-quality reserves, a safety factor of 1.5:1 is sometimes used. However, wells that are highly faulted may require a 3:1 or higher safety factor. Terms will usually require that the loan be fully repaid before the safety factor is reduced.

DOCUMENTATION

The documentation for a term loan is relatively simple. There is a note, a loan agreement, a deed of trust/mortgage, an assignment of production (usually in the mortgage), a title opinion, and a security agreement/financing statement. The assignment of oil and gas interests is unique because oil and gas are treated as real property while in the ground but convert to personal property interests as production is generated at the wellhead. Most lenders also require an affidavit as to payment of bills. Also, the owner or the operator is usually required to guarantee payment of the loan.

The bank will obtain an acceptable title opinion that indicates the borrower has, on the date of the loan, clear title to each of the leases under mortgage and that properties are free and clear of all liens. After the loan is closed, the bank will send a letter of instruction to notify the company sending out production checks that the bank has taken a lien on the production and to request that production checks be sent directly to the bank. The mortgage covers surface rights and mineral interests. A copy of the mortgage containing an assignment of production will be sent to the company purchasing the production, along with a request that division orders or transfer orders be prepared recording its interest in production payments. This authorizes the purchaser to send production payments directly to the bank for the account of the borrower. The security agreement and financing statement covers removable equipment, oil and gas inventory above the ground, and accounts receivable. The financing statements are filed in the real estate records of the county in which the properties are located (usually with the county clerk) and in the secretary of state's office. This filing is done to perfect security interests in equipment, which may be moved from place to place. However, some states have different requirements, and the examiner should be familiar with each state's filing requirements. The affidavit as to payment of bills is executed by the borrower to ensure that all the bills have been paid on the properties or will be paid out of loan proceeds. If bills are to be paid out of proceeds, the bank should ensure that payments are verified. The loan agreement should be read very carefully by the examiner with close attention paid to both positive and negative covenants.

The bank will usually take a collateral interest in equipment, accounts receivables, and inventory. The deed of trust/mortgage will cover real estate, surface rights, and mineral interests, and a security agreement will cover removable equipment, oil as inventory (in tanks), and accounts receivable. An appropriate filing is needed for each type of collateral. Filing requirements may vary from state to state and should be researched. Generally, collateral documents should be filed with the state and county. It is reasonable to expect the bank to have collateral files completed within two to three months.

CLASSIFICATION GUIDELINES FOR TROUBLED PRODUCTION LOANS

The classification of production loans is like all loan classifications in that it must be predicated on an independent assessment of all credit factors that are germane to the specific credit being reviewed. A comprehensive analysis of the credit must take place if any of the following factors are present:

- The loan balance exceeds 65 percent of the discounted present worth of future net income (PWFNI) of proved-developed-producing reserves, or the cash-flow analysis indicates that the loan will not amortize over four to five years.
- The credit is not performing in accordance with terms or payment of interest and/or principal.
- The credit is identified by the bank as a problem credit.
- Other factors indicate a potential problem credit.

After performing the analysis, the examiner must determine if classification is warranted. When classification is warranted, the following guidelines are to be applied when repayment of the debt is solely dependent on oil and/or gas properties pledged as collateral. A lesser percentage or less severe criticism may be appropriate when other reliable means of repayment exist for a portion of the debt.

Proved-Developed-Producing Reserves

Sixty-five percent of discounted PWFNI should be classified substandard when the discounted PWFNI is determined using historical production data (decline-curve-analysis engineering). When less than 75 percent of the reserve estimate is determined using historical production data, or when the discounted PWFNI is predicated on engineering estimates of the volume of oil/gas flow (volumetric and/or analogy-based engineering data), the collateral value assigned to substandard should be reduced accordingly. The balance, but not more than 100 percent of discounted PWFNI of proved-developed-producing (PDP) reserves, should be extended doubtful. Any remaining deficiency balance should be classified loss.

Other Reserves

In addition to PDP, many reserve-based credits will include proved-developed-nonproducing reserves, shut-in reserves, behind-the-pipe reserves, and proved-undeveloped properties (PUPs) as collateral. Due to the nature of these other reserves, there are no strict percentage guidelines for the proportion of the credit supported by this type of collateral that should remain as a bankable asset. However, only in very unusual situations would the proportion of collateral values assigned to a classification category approach the values for PDP. The examiner must ascertain the current status of each reserve and develop an appropriate amount. Examples could be reserves that are shut in due to economic conditions versus reserves that are shut in due to the absence of pipeline or transportation. PUPs require careful evaluation before allowing any bankable collateral value. An example of a bankable value for a PUP could be one that has a binding purchase contract. In every classification where a bankable value is given for any of these other reserves, the loan write-up should fully support the examiner's determination.

The above guidelines apply to production loans that are considered collateral-dependent and are devoid of repayment capacity from any other tangible source. Rarely should bankable consideration be given to loans that are completely collateral dependent in excess of the liquidation value of the pledged reserves. Once again, there is no substitute for a specific, case-by-case analysis of applicable credit and collateral factors pertaining to each individual credit. Frequently, when a lender encounters problems with a production credit, numerous other types of assets (for example A/R, inventories, or real estate) are encumbered in an effort to protect the bank's interests. Other types of collateral and sources of repayment should be carefully evaluated on a case-by-case basis.

SAMPLE CASE

The following case describes some of the general principles related to production lending. A customer applied for a $100,000 loan to help fund the purchase of oil reserves, which will be used to secure the note. Based on an analysis, the loan officer agreed to make a loan and secure it with oil production. As part of the analysis, the loan officer ordered an engineer's report on the properties to determine the half-life of the cash flow—the point at which 50 percent of cash flow available for debt service has been depleted. Using table 1 (presented earlier in the "Evaluation of Reserves" subsection), the loan officer determined that cumulative PWFNI equals $198,800 and 50 percent of that amount equals $99,400. In the next step, the loan officer determined the point in time that $99,400 is reached, which in this case is 17 months. Based on these calculations, the loan officer determined that the maximum loan should not exceed $99,400 and should be repaid within 17 months. He offered a term loan to the borrower for $99,400 with 17 monthly payments of $5,847 principal plus interest of 12 percent. Although the loan request was for $100,000, the borrower accepted the offer. Shortly after the loan is made, the value of oil declines from $18 bbl to $12 bbl, and the discount used for evaluations increases from 10 to 15 percent. As a result, table 1 was revised. Table 2 includes these new factors.

TABLE 2
ENGINEER'S REPORT—EVALUATION OF OIL AND GAS PROPERTIES

Year	*Production @$12 bbl*	*Future Income*	*Operating and Other Expenses*	*Future Net Income*	*PW Future Income @15%*	*PW Future Net Income @15%*
1	5,000	$ 60,000	$10,000	$ 50,000	$ 56,000	$ 46,600
2	4,000	48,000	8,000	40,000	38,900	32,400
3	3,000	36,000	7,000	29,000	25,400	20,400
4	2,000	24,000	6,000	18,000	14,700	11,000
5	1,000	12,000	5,000	7,000	6,400	3,700
Total	15,000	$180,000	$36,000	$144,000	$141,400	$114,100

The loan now exceeds 65 percent of PWFNI of PDP reserves, and a comprehensive analysis of the credit is performed. Because the obligor is devoid of other repayment capacity or other reliable means of repayment, with total support of the debt provided solely by the pledged production, the loan should be classified. Sixty-five percent of discounted PWFNI of PDP reserves equals $74,165, and this amount will be classified substandard. The balance of $16,827, which is also supported by discounted PWFNI of PDP reserves, should be classified doubtful. The loan should be placed on nonaccrual status with any outstanding interest classified as loss.

TERMINOLOGY

The following are abbreviated explanations or discussions of some of the terms found in engineering reports and energy-lending transactions.

Analogy-based engineering data. Comparative analyses relating past performances of comparable properties to determine possible future reserves.

Assignment of production. Usually in the mortgage agreement, it allows direct payment from purchaser to the bank for oil production. Gas purchases generally are paid to the operator, and the operator then pays the bank.

Carried interest. When a party or parties have their expenses paid (carried) by other parties up to a specified limit.

Decline curves. Used to determine reserves by extrapolation of historical production data.

Deed of trust/mortgage. Covers real estate, surface rights, and mineral interests. Mortgage is unique because oil and gas are treated as real property while in the ground but converted to personal property interests as production is generated at the wellhead and as oil and gas enter storage tanks or a pipeline. The security agreement portion of the oil and gas mortgage will usually cover fixtures and equipment affixed to the well site.

Development wells. Drilled in the proven territory of a field, they have a high likelihood of producing oil or gas.

Division orders. Set out the borrower's interest in the property and direct production payments. Division order title opinions can be used to verify ownership and will contain the legal description of properties.

Escalating. Involves the difficult task of predicting future prices of oil and gas for valuing production. Escalating the value of production usually increases the risk to the lender. Examiners should carefully review the basis for escalating values when it has a significant impact on the value of the collateral and/or cash flow. Also, the examiner should carefully review how future expenses related to each well are estimated.

Exploratory well. Also known as a ''wildcat,'' a well drilled in an unproven area. The term originated in early drilling days in Pennsylvania when wells were drilled within the sight and sound of wildcats.

Fault. A break or fracture in the earth's crust that causes rock layers to shift.

Field. An area in which a number of wells produce from a reservoir or from several reservoirs at various depths.

Formation. A bed or deposit of substantially the same kinds of rocks.

Fracturing, frac'ing, frac job. Refers to pumping fluids under extremely high pressure into a formation to create or enlarge fractures through which oil or gas can move. Propping agents such as sand are sent down with fluids to hold the fractures open. Many completed wells require additional treatment (stimulation) before oil or gas can be produced.

Lease. A contract between the landowner (lessor) and the lessee that gives the lessee the right to exploit the premises for minerals or other products and to use the surface as needed. However, surface damages would normally have to be reimbursed. Surface ownership is different from mineral ownership in many cases. Also, if drilling does not begin during a specified time period, the lease will expire.

Lithology. The scientific study of rocks.

Log(s). Used to record three basic measurements: electrical, radioactive, and sonic. The logging device is lowered into the well bore and transmits signals to the surface. These are recorded on film and used to make a log showing the recorded measurements that are used to analyze the formation's porosity, fluid saturation, and lithology. The log's header gives the log's type and date, the operator, the well name, and other information.

Market-out. A clause that basically allows the purchaser to stop paying the original contract price and institute a lower price with the intent of maintaining the marketability of the gas. Some contracts allow the producer to be released from the contract if he refuses the lower price or may offer other remedies.

Mineral rights. The ownership of minerals under a tract, which includes the right to explore, drill, and produce such minerals, or assign such rights in the form of a lease to another party. Mineral-rights ownership may or may not be severed from land-surface ownership, depending on state law. Title in fee simple means all rights are held by one owner; the fee in surface owner does not hold mineral rights. The term ''minerals'' is loosely used to refer to mineral ownership and even, incorrectly, to royalty ownership. A mineral acre is the full mineral interest under one acre of land.

Operator. The manager of drilling and production for the owner.

Perforations. The holes in casing and cement through which oil and/or gas flow from formation into wellbore and up to surface.

Permeability. A measure of how easily fluids may flow through pore spaces. A tight rock or sand formation will have low permeability and, thus, low capacity to produce oil or gas. Wells in these zones usually require fracturing or other stimulation.

Porosity. Refers to the pore space in rock that enables it to hold fluids.

Reservoir or pool. A single accumulation of oil or gas trapped in a rock body.

Reserves. The estimated amount of oil and gas in a given reservoir that is capable of being profitably recovered, assuming current costs, prices, and technology. Not to be confused with oil and gas in place, which is the total amount of petroleum in the earth regardless of whether or not it can be recovered. Recovery is a function not only of technology, but of the marketplace.

Reserve interest. The term used to describe the percent of revenue received.

Royalty interest. The share of gross production proceeds from a property received by its mineral owner(s), free of exploration, drilling, and production costs. Typically one-eighth to one-sixth of production, but fractions may be higher. Royalty payments take precedence over all other payments from lease revenues.

Primary, secondary, and tertiary recovery. Relates to the method of obtaining production from a well. Primary recovery is production from a reservoir through flowing or pumping wells because of the existence of natural energy within the reservoir. This usually recovers about 10 to 35 percent of the oil and gas in place. Secondary recovery is any method by which essentially depleted reservoir energy is restored. This may be accomplished by injection of liquids or gases or both. Tertiary recovery is any enhanced method employed after secondary recovery and is generally very costly.

Runs. A term used to refer to oil or gas production income from a lease.

Seismic survey or shooting. A method of gathering information by recording and analyzing shock waves artificially produced and reflected from subsurface rocks.

Stripper wells. Wells that make less than 10 barrels of oil per day based on the last 12 months or wells that make less than 60,000 cubic feet of gas per day based on the last 90 days.

Volumetric calculations. Determine oil or gas reserves by use of rock volume and characteristics.

Working interest. Also referred to as an operating interest, the term used to describe the lease owner's interest in the well. Lease owners are the ones who pay for drilling and completing the well. Lease owners pay 100 percent of cost and receive all revenues after taxes and royalties are paid.

Workover. Relates to the process of cleaning out or other work on a well to restore or increase its production.

Energy Lending—Production Loans
Examination Objectives
Effective date May 1996

Section 2150.2

1. To determine if policies, practices, procedures, and internal controls for energy loans are adequate to identify and manage the risks the bank is exposed to.
2. To determine if bank officers are operating in conformance with the established guidelines.
3. To evaluate the portfolio for performance, credit quality, collateral sufficiency, and collectibility.
4. To determine the scope and adequacy of the audit function.
5. To determine compliance with applicable laws and regulations.
6. To initiate corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws or regulations have been noted.

INTRODUCTION

Asset-based lending is a specialized area of commercial bank lending in which borrowers assign their interests in certain accounts receivable and inventory, and in selected cases fixed assets, to the lender as collateral. In asset-based lending, the primary repayment source is the conversion of the pledged assets into cash. Asset-based lending differs from a commercial loan in which the bank takes a security interest in all accounts receivable and inventory owned or acquired by the borrower. This section will discuss asset-based lending in relation to the characteristics of the borrower, its advantages to the borrower and the bank, credit and collateral analysis, documentation, and safeguards to ensure the authenticity and collectibility of the assigned receivables.

The examiner must judge the quality of the asset-based credit by evaluating the financial condition and debt-servicing ability of the borrower and the quality of the collateral. In addition, the examiner must evaluate the bank's credit policy, internal controls, audit procedures, and operational practices.

Many borrowers whose financial condition is not strong enough to allow them to qualify for regular, secured commercial bank loans may use asset-based loans to meet their financial needs. Some examples of asset-based borrowers are—

- businesses that are growing rapidly and need year-round financing in amounts too large to justify commercial lines of credit secured by blanket liens on accounts receivable and inventory,
- businesses that are nonseasonal and need year-round financing because working capital and profits are insufficient to permit periodic cleanups,
- businesses whose working capital is inadequate for their volume of sales and type of operation, and
- businesses that cannot obtain regular commercial loan terms because of deteriorating credit factors.

Some advantages of asset-based lending for the borrower are—

- efficiency in financing an expanding operation because the business's borrowing capacity expands along with increases in levels of accounts receivables, inventory, and sales;
- the ability to take advantage of purchase discounts because the company receives immediate cash on its sales and is able to pay trade creditors in a timely manner (consistent usage of purchase discounts reduces the cost of goods sold and enhances the gross profit margin); and
- the interest paid on asset-based loans may be lower than for alternate sources of funds.

Some advantages of asset-based lending for banks are—

- a relatively high-yield loan is generated commensurate with the perceived credit risk of the borrower;
- a depository relationship is formed that provides income and enhances the bank's ability to monitor changes in the borrower's cash flow and overall financial condition;
- banking relationships with longstanding customers whose financial conditions no longer warrant traditional commercial bank loans can continue;
- new business is generated by prudently lending to financially weaker customers who could not qualify for normal commercial loans; and
- potential loss is minimized when the loan is collateralized by a percentage of the accounts receivable and inventory.

CREDIT ANALYSIS

Although asset-based loans are collateralized and closely monitored, it is important to analyze the borrower's financial statements. Even if the collateral is of good quality and supports the loan, the borrower should demonstrate financial progress. Full repayment through collateral liquidation is normally a solution of last resort. An examiner should analyze the borrower's financial statements with particular emphasis on trends in working capital, review trade reports, analyze accounts receivable and inventory turnover, and review the agings of receivables and payables. Furthermore, the prompt payment of taxes, especially payroll taxes, should be verified. One reason for a company to obtain asset-based financing is to maximize discounts offered by suppliers; therefore, it should pay creditors promptly upon receiving the financing.

Bank management's ability to recognize a customer's financial problems as they develop, and to initiate orderly liquidation, if necessary, is important in the supervision of asset-based financing. Theoretically, a borrower's line could be fully liquidated by discontinuing further advances, collecting the assigned receivables, and liquidating pledged inventory. However, such drastic action would most likely cause the borrower's business to close, resulting in a probable deterioration of the receivables from new disputes and in returns and offsets. Consequently, the bank usually notifies its borrower of a contemplated liquidation, which gives the borrower time to seek other means of continuing business so that the bank's loan may be liquidated in an orderly manner without losses or other adverse effects. Unless the bank has initiated an orderly liquidation, examiners should specially mention or classify receivable and inventory lines in which the borrower's financial position has declined so that continued financing is not prudent. When a liquidation is occurring, classification of the credit may not be necessary if the borrower's business is continuing, the existing collateral is of good quality, liquidation value sufficiently covers outstanding debt, and no collateral deterioration is anticipated.

A related issue concerning asset-based loans is the amount of excess availability associated with the revolving line of credit. The quantity of a borrowing company's excess availability is an excellent indicator of whether it has the capacity to service its loan. If a status report shows little availability, the borrower has used all of the cash that the pledged receivables and inventory are capable of generating under the asset-based line of credit. Since these loans may not yet be on the bank's watch list or problem-loan report, it is important for the examiner to track, over a fiscal-year period, a borrower's changing levels of availability when performing an analysis of creditworthiness. This analysis is especially critical for borrowers whose business is seasonal. Initial credit analyses of potential asset-based loan customers should include detailed projections showing that availability under revolving lines of credit at anticipated advance rates would be sufficient to meet the borrower's working-capital needs. Occasionally, overadvance lines are part of the initial credit facility.

Bank management must continually evaluate the realizable value of receivables and inventory pledged. To do so, management should review the quality of the receivables and inventory pledged, including documentation; the safeguards imposed to ensure the authenticity and collectibility of the assigned receivables; and the loan agreement and compliance therewith. The information obtained is sometimes difficult to interpret unless it is related to other periods, comparable businesses, or industry statistics. Comparative analysis helps indicate the continuing value of the collateral.

Lender-liability exposure is a risk in all types of commercial lending, but especially in asset-based lending. Borrowers using asset-based financing are generally very dependent on its continuation, so an abrupt cessation of a line of credit would be more likely to result in legal action against a lender. To protect themselves as much as possible from lender-liability lawsuits, banks frequently use time notes (with renewal options). Time notes are supported by loan agreements that usually include more numerous and detailed loan covenants. Legal counsels for both the lender and borrower should approve the loan agreement and covenants. At times, the borrower may not comply with one or more covenants in a loan agreement. The lender may agree to waive specific covenant violations to give a borrower time to take corrective action. If a covenant such as a financial covenant requiring a minimum capital level is waived, the waiver should be formally communicated to the borrower in writing. The lender should avoid both not taking action for a period of time and not issuing a written waiver for a covenant violation. In either case, if a covenant violation is subsequently used as a reason to cancel an asset-based loan, the lender is more vulnerable to lender liability. The lender should be careful to be consistent in all actions regarding the borrower.

ASSET-BASED LOAN AGREEMENTS

An asset-based loan agreement is a contract between a borrower and the bank that sets forth conditions governing the handling of the account and the remedies available in the event of default. The following areas should be addressed in the loan agreement:

- *Eligible accounts receivable.* This involves identifying classes of receivables that will not be regarded as acceptable collateral. Certain types of receivables carry a higher degree of risk relative to the willingness and ability of account debtors to pay and, by their very nature, should be excluded from the lending formula. The following are typical classes of ineligible receivables:

—*Delinquent accounts.* Eligible receivables generally exclude accounts that are more than a given number of days delinquent, most often 60 days or more past due. Delinquency is frequently expressed in loan agreements as a given number of days from the invoice date, such as 90 days from the invoice date when payment is required in 30 days, which is the most common payment term. Expressing delinquency in days from the invoice date prevents a borrower from reducing the volume of ineligible delinquent accounts by giving dated terms (extending payment days). For example, accounts with 30-day trade terms that are becoming 60 days delinquent could otherwise be maintained in the eligible-receivable base by increasing payment terms to 90 days. Also, under what is commonly referred to as the "50 percent rule," accounts with multiple invoices that have more than 50 percent of the total balance past due are excluded from the eligible-receivable base. For example, if a borrower's customer owes payment for ten invoices, of which six are delinquent, all ten would be considered ineligible, not just the six that are delinquent. While 50 percent is standard industry practice, lenders may be more conservative and require ineligibility for an entire account if less than 50 percent of it is past due.

—*Contra accounts.* These usually arise when the borrower both sells to and purchases from the account debtor. The risk is the possibility of direct offset against these accounts.

—*Affiliate accounts.* These accounts, unlike contra-accounts, occur when a borrower sells to an account debtor, both of whom are associated through common ownership. Associated risks include forgiveness of debt on behalf of the affiliate and a temptation for the borrower to create fraudulent invoices.

—*Concentration accounts.* A lender may be vulnerable to loss if a large percentage of the dollar amount of receivables assigned is concentrated in a few accounts. Too many sales, even to a good creditworthy customer, could ultimately cause problems should disputes arise over products or contracts. A common benchmark is that no more than 20 percent of the receivables assigned should be from one customer. Some lenders will use a percentage that is also subject to a dollar limit.

—*Bill-and-hold sales.* These occur when a product ordered by a buyer has actually been billed and is ready for shipment, but is held by the seller pending receipt of shipping instructions from the buyer. Bill-and-hold sales are not eligible as receivables to be loaned against because they are not fully executed transactions. A second party's claim could be of little value when merchandise has not been shipped and there is no evidence of acceptance on behalf of the buyer.

—*Progress billings.* These are invoices issued on partial completion of contracts, usually on a percentage basis. This practice is standard in construction and other industries where long-term contracts are generally used. Failure to complete a contract could jeopardize the collectibility of progress receivables and, therefore, should generally not be considered eligible collateral. Moreover, failure to complete contracts can expose companies to lawsuits from their customers, who may be forced to pay higher prices to other parties to complete the contracts over much shorter time periods. The only exception for progress billings is when, on partial completion, there has been delivery of the product, and the contract clearly states that buyers have accepted the product and are responsible for payment of the product delivered.

—*Receivables subject to a purchase-money interest.* These include floor-plan arrangements, under which a manufacturer will frequently file financing statements when merchandise is delivered to the borrower. That filing usually gives the manufacturer a superior lien on the receivable. An alternative would be to enter into an agreement with the manufacturer, which specifies that rights to the receivables are subordinated to the bank.

- *Percentage advanced against eligible or acceptable accounts receivable.* The accounts-receivable advance rate, typically in the range of 75 to 85 percent, must serve the two primary functions of providing adequate cash flow for the borrower and providing a margin that gives adequate protection for the lender. Protection for the lender requires a sufficient margin for the continual costs of collection and absorption of dilution in the receivables. Selecting the proper advance rate for a borrower involves understanding the amounts and causes of portfolio dilution. Causes of dilution that are positive include the offering of discounts and various allowances. Causes that are negative include merchandise returns, bad debts, product liability, or warranty claims. An abundance of negative causes, such as bad debts, might indicate poor receivable-management practices. A lender must know how dilution is occurring in each receivable portfolio to measure it continually. This knowledge should lead to proper advance-rate selection, resulting in a loan balance protected by a receivables base with sufficient liquidation value to repay the loan.

- *Percentage advanced against eligible inventory.* The inventory advance rate typically ranges from 35 to 65 percent for finished products. Marketability and accessibility of the inventory are key factors in determining the advance rate. Proper evaluation of the liquidation value of inventory requires a firm understanding of marketability in all the various inventory stages (raw materials, works-in-process, finished merchandise). Works-in-process often have very low marketability because of their unfinished nature, and they will typically carry a very low advance rate—if they are even allowed as eligible inventory. Conversely, the raw materials or commodities (such as aluminum ingots, bars, and rolls) have a broader marketability as separately financed collateral components. When setting advance rates, it is also important to consider whether inventory is valued at LIFO (last in, first out) or FIFO (first in, first out). In an inflationary environment, FIFO reporting will result in higher overall inventory values on the customer's books.

The above factors are considerations in the conduct of inventory audits performed in connection with the granting and monitoring of asset-based loans. These audits will generally discuss the inventory from a liquidation basis. This information is critical in determining appropriate advance rates.

Pledged Receivables

The following factors should be considered in evaluating the quality of receivables pledged:

- Standard procedures require that the bank obtain a monthly aging report of the accounts receivable pledged. The eligible receivables base is then calculated by deducting the various classes of ineligible receivables. Usually the eligible receivables base will be adjusted daily during the month following receipt of the aging report. If accounts are ledgered, the base will be increased by additional sales, as represented by duplicate copies of invoices together with shipping documents and/or delivery receipts received by the bank. The receivables base will be decreased daily by accounts-receivable payments received by the borrower, who then remits the payments to the bank. Another method of payment in which the bank has tighter control is a lockbox arrangement. Under this arrangement, receivables are pledged on a notification basis and the borrower's customers remit their payments on accounts receivable directly to the bank through deposit in a specially designated account. If accounts are not ledgered but a blanket assignment procedure is used, the borrower periodically informs the bank of the amount of receivables outstanding on its books. Based on this information, the bank advances the agreed percentage of the outstanding receivables. Receivables are also pledged on a non-notification basis, with payments on the receivables made directly to the borrower who then remits them to the bank. Proper management of any asset-based credit line requires that all payments on accounts receivable be remitted to the bank, with the accounts-receivable borrowing base reduced by a like amount. The borrower's working-capital needs should then be met by drawing against the asset-based credit line.
- Slower turnover of the pledged receivables can be a strong indication of deterioration in credit quality of accounts receivable.
- Debtor accounts that are significant to the bank borrower's business should be well rated and financially strong. Borrowers should also

obtain financial statements on their major customers to make credit decisions. These financial statements should be reviewed when the bank performs its periodic audits. In addition, the borrower should maintain an appropriate level of reserves for doubtful accounts. Credit insurance is often used, which indemnifies a company against noncollection of accounts receivable for credit reasons. When credit insurance is used, the asset-based lender should be named as beneficiary.

- Dilution or shrinking of the accounts-receivable borrowing base can result from disputes, returns, and offsets. A large or increasing volume of these transactions could adversely affect the bank's collateral position.

The following safeguards, which bank management should consider and the examiner should evaluate, ensure the authenticity and collectibility of the pledged accounts receivable:

- *Audits.* To verify the information supplied by the borrower to the bank, the bank should audit the borrower's books. Audits should occur several times a year at the borrower's place of business. For satisfactory borrowers, the audit is usually performed quarterly. However, audits can occur more frequently if deemed necessary. Individuals who perform bank audits should be independent of the credit function. The scope of an audit should include—
  —verification that the information on the borrowing-base certificate reconciles to the borrower's books;
  —review of concentrations of accounts;
  —review of trends in accounts receivable, accounts payable, inventory, sales, and costs of goods sold;
  —review of the control of cash proceeds;
  —determination that the general ledger is regularly posted;
  —verification of submitted aging reports;
  —review of bank reconciliations and canceled checks;
  —determination if any accounts receivable are being settled with notes receivable;
  —verification that the accounts-receivable ledger is noted to show that an assignment has been made to the bank;
  —determination on non-notification accounts that all payments are remitted to the bank and that positive written confirmations are issued timely (for example, semiannually);
  —verification that all taxes, especially sales and payroll, are paid timely; and
  —review of compliance with the loan agreement.
- *Confirmation.* To verify the authenticity of the pledged collateral, the bank should institute a program of direct confirmation. This procedure is particularly important if the accounts receivable are pledged on a non-notification basis, since the bank does not have the same control over debtor accounts as it does when the receivables are pledged on a notification basis. Direct confirmation should be made before the initial lending arrangement and periodically thereafter. Confirmation should be on a positive basis. The bank should obtain written approval from the borrower before confirming accounts receivable on a non-notification basis.

Pledged Inventory

The following factors should be considered in evaluating the inventory pledged:

- A borrowing-base certificate, obtained from the borrower at least monthly, is normally used to calculate the dollar amount of inventory eligible for collateral. The borrowing-base certificate will show the different classes of inventory, such as raw materials, works-in-process, and finished goods. After this will be listed the different types of ineligible inventory, which will be subtracted to give the amount of eligible inventory. Finally, the advance rates are applied to the different classes of eligible inventory to determine the borrowing base.
- Factors affecting marketability, advance rates, and the decision whether to allow a class of inventory as eligible at even a low advance rate:
  —*Obsolescence.* This could involve not only merchandise that is no longer in demand for various reasons, such as technological advances, but also style products, such as clothing, which obviously have a greater potential for obsolescence.
  —*Seasonal goods.* It is necessary to know the seasonal highs and lows associated with a particular class of inventory, as well as the costs associated with these seasonal variations.

—*Oversupply.* If there is an oversupply in the general market of a particular class of inventory, then its value would be negatively affected.

—*Limited-use raw materials and finished goods.* These would be difficult to liquidate at a reasonable value.

Two other areas a lender must analyze in setting the inventory advance rate are the ease or difficulty, in terms of cost, of liquidating inventory in multiple locations, and the cost of maintaining certain inventory, such as food products that require refrigeration, in a salable state.

In addition to marketability, accessibility of the collateral is extremely important, as liquidation plans become meaningless if a lender cannot gain access to collateral. Constant vigilance is necessary to guard against actions that would preempt a lender's security interest in inventory. Following are some common actions that impede a lender's access to collateral:

- *Possessory liens.* A landlord lien is a common example. To protect their interest, lenders need to obtain landlord waivers to the lien.
- *Nonpossessory liens.* A purchase-money security interest is a common example. These are usually filed by trade suppliers against their customers.
- *Secret lien.* A tax lien is the most common example. To ensure that a loss of collateral does not occur, it is necessary to conduct periodic lien searches if a borrower develops financial problems.

Commercial lenders often use outside appraisal firms to help them determine prudent inventory-advance rates. Also, normal industry practice for advance rates on different classes of inventory is available through the Commercial Finance Association Information Exchange.

Turnover rates should be analyzed to identify potential slow-moving or obsolete inventory, which should be subject to a lower or no advance rate. The borrower should establish inventory reserves if the volume of slow-moving or obsolete inventory is significant, and charge-off procedures should be in effect. Inventory should be adequately insured in relation to its location and amount. Furthermore, bill-and-hold merchandise and goods held on consignment should be physically segregated from other warehoused inventory and should not be included as inventory on the borrower's books or on the borrowing-base certificate submitted to the bank.

UCC Requirements for Secured Transactions

Article 9 of the UCC applies to any transaction that is intended to create a security interest in personal property. For a detailed discussion of the UCC requirements regarding secured transactions, refer to section 2080.1, "Commercial and Industrial Loans."

1. To determine if the policies, practices, procedures, and internal controls for accounts receivable and inventory financing are adequate.
2. To determine if bank officers are conforming to established guidelines.
3. To evaluate the portfolio for collateral sufficiency, credit quality, and collectibility.
4. To determine the scope and adequacy of the audit function.
5. To determine compliance with laws and regulations.
6. To initiate corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws or regulations have been noted.

1. If selected for implementation, complete or update the asset-based lending section of the internal control questionnaire.
2. On the basis of the evaluation of internal controls and the work performed by internal or external auditors, determine the scope of the examination.
3. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examination procedures. Also, obtain a listing of any deficiencies noted in the latest review done by internal or external auditors, and determine if corrections have been accomplished.
4. Obtain a trial balance of the customer liability records.
   a. Agree or reconcile balances to department controls and the general ledger.
   b. Review reconciling items for reasonableness.
5. Using an appropriate technique, select borrowers for examination. Prepare credit line cards.
6. Obtain the following information from the bank or other examination areas, if applicable:
   a. past-due loans
   b. loans in a nonaccrual status
   c. loans on which interest is not being collected in accordance with the terms of the loan (Particular attention should be paid to loans that have been renewed without payment of interest.)
   d. loans whose terms have been modified by a reduction of interest rate or principal payment, by a deferral of interest or principal, or by other restructuring of repayment terms
   e. loans transferred, either in whole or in part, to another lending institution as a result of a sale, participation, or asset swap since the previous examination
   f. loans acquired from another lending institution as a result of a purchase, participation, or asset swap since the previous examination
   g. loan commitments and other contingent liabilities
   h. Extensions of credit to employees, officers, directors, and principal shareholders and their interests, specifying which officers are considered executive officers
   i. extensions of credit to executive officers, directors, and principal shareholders and their interests of correspondent banks
   j. a list of correspondent banks
   k. miscellaneous loan-debit and credit-suspense accounts
   l. loans considered "problem loans" by management
   m. Shared National Credits
   n. specific guidelines in the lending policy
   o. each officer's current lending authority
   p. current interest-rate structure
   q. any useful information obtained from the review of the minutes of the loan and discount committee or any similar committee
   r. reports furnished to the loan and discount committee or any similar committee
   s. reports furnished to the board of directors
   t. loans classified during the preceding examination
7. Review the information received and perform the following procedures.
   a. *Loans transferred, either in whole or in part, to or from another lending institution as a result of a participation, sale or purchase, or asset swap.*
      - Participations only:
        — Test participation certificates and records, and determine that the parties share in the risks and contractual payments on a pro rata basis.
        — Determine that the bank exercises similar controls and procedures over loans serviced for others as for loans in its own portfolio.
        — Determine that the bank, as lead or agent in a credit, exercises similar controls and procedures over syndications and participations sold as for loans in its own portfolio.
      - Procedures pertaining to *all* transfers:
        — Investigate any situations in which loans were transferred immediately before the date of examination to determine if any were transferred

to avoid possible criticism during the examination.

— Determine whether any of the loans transferred were either nonperforming at the time of transfer or classified at the previous examination.

— Determine that the consideration received for low-quality loans transferred from the bank to an affiliate is properly reflected on the bank's books and is equal to the fair market value of the transferred loans. (While fair market value may be difficult to determine, it should at a minimum reflect both the rate of return being earned on these loans as well as an appropriate risk premium.) Section 23A of the Federal Reserve Act prohibits a state member bank from purchasing a low-quality asset.

— Determine that low-quality loans transferred to an affiliate are properly reflected at fair market value on the books of both the bank and its affiliate.

— If low-quality loans were transferred to or from another lending institution for which the Federal Reserve is not the primary regulator, prepare a memorandum to be submitted to the Reserve Bank supervisory personnel. The Reserve Bank will then inform the local office of the primary federal regulator of the other institution involved in the transfer. The memorandum should include the following information, as applicable:

(1) name of originating institution
(2) name of receiving institution
(3) type of transfer (i.e., participation, purchase or sale, swap)
(4) date of transfer
(5) total number of loans transferred
(6) total dollar amount of loans transferred
(7) status of the loans when transferred (e.g., nonperforming, classified, etc.)
(8) any other information that would be helpful to the other regulator

b. *Miscellaneous loan-debit and credit-suspense accounts.*
- Discuss with management any large or old items.
- Perform additional procedures as deemed appropriate.

c. *Loan commitments and other contingent liabilities.* Analyze the commitment or contingent liability if the borrower has been advised of the commitment, and analyze the combined amounts of the current loan balance (if any) and the commitment or other contingent liability exceeding the cutoff.

d. *Loans classified during the previous examination.*
- Determine the disposition of loans so classified by transcribing—
  - — current balance and payment status, or
  - — date loan was repaid and source of payment.
- Investigate any situations in which all or part of the funds for the repayment came from the proceeds of another loan at the bank, or as a result of a participation, sale, or swap with another lending institution. If repayment was a result of a participation, sale, or swap, refer to step 7a of this section for the appropriate examination procedures.

e. *Uniform review of Shared National Credits.*
- Compare the schedule of credits included in the uniform review of Shared National Credits Program with line cards to ascertain which loans in the sample are portions of Shared National Credits.
- For each loan so identified, transcribe appropriate information from schedule to line cards. (No further examination procedures are necessary in this area.)

8. Consult with the examiner responsible for the asset/liability management analysis to determine the appropriate maturity breakdown of loans needed for the analysis. If requested, compile the information using bank records or other appropriate sources. See ''Instructions for the Report of Examination,'' section 6000.1, for the considerations to be taken into account when compiling maturity information for the gap analysis.

9. Prepare line cards for any loan not in the sample that, on the basis of the information

derived from the above schedules, requires in-depth review.

10. Obtain liability and other information on common borrowers from examiners assigned to cash items, overdrafts, lease financing, and other loan areas, and together decide who will review the borrowing relationship.
11. Obtain credit files for each loan for which line cards have been prepared. In analyzing the loans, perform the following procedures:
    a. Analyze balance-sheet and profit-and-loss items as reflected in current and preceding financial statements, and determine the existence of any favorable or adverse trends.
    b. Review components of the balance sheet as reflected in the current financial statements, and determine the reasonableness of each item as it relates to the total financial structure.
    c. Review supporting information and consolidation techniques for major balance-sheet items.
    d. Ascertain compliance with provisions of loan agreements.
    e. Review digests of officers' memoranda, mercantile reports, credit checks, and correspondence.
    f. Review the following:
       - relationship between amount collected in a month on the receivables pledged as collateral and the borrower's credit limit
       - aging of accounts receivable
       - ineligible receivables
       - concentration of debtor accounts
       - financial strength of debtor accounts
       - disputes, returns, and offsets
       - management's safeguards to ensure the authenticity and collectibility of the assigned receivables
    g. Analyze secondary support offered by guarantors and endorsers.
    h. Ascertain compliance with established bank policy.
12. Transcribe significant liability and other information on officers, principals, and affiliations of appropriate borrowers contained in the sample. Cross-reference line cards to borrowers, where appropriate.
13. Determine compliance with laws and regulations pertaining to accounts receivable lending by performing the following steps.
    a. *Lending limits.*
       - Determine the bank's lending limit as prescribed by state law.
       - Determine advances or combinations of advances with aggregate balances above the limit, if any.
    b. *Section 23A, Relations with Affiliates (12 USC 371c), and section 23B, Restrictions on Transactions with Affiliates (12 USC 371c-1), of the Federal Reserve Act, and Regulation W.*
       - Obtain a listing of loans to affiliates.
       - Compare the listing with the bank's customer liability records to determine its accuracy and completeness.
       - Obtain a listing of other covered transactions with affiliates (i.e., acceptance of affiliate's securities as collateral for a loan to any person).
       - Ensure that covered transactions with affiliates do not exceed the limits of section 23A and Regulation W.
       - Ensure that covered transactions with affiliates meet the collateral requirements of section 23A and Regulation W.
       - Determine that low-quality loans have not been purchased from an affiliate.
       - Determine that all covered transactions with affiliates are on terms and conditions that are consistent with safe and sound banking practices.
       - Determine that all transactions with affiliates comply with the market-terms requirement of section 23B and Regulation W.
    c. *18 USC 215, Receipt of Commission or Gift for Procuring Loans.*
       - While examining the accounts receivable loan area, determine the existence of any possible cases in which a bank officer, director, employee, agent, or attorney may have received anything of value for procuring or endeavoring to procure any extension of credit.
       - Investigate any such suspected situation.
    d. *Federal Election Campaign Act (2 USC 441b), Political Contributions and Loans.*
       - While examining the accounts receivable loan area, determine the existence of any loans in connection with any political campaign.
       - Review each such credit to determine

whether it is made in accordance with applicable banking laws and regulations and in the ordinary course of business.

e. *12 USC 1972, Tie-In Provisions.* While examining the accounts receivable loan area, determine whether any extension of credit is conditioned upon—
   - obtaining or providing an additional credit, property, or service to or from the bank or its holding company (or a subsidiary of its holding company), other than a loan, discount, deposit, or trust service, or
   - the customer not obtaining a credit, property, or service from a competitor of the bank or its holding company (or a subsidiary of its holding company), other than a reasonable condition to ensure the soundness of the credit.

f. *Insider lending activities.* The examination procedures for checking compliance with the relevant law and regulation covering insider lending activities and reporting requirements are as follows. (The examiner should refer to the appropriate sections of the statutes for specific definitions, lending limitations, reporting requirements, and conditions indicating preferential treatment.)
   - *Regulation O (12 CFR 215), Loans to Executive Officers, Directors, and Principal Shareholders and Their Related Interests.* While reviewing information relating to insiders that is received from the bank or appropriate examiner (including loan participations, loans purchased and sold, and loan swaps)—
     — test the accuracy and completeness of information about accounts receivable loans by comparing it with the trial balance or loans sampled;
     — review credit files on insider loans to determine that required information is available;
     — determine that loans to insiders do not contain terms more favorable than those afforded other borrowers;
     — determine that loans to insiders do not involve more than normal risk of repayment or present other unfavorable features;
     — determine that loans to insiders do not exceed the lending limits imposed by Regulation O;
     — if prior approval by the bank's board was required for a loan to an insider, determine that this approval was obtained;
     — determine compliance with the various reporting requirements for insider loans;
     — determine that the bank has made provisions to comply with the disclosure requirements for insider loans; and
     — determine that the bank maintains records of public disclosure requests and the disposition of the requests for a period of two years after the dates of the requests.
   - *Title VIII of the Financial Institutions Regulatory and Interest Rate Control Act of 1978 (FIRA) (12 USC 1972(2)), Loans to Executive Officers, Directors, and Principal Shareholders of Correspondent Banks.*
     — Obtain from or request that the examiners reviewing due from banks and deposit accounts verify a list of correspondent banks provided by bank management, and ascertain the profitability of those relationships.
     — Determine that loans to insiders of correspondent banks are not made on preferential terms and that no conflict of interest appears to exist.

g. *Financial Recordkeeping and Reporting of Currency and Foreign Transactions (31 CFR 103.33), Retention of Credit Files.* Review the operating procedures and credit file documentation and determine if the bank retains records of each extension of credit over $10,000, specifying the name and address of the borrower, the amount of the credit, the nature and purpose of the loan, and the date thereof. (Loans secured by an interest in real property are exempt.)

14. Determine whether the consumer compliance examination uncovered any violations of law or regulation in this department. If violations were noted, determine whether corrective action was taken. Extend testing to determine subsequent compliance with

any noted law or regulation.

15. Perform the appropriate steps in ''Concentrations of Credits,'' section 2050.3.
16. Discuss with appropriate officers, and prepare summaries in appropriate report form of—
    a. delinquent loans
    b. loans not supported by current and complete financial information
    c. loans on which documentation is deficient
    d. inadequately collateralized loans
    e. classified loans
    f. Small Business Administration delinquent or criticized loans
    g. transfers of low-quality loans to or from another lending institution
    h. concentrations of credit
    i. extensions of credit to major shareholders, employees, officers, directors, and/or their interests
    j. violations of laws and regulations
    k. other matters concerning the condition of the department
17. Evaluate the function for—
    a. the adequacy of written policies, relating to accounts receivable financing;
    b. the manner in which bank officers are conforming with established policy;
    c. adverse trends within the accounts receivable financing department;
    d. the accuracy and completeness of the schedules obtained from the bank;
    e. internal control deficiencies or exceptions;
    f. recommended corrective action when policies, practices, or procedures are deficient;
    g. the competency of departmental management; and
    h. other matters of significance.
18. Update the workpapers with any information that will facilitate future examinations.

Review the bank's internal controls, policies, practices, and procedures for making and servicing accounts receivable financing loans. The bank's system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flow charts, copies of forms, and other pertinent information. Items marked with an asterisk require substantiation by observation or testing.

POLICIES

*1. Has the board of directors, consistent with its duties and responsibilities, adopted written accounts receivable financing policies that—
   a. establish procedures for reviewing accounts receivable financing applications,
   b. establish standards for determining credit lines,
   c. establish standards for determining percentage advance to be made against acceptable receivables,
   d. define acceptable receivables,
   e. establish minimum requirements for verification of borrower's accounts receivable, and
   f. establish minimum standards for documentation?

2. Are accounts receivable financing policies reviewed at least annually to determine if they are compatible with changing market conditions?

RECORDS

*3. Is the preparation and posting of subsidiary accounts receivable financing records performed or reviewed by persons who do not also—
   a. issue official checks and drafts or
   b. handle cash?

*4. Are the subsidiary accounts receivable financing records reconciled, at least monthly, to the appropriate general ledger accounts, and are reconciling items investigated by persons who do not also handle cash?

5. Are loan statements, delinquent account collection requests, and past-due notices checked to the trial balances that are used in reconciling subsidiary records of accounts receivable financing loans with general ledger accounts, and are they handled only by persons who do not also handle cash?

6. Are inquiries about accounts receivable financing loan balances received and investigated by persons who do not also handle cash or pass adjustments?

*7. Are documents supporting recorded credit adjustments to loan accounts or accrued interest receivable accounts checked or tested subsequently by persons who do not also handle cash or initiate transactions (if so, explain briefly)?

8. Are terms, dates, weights, descriptions of merchandise, etc., shown on invoices, shipping documents, delivery receipts, and bills of lading scrutinized for differences?

9. Are procedures in effect to determine if the signatures shown on the above documents are authentic?

10. Are payments from customers scrutinized for differences in invoice dates, numbers, terms, etc.?

LOAN INTEREST

*11. Is the preparation and posting of loan interest records performed or reviewed by persons who do not also—
   a. issue official checks and drafts or
   b. handle cash?

12. Are independent interest computations made and compared or tested to initial loan interest records by persons who do not also—
   a. issue official checks and drafts or
   b. handle cash?

COLLATERAL

*13. Does the bank record, on a timely basis, a first lien on the assigned receivables for each borrower?

14. Do all loans granted on the security of the receivables also have an assignment of the inventory?

15. Does the bank verify the borrower's accounts receivable or require independent verification periodically?
16. Does the bank require the borrower to provide aged accounts receivable schedules periodically?
17. If applicable, are cash receipts and invoices block proven in the mailroom and subsequently traced to posting on daily transaction records?

CONCLUSION

18. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly and indicate any additional examination procedures deemed necessary.
19. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

Some member banks provide lending services to stock brokerage firms using marketable securities as collateral. While various financial services are offered, typically most banks make loans to brokerage firms to provide them with the funding needed to carry their securities portfolio. The securities can either be held by the bank or a tri-party custodian or pledged to the bank at a depository. Collateral securities can be in physical form or can be held at a depository in book-entry form.

To promote efficiency, a brokerage firm may use a depository to hold the securities it has pledged as collateral for a bank loan. Brokerage firms deposit shares of eligible securities with the depository, and the stock certificates representing those shares are registered in the name of a common nominee. Beneficial ownership of the securities is transferred through computerized book entries, thus eliminating the physical movement of the securities. The depository has physical control of the securities while they are on deposit. Loan arrangements are made between the broker and the lending bank, with the broker providing electronic instructions to the depository to debit the firm's account and credit that of the lending bank. The depository acknowledges the transaction to the lending bank and will not reverse the entry or allow partial withdrawals without authorization from that institution. Participating banks receive daily reports showing their position in the program by broker name and type of security.

The New York Stock Exchange formed a subsidiary, the National Securities Clearing Corporation (NSCC), to provide equity clearance and continuous net settlement for the brokerage community. The Depository Trust Company in New York, under contract with the NSCC, handles the technical aspects of that operation, including final settlement. Collateral-pledging services may be offered by other depositories as well.

Book-entry transfer of ownership is limited to only those securities that are eligible for deposit in a depository. However, even if a security was depository-eligible, it would not be eligible for book-entry movement unless the lending bank was a direct or indirect participant in the depository. If the lending institution does not have a relationship, either directly or indirectly, with a depository, the securities would have to be delivered physically to the ultimate custodian (presumably the lending bank).

Securities lending is not always constrained by eligibility. Depending on the bank's underwriting standards, some banks may be willing to lend on the basis of securities that are not depository-eligible. This would preclude book-entry movement and require physical delivery.

1. To determine if policies, practices, procedures, objectives, and internal controls for securities broker and dealer loans are adequate.
2. To determine the types of loans (underwriting loan, day loan, inventory loan, margin loan, or guidance line) made, loan pricing and fees, loan-to-value ratios, and margin calls.
3. To evaluate credit quality, credit analysis, collateral and custody requirements, and procedures for lost and stolen securities.
4. To determine if bank officers are operating in conformance with the established guidelines.
5. To determine compliance with applicable laws and regulations, including Regulations T and U, the Securities Act of 1933, and the Securities Exchange Act of 1934.
6. To evaluate management information systems, particularly the lender's ability to ensure adequate collateral coverage by being able to automatically price collateral daily.
7. To determine the scope and adequacy of the audit function.
8. To initiate corrective action when policies, practices, procedures, objectives, or internal controls are deficient or when violations of laws or regulations have been noted.

1. If selected for implementation, complete or update the Securities Broker and Dealer Loans section of the Internal Control Questionnaire.
2. Based on the evaluation of internal controls and of the work performed by internal/external auditors ascertain the scope of the examination.
3. Test for compliance with policies, practices, procedures and internal controls in conjunction with performing the remaining examination procedures. Also, obtain a listing of any deficiencies noted in the latest review done by internal/external auditors, and determine if corrections have been accomplished.
4. Request the bank to supply:
   a. Schedule of approved lines for each dealer including outstanding balances.
   b. Delinquent interest billings, date billed amount of past-due interest.
5. Obtain a trial balance of all dealer accounts and:
   a. Agree balances to department controls and general ledger.
   b. Review reconciling items for reasonableness.
6. Using an appropriate technique, select borrowers to be reviewed.
7. Using the trial balance, transcribe the following information for each borrower selected onto the credit line cards.
   a. Total outstanding liability.
   b. Amount of approved line.
8. Obtain from the appropriate examiner the following schedules, if applicable to this area:
   a. Past-due loans.
   b. Loan commitments and other contingent liabilities.
   c. Miscellaneous loan debit and credit suspense accounts.
   d. Loans considered "problem loans" by management.
   e. Each officer's current lending authority.
   f. Current interest rate structure.
   g. Any useful information obtained from the review of the minutes of the loan and discount committee or any similar committee.
   h. Reports furnished to the loan and discount committee or any similar committee.
   i. Reports furnished to the board of directors.
   j. Loans classified during the preceding examination.
   k. A listing of loans charged-off since the preceding examination.
9. Review the information received and perform the following:
   a. For miscellaneous loan debit and credit suspense accounts:
      - Discuss with management any large or old items.
      - Perform additional procedures as deemed appropriate.
   b. For loans classified during the previous examination, determine disposition of loans so classified by transcribing:
      - Current balances and payment status, *or*
      - Date loan was repaid and sources of payment.
   c. For loan commitments and other contingent liabilities, analyze if:
      - The borrower has been advised of the contingent liability.
      - The combined amounts of the current loan balance and the commitment or contingent liability exceed the cutoff.
   d. Select loans which require in-depth review based on information derived when performing the above steps.
10. For those loans selected in step 6 above and for any other loans selected while performing the above steps, transcribe the following information from the bank's collateral record onto the credit-line cards:
    a. A list of collateral held, including date of entry, and amount advanced.
    b. A brief of the agreement between the bank and the dealer.
    c. Evidence that the proper documentation is in place.
    d. Details of any other collateral held.
11. The examiner should be aware that certain stock-secured purpose transactions with and for brokers and dealers are exempt from the

margin restrictions of Regulation U. Refer to the regulation for a complete description of such transactions, which include the following:

a. Temporary advances to finance cash transactions.
b. Securities in transit or transfer.
c. Day loans.
d. Temporary financing of distributions.
e. Arbitrage transactions.
f. Credit extended pursuant to hypothecation.
g. Emergency credit.
h. Loans to specialists.
i. Loans to odd-lot dealers.
j. Loans to OTC market makers.
k. Loans to third-market makers
l. Loans to block positioners.
m. Loans for capital contributions.

12. Discuss with appropriate officer(s) and prepare summaries in appropriate report form of:
    a. Delinquent loans, including a breakout of ''A'' paper.
    b. Loans on which collateral documentation is deficient.
    c. Recommended corrective action when policies, practices or procedures are deficient.
    d. Other matters regarding the condition of the department.
13. Prepare appropriate comments for examination report stating your findings with regard to:
    a. The adequacy of written policies relating to dealer loans.
    b. The manner in which bank officers are conforming with established policy.
    c. Schedules applicable to the department that were discovered to be incorrect or incomplete.
    d. The competence of departmental management.
    e. Internal control deficiencies or exceptions.
    f. Other matters of significance.
14. Update the workpapers with any information that will facilitate future examinations.

Review the bank's internal control, policies, practices and procedures for making and servicing loans. The bank's system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used and other pertinent information.

POLICIES

1. Has the board of directors, consistent with its duties and responsibilities, adopted written loan policies that:
   a. Establish standards for determining broker and dealer credit lines?
   b. Establish minimum standards for documentation?
2. Are such loan policies reviewed at least annually to determine if they are compatible with changing market conditions?
3. Is a daily record maintained summarizing loan transaction details, i.e., loans made, payments received and interest collected to support applicable general ledger account entries?
4. Are frequent note and liability ledger trial balances prepared and reconciled with controlling accounts by employees who do not process or record loan transactions?
5. Is an exception report produced and reviewed by operating management that encompasses extensions, renewals or any factors that would result in a change in customer account status?
6. Do customer account records clearly indicate accounts which have been renewed or extended?

LOAN INTEREST

7. Is the preparation and posting of interest records performed and reviewed by appropriate personnel?
8. Are any independent interest computations made and compared or adequately tested to initial interest records by appropriate personnel?

COLLATERAL

9. Are multicopy, prenumbered records maintained that:
   a. Detail the complete description of collateral pledged?
   b. Are typed or completed in ink?
10. Are receipts issued to customers covering each item of negotiable collateral deposited?
11. If applicable, are the functions of receiving and releasing collateral to borrowers and of making entries in the collateral register performed by different employees?
12. Are appropriate steps with regard to Regulation U being considered in granting dealer and broker loans?

CONCLUSION

13. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficienicies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
14. Based on composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

INTRODUCTION

Factoring is the purchase, essentially without recourse, of the accounts receivable of a client by a bank (the factor). Generally, factor clients are small, undercapitalized companies or start-up firms with limited liquidity that generally do not qualify for more traditional bank financing. In contrast to accounts receivable financing, where the client retains the credit and collection risk associated with the receivables, factoring transfers these risks to the factor. For the client, the principal advantage of factoring is the assurance that it will receive the proceeds of its sales, regardless of whether the factor is paid. Furthermore, the client does not have to maintain a credit department to evaluate the creditworthiness of customers, collect past-due accounts, or maintain accounting records on the status of receivables. The factor assumes these responsibilities. An additional advantage for the client is that under the terms of an "advance factoring" arrangement, the client receives payment for its receivables before the time stated on the invoice.

Two basic types of factoring service offered by the industry are (1) maturity factoring and (2) advance factoring. In maturity factoring, an average maturity due date is computed for the receivables purchased within a given time period, and the client receives payment on that date. Advance factoring is computed in the same way; however, the client has the option of taking a percentage of the balance due on a receivable in advance of the computed average maturity due date. The remainder of the receivable, sometimes called the "client's equity," is payable on demand at the due date.

ACCOUNTING FOR FACTORING

The factor's balance sheet reflects the purchased accounts receivable as an asset account, "factored receivables," with "due to clients" as the corresponding liability. Usually, the balance of due-to-clients will be less than the factored receivables because of payments and advances to the clients. If, however, the factor makes advances to the client in amounts that exceed amounts due to the client, the advances will be shown as "overadvances." Overadvances are common and usually secured by other collateral. The factoring agreement should set limits on the amount of overadvances available at any one time, generally based on specified collateral, such as the client's inventory. The relationship to inventory is based on the premise that the inventory will be sold, thus generating receivables that the factor has contracted to purchase. Proceeds from the factored receivables resulting from the sale of inventory are then used to repay the overadvance. If the overadvance is unsecured, it should be offset by a corresponding reduction in the "client's equity." The factor's income statement will show factoring commissions, which represent the discount on the receivables purchased, as income. Interest income for advances on the due-to-client balances may or may not be a separate line item.

Since factoring is a highly competitive industry, price cutting has reduced factoring commissions to the point that they provide minimal support to a factor's earnings. As a result, interest margins on factoring advances represent an increasingly important part of a factor's net income. An analysis of proportional changes in the due-to-clients account should provide valuable insight into the analysis of the earnings of a bank's factoring activities. As more clients take advances (reducing due-to-clients), profit margins should widen. Conversely, as the due-to-clients proportion of total liabilities rises, profit margins may be expected to narrow.

FACTORING AGREEMENT, APPROVAL PROCEDURES, AND EXAMINER'S EVALUATION

The typical factoring agreement stipulates that all of a client's accounts receivable are assigned to the factor. However, the agreement between the factor and the client will usually state that receivables subject to shipping disputes and errors, returns, and adjustments are chargeable back to the client because they do not represent bona fide sales. The agreement will, in most instances, require that a reserve be established against the purchased receivables to ensure the factor's access to funds for any future chargeback adjustments.

The usual approval process requires the client to contact the factor's credit department before filling a sales order on credit terms. The credit department conducts a credit review, determines the creditworthiness of the customer, and approves or rejects the sale. If the credit department rejects the sale, the client may complete the sale, but at its own risk. The most commonly rejected sales are those to affiliates, known bad risks, customers whose credit cannot be verified, and customers whose outstanding payables exceed the factor's credit line to that customer. Sales made by the client without the factor's approval are considered client-risk receivables, and the factor has full recourse to the client.

Once a sale has been made and the receivable assigned to the factor, whether or not the factor has approved it, the client's account will be credited for the net invoice amount of the sale. Trade or volume discounts, early payment terms, and other adjustments are deducted from the invoice amount. The receivable then becomes part of the client's ''availability'' to be paid immediately or at the computed date, depending on the basis of the factoring arrangement.

Each month the client receives an ''accounts-current'' statement from the factor, which details daily transactions. This statement reflects the daily assignments of receivables, remittances made (including overadvances and amounts advanced at the client's risk), deductions for term loans, interest charges, and factoring commissions. Credit memos, client-risk charge-backs, and other adjustments will also be shown. Client-risk charge-backs are the amounts deducted from the remittances to the client resulting from the failure of the client's customers to pay receivables that were advanced at the client's risk.

The accounts-current statement and the availability sheets are necessary for analyzing asset quality. The factor's ability to generate these reports daily is a basic control feature. Accounting systems for a high-volume operation probably will be automated, providing the factor with the data necessary to properly monitor the client. If a monitoring system is in place, the examiner should use the data provided in the asset analysis process.

The evaluation of a factoring operation includes a review of its systems and controls as well as an analysis of the quality of its assets. A major portion of a factor's assets will be factored receivables, for which the credit department has the responsibility for credit quality and collection. The other major portion of assets will consist of client loans and credit accommodations, such as overadvances and amounts advanced at the client's risk, for which the account officers are responsible.

CREDIT DEPARTMENT EVALUATION

Because of its integral function in the credit and collection process, the credit department is the heart of a factoring operation. The department should maintain a credit file for each of its client's customers, and these files should be continually updated as purchases are made and paid for by the customers. These files should include financial statements, credit bureau reports, and details of purchasing volume and paying habits. Each customer should have an assigned credit line based on the credit department's review of the customer's credit capacity.

The objective of a credit department evaluation is to critique the credit and collection process and to assess departmental effectiveness. The examiner should have a copy of departmental policies and procedures as well as a verbal understanding of them before beginning the review. The factor's policies should include, at a minimum, well-defined field audit procedures, a fraud detection and monitoring plan, and a computer back-up plan. Customer files selected for review may be drawn from large and closely monitored customers, or they may be selected by a random sample.

ASSET EVALUATION

The asset evaluation is a twofold process. The first part is to evaluate credit accommodations to each client. The second part is to evaluate customer receivables purchased by the factor at its own risk. For the first part of the process, the examiner should obtain a list that shows the aggregate of each client's credit exposure to the factor, both direct and indirect, including overadvances and receivables purchased at the client's risk. For the second part of the process, the examiner should obtain an aging schedule of factored receivables aggregated by customer but net of client-risk receivables. The selection of clients and customers for review should be based on the same selection methods as those used for the commercial loan review. Clients with a high ''dilution'' of receivables (that is, customer nonpayment due to returns, shipping disputes, or errors) and those with client-risk receivables equal to 20 percent or more of factored volume might also be selected for review. Past-due factored volume is not a meaningful measure of client quality because a factor usually collects principal and interest payments directly from the client's availability.

A maturity client's availability is the sum of all factored receivables less trade and other discounts, factoring commissions, client-risk charge-backs, and other miscellaneous charges to the client's account. There may also be deductions for letters of credit and other credit accommodations. An advance client's availability would be further reduced by advances on the factored receivables, interest charges, and the reciprocal of the contractually agreed-upon ''advance'' percentage. This reciprocal, 20 percent in the case of a client who receives an 80 percent advance, is sometimes referred to as the client's equity in the factored receivables. Availability may be increased by liens on additional collateral, such as inventory, machinery and equipment, real estate, and other marketable assets.

A client's balance sheet will show a ''due-from-factor'' account instead of accounts receivable. The account balance may be somewhat lower than a normal receivables balance, thus distorting turnover ratios and other short-term ratios. A client can convert sales to cash faster with a factor than if it collected the receivables. The statement analysis should consider the client's ability to repay any advances received from the factor in the form of overadvances, term loans, or other credit accommodations. The analysis should also assess the client's ability to absorb normal dilution and the potential losses associated with client-risk receivables, particularly when these elements are unusually high.

CLASSIFICATION GUIDELINES

When classifying the credit exposure to a client, the client-risk receivables portion of factored volume is the only amount subject to classification. Because of the recourse aspect, the balance is considered an indirect obligation rather than a direct obligation. Any other credit accommodations to a client that are not included in factored receivables, such as overadvances or term loans, are also subject to classification. Customer receivables purchased by the factor at its own risk are subject to classification. Care should be taken not to classify any receivables that have already been classified under client-risk exposure. Seasonal aspects of clients' businesses should be carefully analyzed in assessing asset quality based on classification data.

CONCLUSION

Due to the large volume of daily transactions that typically flows through a factor, any internal control procedure that can be easily circumvented is a potential problem. The review of the department's internal systems and controls should be continuous throughout the examination. This review should include credit controls for both clients and customers. Since credit problems can develop rapidly in factoring, credit controls and systems must be responsive to the identification of these problems. Earnings and capital adequacy are evaluated based on the department's own performance. The factoring department's earnings trends may be evaluated by comparing the yield on assets for various periods. Factors are subject to the same price competition in the commercial finance market as accounts receivable financiers. Declining portfolio yields may reflect competitive pressures and may portend declining future profitability.

1. To determine if policies, practices, procedures, and internal controls for factoring are adequate.
2. To determine if bank officers are operating in conformance with the established guidelines.
3. To evaluate the portfolio for performance, credit quality, collectibility, and collateral sufficiency.
4. To determine the scope and adequacy of the audit function.
5. To determine compliance with applicable laws and regulations.
6. To initiate corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws or regulations have been noted.

1. If selected for implementation, complete or update the Factoring section of the Internal Control Questionnaire.
2. Based on the evaluation of internal controls and the work performed by internal/external auditors, determine the scope of the examination.
3. Test for compliance with policies, practices, procedures and internal controls in conjunction with performing the remaining examination procedures. Also obtain a listing of any deficiencies noted in the latest reviews done by internal/external auditors, and determine if appropriate corrections have been made.
4. Obtain a trial balance(s) of applicable asset and liability accounts and:
   a. Agree or reconcile balances to department controls and general ledger.
   b. Review reconciling items for reasonableness.
5. Obtain the following information:
   a. A list of all clients with their outstanding balances including total factored receivables with those purchased at the client's risk segregated, overadvances, term loans and other credit accommodations.
   b. If not included in 5a above, a list of amounts due to each client by the factor (availability reports).
   c. Aging schedules of factored receivables by client and by customer with client risk receivables segregated.
   d. Past due status reports for 5c, above.
   e. Listings of all clients and customers considered to be problems.
   f. Credits classified at the previous examination.
   g. Concentration reports by client and by customer.
   h. Exception reports highlighting dilution of factored receivables because of shipping disputes and errors, returns, or any other adjustments.
   i. Credit commitments/lines for each client including amounts for overadvances and receivables purchased at the client's risk.
   j. Credit lines for each customer.
   k. Specific lending policy guidelines including each officer's current lending authority.
   l. Current fee schedule.
   m. Any useful information obtained from the review of the minutes of the loan and discount committee or any similar committees.
   n. Reports furnished to the board of directors.
   o. Any other management reports maintained by the factoring department.
6. After consulting with the examiner-in-charge, determine the appropriate cut-off lines for:
   a. Client's aggregate direct liability (i.e., overadvances, term loans and other credit accommodations).
   b. Client's indirect liability (i.e., client-risk exposure).
   c. Customer's factored receivables not including those in 6b above.
7. Transcribe information to line cards for all client and customer credits over the cut-off limits, for all credits recognized as problems, and for credits classified at the previous examination.
8. Cross reference clients and customers with the examiners assigned to other loan areas for common borrowers, and together decide who will review the borrowing relationship.
9. Obtain credit files for all clients and customers for whom line cards were prepared and analyze the accounts by performing the following procedures:
   a. Analyze balance sheet and profit and loss items as reflected in current and preceding financial statements, determine the existence of any favorable or adverse trends.
   b. Review components of the balance sheet as reflected in the current financial statements and determine the reasonableness of each item as its relates to the total financial structure.
   c. Review supporting information for the major balance sheet items and the techniques used in consolidation, if applicable, and determine the primary sources of repayment and evaluate their adequacy.
   d. Compare the amount of the credit line(s) with the lending officer's authority.
   e. Determine compliance with the bank's established commercial loan policy.

In addition to the above procedures which are applicable to both client and customer accounts, the following additional procedures should be performed for client accounts only:

f. Determine compliance with provisions of factoring agreements.
g. Review digest of officers' memoranda, mercantile reports, credit checks and correspondence to determine the existence of any problems which might deter the contractual program as set forth in the factoring agreement.
h. Relate collateral values to outstanding debt.
i. Compare fees charged to the fee schedule and determine that the terms are within established guidelines.
j. Analyze secondary support afforded by guarantors and endorsers.

10. Perform appropriate procedural steps in Concentration of Credits section, if applicable.
11. Discuss with appropriate officer(s) and prepare summaries in appropriate report form of:
    a. Delinquent amounts, segregating those considered ''A'' paper.
    b. Violations of laws and regulations.
    c. Accounts not supported by current and complete financial information or on which other documentation is deficient.
    d. Concentrations of credit.
    e. Criticized accounts.
    f. Other matters regarding condition of asset quality.
12. Evaluate the factoring department with respect to:
    a. The adequacy of written policies relating to factoring.
    b. The manner in which bank officers are operating in conformance with established policy.
    c. Adverse trends within the factoring department.
    d. Internal control deficiences or exceptions.
    e. Recommended corrective action when policies, practices or procedures are deficient.
    f. The competency of departmental management.
    g. Other matters of significance.
13. Update the workpapers with any information that will facilitate future examinations.

Review the bank's internal controls, policies, practices and procedures for its factoring operation. The bank's system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used and other pertinent information. Items marked with an asterisk require substantiation by observation or testing.

POLICIES

1. Has the board of directors, consistent with its duties and responsibilities, adopted written factoring policies that:
   a. Establish procedures for reviewing factoring agreements?
   b. Establish standards for determining client credit lines for each of the various types of accommodations available (i.e., factored receivables, client-risk receivables, overadvances, term loans, etc.)?
   c. Establish standards for determining individual customer limits?
   d. Require a client to contact the factor for approval before filling a sales order on credit terms?
   e. Establish standards for approving the sales orders referred to above.
   f. Establish standards for determining the percentage of advance that will be made against acceptable receivables in advance factoring arrangements?
   g. Establish standards for determining the discount on factored receivables and the interest rate or fee charged for other credit accommodations?
   h. Establish minimum standards for documentation?
2. Are factoring policies reviewed at least annually to determine if they are compatible with changing market conditions?

INTERNAL CONTROL

*3. Is the preparation and posting of subsidiary factoring records performed or reviewed by persons who do not also:
   a. Issue official checks and drafts?
   b. Handle cash?

*4. Are the subsidiary factoring records reconciled, at least monthly, to the appropriate general ledger accounts, and reconciling items investigated by persons who do not also handle cash?

5. Are accounts current statements, delinquent account collection requests, and past-due notices checked to the trial balances that are used in reconciling subsidiary records of factoring accounts with general ledger accounts, *and* handled only by persons who do not also handle cash?

6. Are inquiries about factored balances received and investigated by persons who do not also handle cash?

*7. Are documents supporting recorded credit adjustments to factored receivable accounts and the due-to-clients accounts checked or tested subsequently by persons who do not also handle cash (if so, explain briefly)?

8. Are proper records maintained for approval of:
   a. Customer orders?
   b. Client credit accommodations?

9. Are items, dates, weights, description of merchandise, etc., shown on invoices, shipping documents, delivery receipts, and bills of lading scrutinized for differences?

10. Are procedures in effect to determine if the signatures shown on the above documents are authentic?

11. Are payments from customers scrutinized for differences in invoice dates, numbers, terms, etc.?

INTEREST AND FEES

*12. Is the preparation and posting of discount, interest, and fee records performed or reviewed by persons who do not also:
   a. Issue official checks and drafts singly?
   b. Handle cash?

13. Are independent discount, interest and fee computations made and compared or tested to initial records by persons who do not also:
   a. Issue official checks and drafts?
   b. Handle cash?

COLLATERAL

*14. Does the bank record, on a timely basis, a first lien on the assigned receivables for each borrower?

15. Does the bank verify the borrower's accounts receivable or require independent verification on a periodic basis?

16. Does the bank review aged accounts receivable schedules on a regular basis?

17. If applicable, are cash receipts and invoices block proved in the mailroom and subsequently traced to posting on daily transaction records?

CONCLUSION

18. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.

19. Based on a composite evaluation as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

Bank premises and equipment includes land, buildings, furniture, fixtures, and other equipment, either owned or acquired by means of a capitalized lease, and any leasehold improvements. This section covers the fair valuation, general propriety, and legality of the bank's investment in premises and equipment. Other real estate owned and insurance coverage on fixed assets are discussed in other sections of this manual. (See sections 2200.1 and 4040.1, respectively.

ACQUISITION AND VALUATION

Banks obtain premises and equipment in three primary ways:

- directly purchasing premises and equipment with cash outlays or by incurring debt, such as a mortgage
- indirectly investing in a corporation that holds title to bank premises (the corporation may or may not be affiliated with the bank)
- leasing bank premises and equipment from a third party

The bank's initial investment in premises and equipment should be booked at cost, which should be determined according to generally accepted accounting principles (GAAP). Nondepreciable assets such as land and art should remain on the books at cost, unless the asset incurs a material and permanent decline in value. Under such circumstances, the asset should be reduced to fair market value on the books, and a loss should be recorded.

The bank should depreciate assets that, over time, decline in economic value. These assets may be depreciated differently for book and tax purposes, which may give rise to deferred tax implications. GAAP allows depreciation using methods such as straight-line, double-declining, or sum-of-years'-digits. The Internal Revenue Service allows accelerated depreciation methods for many assets to encourage businesses to make capital investments. While many banks follow these accelerated schedules for tax purposes, they may not depreciate these same assets as rapidly for book purposes.

Examiners should closely review internal controls for the bank's premises and equipment to ensure that these assets are properly safeguarded and appropriately recorded on the bank's books. Controls should be in place to inventory these assets and periodically review their economic usefulness. Furniture, fixtures, and equipment whose economic usefulness has expired or that are otherwise damaged, impaired, or obsolete should be written down to value. Assets that cannot be located should be accounted for as a loss.

LEASES

Banks frequently lease their premises and equipment rather than own them. Leases should be accounted for in accordance with Financial Accounting Standards Board Statement No. 13 (FAS 13), "Accounting for Leases." FAS 13 requires, among other things, that the lessee capitalize certain leases. The instructions for the preparation of Reports of Condition and Income detail the capitalization of leases and specify treatment for leases entered into before 1977. If a lease is required to be capitalized, the lessee records a capital lease as an asset and a corresponding liability. The amount capitalized would be the present value of the minimum required payments over the noncancelable term, as defined, of the lease, plus the present value of the payment required under the bargain-purchase option, if any, less any portion of the payments representing executory expenses such as insurance, maintenance, and taxes to be paid by the lessor. The amortization period should be the life of the lease or a period established in a manner consistent with the lessee's normal schedule of depreciation for owned assets. The requirements of FAS 13 are somewhat complex, and examiners who have questions on the capitalization of leases are referred to that statement for necessary detail. Leases not required to be capitalized are called "operating leases," and lease payments associated with them are charged to expense over the term of the lease as they become payable.

Lease arrangements between a state member bank and its parent company or other affiliated entity should be reviewed in detail. Examiners should ensure that the lease arrangement is reasonable in relation to the cost of the asset, its current fair market value, or similar lease arrangements in the current market. Transactions that appear to be self-serving or otherwise unreasonable to the bank should be criticized.

INVESTMENT IN BANK PREMISES

Investment in bank premises is limited by section 24A of the Federal Reserve Act, as amended by the Economic Growth and Regulatory Paperwork Reduction Act of 1996. Section 208.21 of Regulation H sets forth the Board's rule on investment limits for bank premises. Except as discussed below, no state member bank is permitted to invest in bank premises or in the stock, bonds, debentures, or other such obligations of any corporation holding the premises of the bank or make loans to or upon the security of any such corporation (collectively, investments in bank premises).

A well-rated and well-capitalized bank may invest an amount that is 150 percent or less of the amount of (1) its perpetual preferred stock and related surplus and (2) its common stock and surplus, provided it gives the appropriate Reserve Bank at least 15 days' notice before making such an investment, and the bank has not received a notice that the investment is subject to further review by the end of that 15-day notice period. State member banks that have a CAMELS rating of 1 or 2 (as of the most recent examination of the bank),[1] and that are, and will continue to be, well capitalized, may make such investments without notice to the Board. Banks that are not well capitalized or well rated may have investments in bank premises only up to 100 percent or less of those amounts, and only with the prior notice indicated above.

When considering the approval of domestic-branch applications, the Board follows the guidelines detailed in section 208.6(b) of Regulation H. The Board will analyze whether the bank's investment in premises for the branch is consistent with section 208.21 of Regulation H. Reserve Banks, under their delegated authority, can also perform this analysis.

1. Alternatively, the state member bank may have an equivalent rating under a comparable rating system, also as defined in the FFIEC Consolidated Reports of Condition and Income.

Member banks are encouraged to plan for their future premises needs. However, examiners should not arbitrarily classify real estate acquired for future use. The examiner needs to review the circumstances surrounding each individual case and determine if the period of time which the property has been held is reasonable relative to the intended use. Real estate acquired for future expansion is considered ‘‘other real estate owned’’ from the date when its use for banking is no longer contemplated. In addition, former banking premises are considered other real estate owned from the date of relocation to new banking quarters.

TRANSACTIONS WITH INSIDERS

If a member bank contracts for or purchases any securities or other property from any of its directors, any firm its directors are members of, or any of its affiliates, the transaction is subject to the requirements of sections 22(d) and 23B of the Federal Reserve Act. These sections require that transactions be made in the regular course of business on terms not less favorable to the bank than those offered to others. When the purchase is authorized by a majority of the board of directors who have no interest in the sale of such securities or property, the authority should be evidenced by affirmative vote or written assent. In addition, a member bank may sell securities or other property to any of its directors subject to the same stipulations.

EXAMINATION CONSIDERATIONS

As indicated earlier, the examiner responsible for bank premises and equipment should assess the appropriateness of the bank's investment in this area and the overall impact of occupancy expense on the bank. Even if a bank's total investment in bank premises is within legal limits and all of its fixed assets are valued fairly, its total expenditures for or investment in premises and equipment may be inappropriate relative to earnings, capital, or the nature and volume of the bank's operations.

1. To determine if the policies, practices, procedures, and internal controls regarding bank premises and equipment are adequate.
2. To determine if bank officers and employees are operating in conformance with the established guidelines.
3. To determine the scope and adequacy of the audit function.
4. To determine the adequacy and propriety of the bank's present and planned investment in bank premises.
5. To determine compliance with laws and regulations.
6. To initiate corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws or regulations have been noted.

1. If selected for implementation, complete or update the Bank Premises and Equipment section of the Internal Control Questionnaire.
2. Based on the evaluation of internal controls and the work performed by internal/external auditors (see separate program) determine the scope of the examination.
3. Test for compliance with policies, practices, procedures and internal controls in conjuction with performing the remaining examination procedures. Also obtain a listing of any audit deficiencies noted in the latest review done by internal/external auditors from the examiner assigned ''Internal Control,'' and determine if appropriate corrections have been made.
4. Obtain a summary of changes in fixed asset and depreciation ledgers that have occurred since the previous examination. Also, balance each of the fixed asset subsidiary accounts to the appropriate general ledger control account.
5. Determine, by reference to excerpts of the minutes of meetings of the board of directors, that all major additions and disposals of fixed assets are properly documented.
6. Determine by observation and inquiry of appropriate management personnel, that the bank's books have been properly adjusted to reflect significant assets that are idle, abandoned, or useless.
7. In instances where bank premises are subject to lease, perform the following for:
   a. Bank as lessee:
      - For each lease which has an initial lease period of more than one year, obtain from the bank:
        — Name of lessor.
        — Expiration date.
        — Required minimum annual payments.
        — Current status.
        — Renewable option provisions.
   b. Bank as lessor:
      - Determine if the bank relies on rental income to contribute to payment of occupancy expenses and if that income is material. As a general guideline, rental income is considered material if it equals or exceeds 1 percent of total operating revenues.
      - If rental income is material, analyze the bank's potential exposure from:
        — Concentrations among lessees.
        — Impending expiration of major leases.
        — Lack of creditworthiness of lessee.
        — Non-compliance with lease terms.
8. Forward to the examiner assigned ''Funds Management:''
   a. The total minimum annual commitment under various lease agreements.
   b. The dollar amount of any significant, future fixed asset expenditure(s).
9. Determine, by reference to appropriate workpapers (see ''Insurance Coverage''), that fire and hazard insurance, in sufficient amounts, is in force.
10. Perform a limited test of the records to verify that depreciation methods are consistent with bank policy, prior years' calculations, generally accepted accounting principles, and applicable IRS laws.
11. Analyze the bank's investment in fixed assets and the annual expenditures required to carry them and determine their reasonableness relative to:
    a. Present total capital structure.
    b. Present annual earnings.
    c. Projected future earnings.
    d. Nature and volume of operations.
12. Test for compliance with the limitations set forth in section 24A of the Federal Reserve Act.
13. Review the following with appropriate management personnel or prepare a memo to other examiners for their use in reveiwing with management:
    a. Any internal control deficiencies.
    b. Any policy deficiencies.
    c. Any violations of law.
14. Review your findings with respect to the propriety and adequacy of present and projected investment in bank premises. In formulating your conclusion, consider:
    a. Size of bank.
    b. Cash flow forecasts.
    c. Existing fixed asset investments.
    d. Anticipated growth potential.

e. Bank programs to maintain assets at their most optimal use.
f. The policy used to establish the useful life of each asset.
g. Control of inventory procedures.
h. Systems used to record all asset purchases, sales and retirements between physical inventories.

15. Prepare comments regarding deficiencies or violations of law for inclusion in the examination report.

16. Prepare the appropriate write-ups for the report of examination.

17. Update workpapers with any information that will facilitate future examinations.

Review the bank's internal controls, policies, practices and procedures over additions, sales and disposals and depreciation of bank premises and equipment. The bank's system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used and other pertinent information. Items marked with an asterisk require substantiation by observation or testing.

CUSTODY OF PROPERTY

*1. Do the bank's procedures preclude persons who have access to property from having "sole custody of property," in that:
   a. Its physical character or use would make any unauthorized disposal readily apparent?
   b. Inventory control methods sufficiently limit accessibility?

ADDITIONS, SALES, AND DISPOSALS

2. Is the addition, sale or disposal of property approved by the signature of an officer who does not also control the related disbursement or receipt of funds?
3. Is board of directors' approval required for all major additions, sales or disposals of property (if so, indicate the amount that constitutes a major addition, sale or disposal $__________)?

*4. Is the preparation, addition and posting of property additions, sales and disposals records, if any, performed and/or adequately reviewed by persons who do not also have sole custody of property?

*5. Are any property additions, sales and disposals records, balanced, at least annually, to the appropriate general controls by persons who do not also have sole custody of property?

6. Are the bank's procedures such that all additions are reviewed to determine whether they represent replacements and that any replaced items are cleared from the accounts?
7. Do the bank's procedures provide for signed receipts for removal of equipment?

*8. Do the bank's policies cover procedures for selecting a seller, servicer, insurer, or purchaser of major assets (through competitive bidding, etc.), to prevent any possibility of conflict of interest or self-dealing?

9. Do the review procedures provide for appraisal of an asset to determine the propriety of the proposed purchase or sales price?

DEPRECIATION

*10. Is the preparation, addition and posting of periodic depreciation records performed and adequately reveiwed by persons who do not also have sole custody of property?

11. Do the bank's procedures require that regular charges be made for depreciation expense?

*12. Are the subsidiary depreciation records balanced, at least annually, to the appropriate general controls by persons who do not also have sole custody of property?

PROPERTY RECORDS

*13. Are subsidiary property records posted by persons who do not also have sole custody of property?

*14. Are the subsidiary property records balanced, at least annually, to the appropriate general ledger accounts by persons who do not also have sole custody of property?

BANK AS LESSOR (BANK PREMISES AND BANK-RELATED EQUIPMENT ONLY)

*15. Do policies provide for division of the duties involved in billing and collection of rental payments?

16. Are the lease agreements subject to the same direct verification program applied to other bank assets and liabilities?

17. Are credit checks performed on potential lesses?
18. Do policies provide for a periodic review of lessees for undue concentrations of affiliated or related concerns?

BANK AS LESSEE (BANK PREMISES AND BANK-RELATED EQUIPMENT ONLY)

19. Does the bank have a clearly defined method of determining whether fixed assets should be owned or leased, and is supporting documentation maintained by the bank?
20. Are procedures in effect to determine whether a lease is a ''capital'' or an ''operating'' lease as defined by the generally accepted accounting principles?
21. Do the bank's operating procedures provide, on ''capital'' leases, that the amount capitalized is computed by more than one individual and/or reviewed by an independent party?

OTHER PROCEDURES

*22. Is the physical existence of bank equipment periodically checked or tested, such as by a physical inventory, and are any differences from property records investigated by persons who do not also have sole custody of property?
23. Do the bank's procedures provide for serial numbering of equipment?
24. Are the bank's policies and procedures on property in written form?
25. Is the benefit of expert tax advice obtained prior to final decision-making on significant transactions involving fixed assets?
*26. Does the bank maintain separate property files which include invoices (including settlement sheets and bills of sale, as necessary), titles (on real estate, vehicles, etc.) and other pertinent ownership data as part of the required documentation?

CONCLUSIONS

27. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant additional deficiencies that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
28. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

A state member bank's authority to hold real estate is governed by its state laws. A bank is permitted to include owned real estate in its premises account if the real estate serves as premises for operations or is intended to be used as premises. In addition, a bank may hold other real estate owned (OREO), which is defined below. State laws dictate the terms and conditions under which state-chartered banks may acquire and hold OREO.

Definition

Bank holdings of OREO arise from the following events:

- the bank purchases real estate at a sale under judgment, decree, or mortgage when the property secured debts previously contracted;
- a borrower conveys real estate to the bank to fully or partially satisfy a debt previously contracted (acceptance of deed in lieu of foreclosure);
- real estate is obtained in exchange for future advances to an existing borrower to fully or partially satisfy debts previously contracted;
- a bank takes possession (although not necessarily title) of collateral in a collateral-dependent real estate loan (i.e., an in-substance foreclosure);
- a bank has relocated its premises and has not yet sold the old premises;
- a bank abandons plans to use real estate as premises for future expansion.

Environmental Liability

Under federal and state environmental liability statutes, a bank may be liable for cleaning up hazardous substance contamination of other real estate owned. In some cases, the liability may arise before the bank takes title to a borrower's collateral real estate. A property's transition from collateral to bank ownership may take an extended period of time. As the financial problems facing a borrower worsen, a bank may become more involved in managing a company or property. Such involvement may become extensive enough that the bank is deemed to have met substantially all ownership criteria, the absence of a clear title in the bank's name notwithstanding. Generally, the more involved bank management is in such activity, the greater the bank's exposure to any future clean-up costs assessed in connection with the property. A more thorough discussion of environmental liability can be found in section 2040.1, "Loan Portfolio Management," of this manual, under the subsection "Other Lending Concerns."

Transfer of Assets to Other Real Estate Owned

Real estate assets transferred to OREO should be accounted for individually on the date of transfer, at the lower of the recorded investment in the loan or fair value. The recorded investment in a loan is the unpaid balance, increased by accrued and uncollected interest, unamortized premium, finance charges, and loan-acquisition costs, if any, and decreased by previous write-downs and unamortized discount, if any. Any excess of the recorded investment in the loan over the property's fair value must be charged against the allowance for loan and lease losses immediately upon the property's transfer to OREO. Legal fees should generally be charged to expenses unless payment of the fees is for the purpose of enhancing the property's value (for example, obtaining a zoning variance).

Establishing a valuation allowance for estimated selling expenses may also be necessary upon transferring each property to OREO to comply with AICPA Statement of Position 92-3, Accounting for Foreclosed Assets. According to this pronouncement, the value of OREO properties must be reported at the lesser of the fair value minus estimated selling expenses or the recorded investment in the loan. For example, if the recorded investment of the property is $125, the fair value is $100, and the estimated selling expenses are $6, the carrying value for this property would be $94. The difference between the recorded investment and the fair value ($25) would be charged to the allowance for loan and lease losses at the time the property was transferred to OREO. In addition, since the bank estimated it would incur selling expenses of $6, a valuation reserve for this amount must be established. The net of the fair value and this valuation reserve for selling expenses is called the ‘‘net realizable value,’’ and in this example would be $94. Changes to this valuation reserve should be handled as outlined in the subsection ‘‘Accounting for Subsequent Changes in Market Value.’’

On the other hand, if the recorded investment in the property is $250, the fair value is $300, and the estimated selling expenses are $18, the carrying value of this property would be $250 (the lesser of the recorded investment or the fair value). In this example, a valuation reserve for estimated selling expenses is unnecessary, as netting the estimated selling expenses ($18) from the fair value ($300) would yield a net realizable value of $282.

The transfer of a loan to OREO is considered to be a ‘‘transaction involving an existing extension of credit’’ under 12 CFR 225.63(a)(7) and is exempt from Regulation Y’s appraisal requirement. However, under 12 CFR 225.63(b), the bank must obtain an ‘‘appropriate evaluation’’ of the real estate that is ‘‘consistent with safe and sound banking practices’’ to establish the carrying value of the OREO. A bank may elect, but is not required, to obtain an appraisal to serve as the ‘‘appropriate evaluation.’’ Until the evaluation is available, a bank should rely on its best estimate of the property’s value to establish the carrying value. The federal banking agencies have issued appraisal and evaluation guidelines to provide guidance to examining personnel and federally regulated institutions regarding prudent appraisal and evaluation policies, procedures, practices, and standards.

The appraisal or evaluation should provide an estimate of the parcel’s market value. Refer to section 4140.1, ‘‘Real Estate Appraisals and Evaluations,’’ for a definition of market value. Generally, market value and fair value are equivalent when an active market exists for a property. In discussing OREO, it is common practice to use the terms ‘‘fair value’’ and ‘‘market value’’ interchangeably. When no active market exists for a property, the accounting industry’s definition of fair value applies because the appraiser cannot determine a market value. The accounting industry definition requires the appraisal or evaluation to contain an estimate of the property’s fair value based on a forecast of expected cash flows, discounted at a rate commensurate with the risks involved. The cash flow estimate should include projected revenues and the costs of ownership, development, operation, marketing, and sale. In such situations, the appraiser or evaluator should fully describe the definition of value and the market conditions that have been considered in estimating the property’s value.

When a bank acquires a property through foreclosure as a junior lienholder, whether or not the first lien has been assumed, the fair value of the property should be recorded as an asset and the senior debt as a liability. The senior debt should not be netted against the assets. Any excess of the recorded investment of the property over the fair value should be charged off, as the recorded investment may not exceed the sum of the junior and senior debt. Payments made on senior debt should be accounted for by reducing both the asset and the liability, and interest that accrues on the senior debt after foreclosure should be recognized as interest expense.

For regulatory reporting purposes, a collateral-dependent real estate loan should be transferred to OREO only when the lender has taken possession (title) of the collateral. Nevertheless, to facilitate administration and tracking, banks may choose to include a collateral-dependent real estate loan in the OREO portfolio as potential or probable OREO. Examiners should review these loans using the same criteria applied to OREO.

Property the bank originally acquired for future use as premises, but for which plans have been abandoned, and property that formerly served as bank premises, should be accounted for at the lower of book value or fair value on the date of transfer to OREO. Any excess of book value over fair value should be charged to other operating expense during the current period.

Carrying Value of Other Real Estate Owned

A bank should have a policy for periodically determining the fair value of its OREO property by obtaining an appraisal or an evaluation, as appropriate. While the Federal Reserve has no prescribed time frame for when a bank should reappraise or reevaluate its OREO property, the bank’s policy should conform to state law, if applicable, and address the volatility of the local real estate market. Specifically, a bank should determine if there have been material changes to the underlying assumptions in the appraisal or valuation that have affected the original estimate of value. If material changes have occurred, the bank should obtain a new appraisal or evaluation based on assumptions that reflect the changed conditions.

Accounting for Subsequent Changes in Market Value

Charges for subsequent declines in the fair value of OREO property should never be posted to the allowance for loan and lease losses. If an appraisal or evaluation indicates a subsequent decline in the fair value of an OREO property, the loss in value should be recognized by a charge to earnings. Banks should attempt to determine whether a property's decline in value is temporary or permanent, taking into consideration each property's characteristics and existing market dynamics. The preferred treatment for permanent losses in value is the direct write-down method, in which the charge to expenses is offset by a reduction in the OREO property's carrying value. If the reduction in value is deemed temporary, the charge to earnings may be offset by establishing a valuation allowance specifically for that property. In the event of subsequent appreciation in the value of an OREO property, the increase can only be reflected by reducing this valuation allowance or recognizing a gain upon disposition, but never by a direct write-up of the property's value. A change to the valuation allowance should be offset with a debit or credit to expense in the period in which it occurs.

In addition to the preceding treatment of the write-down in the OREO value, the previous subsection "Transfer of Assets to Other Real Estate Owned" discusses setting up a valuation allowance for estimated selling expenses associated with the sale of the other real estate. The balance of this valuation reserve can fluctuate based on changes in the fair value of the property held, but it can never be less than zero. The following examples are presented to illustrate the treatment that subsequent depreciation and appreciation would have on OREO properties.

Depreciation in OREO Property Value

Assume a bank has written down its initial recorded investment in an OREO property from $125 to its fair value of $100. Since the fair value of the property was less than the initial recorded investment, a valuation reserve for estimated selling expenses was established. In this example, assume these to be $6. Accordingly, the net realizable value was $94 ($100 minus $6). Next, assume a new appraisal indicates a fair value of $90, reducing the estimated selling expenses to $5. Although the bank must expense the depreciation in the fair value ($10), the valuation reserve for selling expenses would be reduced by the difference in the estimate of the selling expenses ($1). Given this scenario, the "adjusted" net realizable value would be $85 ($90 minus $5).

Appreciation in OREO Property Value

Assume a bank has written down its recorded investment in an OREO property to its fair value of $100. Since the fair value of the property was less than the original recorded investment, an estimated valuation reserve for selling expenses of $6 was established. Accordingly, the net realizable value was $94. A new appraisal indicates an increase in the fair value of the property to $110, with selling expenses now estimated at $7. As a result, the net realizable value is now $103. Given that the new net realizable value is greater than the recorded investment of $100, the selling expense valuation reserve is no longer necessary and the $6 can be reversed to income. Notwithstanding the property's increased fair value, the recorded investment value cannot be increased above $100. The valuation reserve for selling expenses can never be less than zero, thus prohibiting an increase in the value of the property above the recorded investment.

Accounting for Income and Expense

Gross revenue from other real estate owned should be recognized in the period in which it is earned. Direct costs incurred in connection with holding an OREO property, including legal fees, real estate taxes, depreciation, and direct write-downs, should be charged to expense when incurred.

A bank can expend funds to develop and improve OREO when it appears reasonable to expect that any shortfall between the property's fair value and the bank's recorded book value will be reduced by an amount equal to or greater than the expenditure. Such expenditures should not be used for speculation in real estate. The economic assumptions relating to the bank's decision to improve a particular OREO property should be well documented. Any payments for developing or improving OREO property are treated as capital expenditures and should be reflected by increasing the property's carrying value.

Disposition of Other Real Estate Owned

OREO property must be disposed of within any holding period established by state law and, in any case, as soon as it is prudent and reasonable. Banks should maintain documentation reflecting their efforts to dispose of OREO property, which should include—

- a record of inquiries and offers made by potential buyers
- methods used in advertising the property for sale whether by the bank or its agent
- other information reflecting sales efforts

The sale or disposition of OREO property is considered a real estate–related financial transaction under the Board's appraisal regulation. A sale or disposition of an OREO property that qualifies as a federally related transaction under the regulation requires an appraisal conforming to the regulation. A sale or disposition that does not qualify as a federally-related transaction nonetheless must comply with the regulation by having an appropriate evaluation of the real estate, that is consistent with safe and sound banking practices.

The bank should promptly dispose of OREO if it can recover the amount of its original loan plus additional advances and other costs related to the loan or the OREO property before the end of the legal holding period. The holding period generally begins on the date that legal title to the property is transferred to the bank, except for real estate that has become OREO because the bank no longer contemplates using it as its premises. The holding period for this type of OREO property begins on the day that plans for future use are formally terminated. Some states require OREO property to be written off or depreciated on a scheduled basis, or to be written off at the end of a specified time period. The bank should determine whether such requirements exist and comply with them.

Accounting for the Sale of Other Real Estate Owned

Gains and losses resulting from a sale of OREO properties for cash must be recognized immediately. A gain resulting from a sale in which the bank provides financing should be accounted for under the standards described in Statement of Financial Accounting Standards 66 (SFAS 66).

SFAS 66 recognizes that differences in terms of the sale and in selling procedures lead to different profit recognition criteria and methods. Banks may facilitate the sale of foreclosed real estate by requiring little or no down payment, or by offering loans with favorable terms. Profit shall only be recognized in full when the collectibility of the sales price is reasonably ensured and when the seller is not obligated to perform significant activities after the sale to earn the profit. Unless both conditions exist, recognition of all or part of the profit shall be deferred. Collectibility of the sale price of OREO property is demonstrated when the buyer's investment is sufficient to ensure that the buyer will be motivated to honor his or her obligation to the seller rather than lose the investment. Collectibility shall also be assessed by considering factors such as the credit standing of the buyer, age and location of the property, and adequacy of cash flow from the property.

The practice of recognizing all profit from the sale of bank-financed OREO at the time of the sale is referred to as the full-accrual method. A bank shall not recognize profit using this method until all of the following general criteria are met:

- a sale is consummated;
- the buyer's initial and continuing investments adequately demonstrate a commitment to pay for the property;
- the bank's loan is not subject to future subordination;
- the bank has transferred to the buyer the usual risks and rewards of ownership in a transaction that is in substance a sale, and it has no substantial continuing involvement in the property.

A sale will not be considered consummated until the parties are bound by the terms of the contract, all consideration has been exchanged, and all conditions precedent to closing have been performed.

Initial investment, as defined by SFAS 66, includes only cash down payments, notes supported by irrevocable letters of credit from an independent lending institution, payments by the buyer to third parties to reduce existing debt on the property, and other amounts paid by the buyer that are part of the sale price. In these situations, SFAS 66 requires that profit on the sale be deferred until a minimum down payment has been received and annual payments equal those for a loan for a similar type of property with a customary amortization period. The amount of down payment required varies by category of property: land, 20–25 percent; commercial and industrial, 10–25 percent; multifamily residential, 10–25 percent; and single-family residential, 5–10 percent. Ranges within these categories are defined further in the statement.

Continuing investment requires the buyer to be contractually obligated to make level annual payments on his or her total debt for the purchase price of the property. This level annual payment must be able to service principal and interest payments amortized for no more than 20 years for raw land, and for no more than the customary amortization term for a first-mortgage loan by an independent lending institution for other types of real estate.

If a bank finances the sale of foreclosed property it owns with a loan at less than current market interest rates or noncustomary amortization terms, generally accepted accounting principles require that the loan be discounted to bring its yield to a market rate, using a customary amortization schedule. This discount will either increase the loss or reduce the gain resulting from the transaction. Interest income is then generally recognized at a constant yield over the life of the loan.

If a transaction does not qualify for the full-accrual accounting method, SFAS 66 identifies alternative methods of accounting for sales of OREO property as described below.

The Installment Method

This method is used when the buyer's down payment is insufficient to allow the full-accrual method, but when recovery of the cost of the property is reasonably assured if the buyer defaults. The installment method recognizes the sale of the property and the booking of the corresponding loan, although profits from the sale are recognized only as the bank receives payments from the buyer. Under this method, interest income is recognized on an accrual basis, when appropriate.

Since default on the loan usually results in the seller (the bank) reacquiring the real estate, the bank is reasonably assured that it will be able to recover its costs with a relatively small down payment. Cost recovery is especially likely when loans are made to buyers who have verifiable net worth, liquid assets, and income levels adequate to service the loan. Reasonable assurance of cost recovery also may be achieved when the buyer pledges adequate additional collateral.

The Cost-Recovery Method

Dispositions of OREO that do not qualify for either the full accrual or installment methods are sometimes accounted for using the cost-recovery method. This method recognizes the sale of the property and the booking of the corresponding loan, but all income recognition is deferred. Principal payments are applied by reducing the loan balance, and interest payments are accounted for by increasing the unrecognized gross profit. No profit or interest income is recognized until either the buyer's aggregate payments exceed the recorded amount of the loan or a change to another accounting method (for example, the installment method) is appropriate. Consequently, the loan is maintained on nonaccrual status while this method is being used.

The Reduced Profit Method

This method is used in certain situations when the bank receives an adequate down payment, but the loan amortization schedule does not meet the requirements for use of the full-accrual method. The bank again recognizes the sale of the property and the booking of the corresponding loan but, as under the installment method, profits from the sale are recognized only as the bank receives payments from the buyer. Since sales with adequate down payments generally are not structured with inadequate loan-amortization schedules, this method is seldom used.

The Deposit Method

This method is used when a sale of OREO has not been consummated. It also may be used for dispositions that could be accounted for under the cost-recovery method. Under this method, a sale is not recorded, so the asset continues to be reported as OREO. Further, no profit or interest income is recognized. Payments received from the buyer are reported as a liability until the use of one of the other methods is appropriate.

Banks may promote the sale of foreclosed real estate by offering nonrecourse financing to buyers. These loans should be made under the same credit terms and underwriting standards the bank employs for its regular lending activity. Financing arrangements associated with this type of transaction are subject to the accounting treatment discussed above.

Bank records should (1) indicate the accounting method used for each sale of OREO, (2) support the choice of the method selected, and (3) sufficiently document that the institution is correctly reporting associated notes receivable, as either loans or OREO property, with valuation allowances as appropriate.

Classification of Other Real Estate Owned

The examiner should generally evaluate the quality of each OREO property to determine if classification is appropriate. OREO usually should be considered a problem asset, even when it is carried at or below its appraised value. Despite the apparent adequacy of the fair or market value, the bank's acquisition of OREO through foreclosure usually indicates a lack of demand. As time passes, the lack of demand can become more apparent, and the value of the real estate can become increasingly questionable.

When evaluating the OREO property for classification purposes, the examiner must consider the property's market value, whether it is being held in conformance with state law, and whether it is being disposed of according to the bank's plan. The amount of an OREO property subject to classification is the carrying value of the property, net of any specific valuation allowance. The existence of a specific valuation allowance does not preclude adverse classification of OREO. The examiner should review all types of OREO for classification purposes, including sales that fail to meet the standards required for the full-accrual method of accounting. When the bank provides financing, the examiner should determine whether it is prudently underwritten.

The examiner should review all relevant factors to determine the quality and risk of the OREO property and the degree of probability that its carrying value will be realized. Some factors the examiner should consider include—

- the property's carrying value relative to its market value (including the date of any appraisal or evaluation relative to changes in market conditions), the bank's asking price, and offers received;
- the source and quality of the appraisal or evaluation, including the reasonableness of assumptions, such as projected cash flow for commercial properties;
- the length of time a property has been on the market and local market conditions for the type of property involved, such as history and trend of recent sales for comparable properties;
- bank management's ability and track record in liquidating other real estate and assets acquired in satisfaction of debts previously contracted;
- income and expenses generated by the property and other economic factors affecting the probability of loss exposure;
- the manner in which the bank intends to dispose of the property;
- other pertinent factors, including property-title problems, statutory redemption privileges, pending changes in the property's zoning, environmental hazards, other liens, tax status, and insurance.

1. To determine if the policies, practices, procedures, and internal controls regarding other real estate owned are adequate.
2. To determine that bank officers and employees are operating in conformance with the established guidelines.
3. To evaluate the validity and quality of all other real estate owned.
4. To determine the scope and adequacy of the audit function.
5. To determine compliance with laws and regulations.
6. To initiate corrective action when policies, practices, procedures, or internal controls are deficient or when violations of law or regulations have been noted.

1. If selected for implementation, complete the Other Real Estate Owned section of the Internal Control Questionnaire.
2. Test for compliance with policies, practices, procedures and internal controls in conjunction with performing the remaining examination procedures and obtain a listing of any audit deficiencies noted in the latest review done by internal/external auditors and determine if appropriate corrections have been made.
3. Obtain a list of other real estate owned and agree total to general ledger.
4. Review the other real estate owned account to determine if any property has been disposed of since the prior examination and:
   a. If so, determine that:
      - The bank accepted written bids for the property.
      - The bids are maintained on file.
      - There is justification for accepting a lower bid if the bank did not accept the highest one.
   b. Investigate any insider transactions.
5. Test compliance with applicable laws and regulations:
   a. Determine that other real estate owned is held in accordance with the provisions of applicable state law.
   b. Determine if other real estate is being amortized or written off in compliance with applicable state law.
   c. Consult with the examiners assigned to ‘‘Loan Portfolio Management,’’ ‘‘Other Assets and Other Liabilities,’’ ‘‘Reserve for Possible Loan Losses’’ and ‘‘Bank Premises and Equipment’’ to determine if the situation holds real estate acquired as salvage on uncollectible loans, abandoned bank premises or property originally purchased for future expansion, which is no longer intended for such usage.
   d. Review the details of all other real estate owned transactions to determine that:
      - The property has been booked at its fair value.
      - The documentation reflects the bank’s persistent and diligent effort to dispose of the property.
      - If the bank has made expenditures to improve and develop other real estate owned, proper documentation is in the file.
      - Real estate that is former banking premises has been accounted for as other real estate owned since the date of abandonment.
      - Such property is disposed of in accordance with state law.
6. Review parcels of other real estate owned with appropriate management personnel and, if justified, assign appropriate classification. Classification comments should include:
   a. Description of property.
   b. How real estate was acquired.
   c. Amount and date of appraisal.
   d. Amount of any offers and bank’s asking price.
   e. Other circumstances pertinent to the classification.
7. Review the following with appropriate management personnel or prepare a memo to other examiners for their use in reviewing with management:
   a. Internal control exceptions and deficiencies in, or non-compliance with, written policies, practices and procedures.
   b. Uncorrected audit deficiencies.
   c. Violations of law.
8. Prepare comments in appropriate report form for all:
   a. Criticized other real estate owned.
   b. Deficiencies noted.
   c. Violations of law.
9. Update the workpapers with any information that will facilitate future examinations.

Review the bank's internal controls, policies, practices and procedures for other real estate owned. The bank's systems should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used and other pertinent information.

RECORDS

1. Is the preparation, addition, and posting of subsidiary other real estate owned records performed and/or tested by persons who do not have direct, physical or accounting, control of those assets?
2. Are the subsidiary other real estate owned records balanced at least annually to the appropriate general ledger accounts by persons who do not have direct, physical or accounting, control of those assets?
3. Is the posting to the general ledger other real estate owned accounts approved, prior to posting, by persons who do not have direct, physical or accounting, control of those assets?
4. Are supporting documents maintained for all entries to other real estate owned accounts?
5. Are acquisitions and disposals of other real estate owned reported to the board of directors or its designated committee?
6. Does the bank maintain insurance coverage on other real estate owned including liability coverage where necessary?
7. Are all parcels of other real estate owned reviewed at least annually for:
   a. Current appraisal or certification?
   b. Documentation inquiries and offers?
   c. Documented sales efforts?
   d. Evidence of the prudence of additional advances?

OTHER PROCEDURES

8. Are the bank's policies and procedures relating to the real estate owned in writing?

CONCLUSION

9. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
10. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

OTHER ASSETS

Introduction

The term ‘‘other assets,’’ as used in this section, includes all balance sheet asset accounts not covered specifically in other areas of the examination. Such accounts often may be quite insignificant to the overall size of the bank. However, significant subquality assets may be discovered in banks lacking proper internal controls and procedures.

In many banks, ‘‘other assets’’ accounts are maintained on the daily statement but must be reflected in a specific asset category for reporting. Schedule RC-F of the Consolidated Report of Condition lists the specific accounts classified as ‘‘other assets’’ and includes a catchall heading of ‘‘other.’’ (Certain ‘‘other assets’’ accounts, such as securities borrowed, are discussed in other sections of this manual.)

Types of Accounts

Types of ‘‘other assets’’ frequently found in banks are the various temporary holding accounts such as suspense, interoffice, teller, transit, and bookkeeping differences having debit balances. Those accounts should be used only for temporary recording until the offsetting entry is received or fully identified and posted to the proper account. Nothing should be allowed to remain in those accounts for any significant length of time; usually no more than a few business days. Banks should have written procedures to ensure that difference accounts are reconciled and closed out on a timely basis. In any event, all difference accounts should be closed out at least quarterly.

General categories of ‘‘other assets’’ common to banks on the accrual system are prepaid expenses and income earned not collected. Prepaid expenses represent cash outlay for goods and services, the benefits of which will be realized in future periods. Income earned not collected results from the differences between accrual and cash-basis accounting.

Another example of an account that may be found in the ‘‘other assets’’ category is an investment in a community development corporation called Minbanc Capital Corporation. Minbanc is an undiversified closed-end investment company created at the suggestion of the American Bankers Association. The company’s primary objective is to make needed capital funds available to qualifying minority-owned banks so they may better contribute to the growth of their communities and the nation. Banks must have minimum of three years operating history to be eligible for the funds.

There are an unlimited number of account titles that could be included in the ‘‘other assets’’ category, from redeemed food stamps to art objects, antiques, and coin and bullion. Regardless, the examiner must design specific procedures for review and testing to fit the particular account and situation, and must document the scope of the review in the workpapers.

Scope of the Examination

Examiners assigned to review ‘‘other assets’’ must obtain the detailed breakdown of such accounts both when they are reflected as such on the bank’s statement of condition and when they are designated as such for reporting purposes. When the account can best be examined by examiners assigned to other areas of the bank, the detailed breakdown of the accounts should be furnished to those examiners. The remaining accounts should be reviewed and evaluated by examiners assigned to this section.

The major factor in deciding which accounts are to be reviewed is materiality; however, even accounts with small balances may be significant. The examiner should evaluate whether to analyze the nature and quality of each individual item, based upon its impact on the overall soundness of the bank or the quality of its earnings. In this regard, it is important that the examiner verify—

- the existence of the asset;
- the proper valuation of the asset; and
- the adequacy of the accounting and disposition controls, as well as the quality, of the asset.

An examiner should authenticate the existence of the assets selected by ensuring adequate supporting documentation. Also, the examiner should verify that ownership of the asset rests with the bank. (In the case of organizational costs borne by the bank for formation of a holding company, those costs, and the related ownership rights in the capitalized asset, should more properly be borne by the ownership interests and should not be recorded as assets of the bank.)

Proper valuation and reporting of ''other assets'' accounts is another potential area of concern for the examiner. Assets are generally acquired through purchase, trade, repossession, prepayment of expenses, or accrual of income. Generally, assets purchased, traded, or repossessed are transferred at their fair market value. Prepaid expenses and income accrued are booked at cost. An examiner should be particularly alert in identifying those assets that lose value over time to ensure that they are appropriately depreciated or amortized. All intangible assets should be regularly amortized and management should have a system in place to confirm the valuation of the remaining book balance of the intangible assets. The examiner should ensure that the book balance of key man life insurance policies owned by the bank reflects the surrender charge, if any.

Examiners need to review the net deferred tax assets that banks report in their regulatory reports and use to meet capital requirements. Net deferred taxes generally arise from the tax effects of reporting income or expense charges in one period for financial statement purposes and in another period for tax purposes. This effect, known as a temporary difference, is at times sizeable. Charges that result in a significant deferred tax asset are often caused by loan loss provisions exceeding tax bad debt deductions in a given period. While banks are permitted to carry deferred income tax assets on their reports of condition, they are limited by generally accepted accounting principles (GAAP) to the extent these items can be carried.

The Financial Accounting Standards Board (FASB) Statement on Accounting for Income Taxes, No. 109, requires a deferred tax asset to be recognized for all deductible temporary differences and operating loss or tax credit carryforwards, and then be reduced by a valuation allowance if it is expected that some or all of the deferred tax asset will not be realized. Banks must adopt Statement No. 109 as of January 1, 1993, or the beginning of their first fiscal year thereafter, if later.

The Federal Financial Institutions Examination Council has recommended that the regulatory agencies place a limit on the amount of deferred tax assets allowable in computing an institution's core (tier 1) capital. The limit would consider the sources of taxable income available to an institution to realize its deferred tax assets as if it were a separate taxpayer. Deferred tax assets that can be realized from taxes paid in prior carryback years and from future reversals of existing taxable temporary differences generally would not be limited. To the extent that the realization of deferred tax assets is dependent on an institution's future taxable income (exclusive of reversing temporary differences and carryforwards) or its tax-planning strategies, such deferred tax assets would be limited for regulatory capital purposes to the amount that can be realized within one year of the quarter-end report date or 10 percent of core capital, whichever is less. It is anticipated that the agencies will request comment on this proposed capital limitation in the near future.

The examiner should ensure that the controls concerning ''other assets'' protect the bank's ownership rights, that the accounts are properly valued and accurately reported, and that activity is monitored regularly by management. A bank with good control and review procedures will periodically charge-off all uncollectible or unreconcilable items. However, the examiner must frequently go beyond the general ledger control accounts and scan the underlying subsidiary ledgers to determine that posting errors and/or the common practice of netting certain accounts against each other do not cause significant balances to go unnoticed because of lack of proper detail.

OTHER LIABILITIES

Introduction

The term ''other liabilities,'' as used in this section, includes all balance sheet liability accounts not covered in other specific liability categories or in other areas of the examination. The accounts often may be quite insignificant to the overall size of a bank. In some banks, specific accounts are established for control purposes and appear on the balance sheet as ''other liabilities.'' For reporting, however, these accounts must be assigned to specific liability categories or netted from related asset categories, as appropriate.

Schedule RC-G of the Consolidated Report of Condition lists the specific accounts classified as ''other liabilities'' and includes a catchall heading of ''other.'' (Certain ''other liabilities'' accounts, such as securities borrowed, minority interest in consolidated subsidiaries, and dividends declared but not yet payable, are discussed in other sections of this manual.)

Types of Accounts

A general category of ''other liabilities'' common to banks using accrual systems is expenses accrued and unpaid. These accounts represent periodic charges to income based on anticipated or contractual payments of funds to be made at a later date. They include items such as interest on deposits, taxes, and expenses incurred in the normal course of business. There should be a correlation between the amount being accrued on a daily or monthly basis and the amount due on the stated or anticipated payment date.

The examiner should review ''other liabilities'' accounts to determine that accounts, such as deferred taxes (credit balance), are being properly recognized. This review should also determine that matters such as pending tax litigation, equipment contracts, and accounts payable have been recorded properly and are being discharged in accordance with their terms and requirements.

Various miscellaneous liabilities may be found within the accounts, such as undisbursed loan funds, deferred credits, interoffice, suspense, and other titles denoting pending status. The number of possible items that could be included are unlimited, and the accounts should be reviewed to determine that they are used properly and that all such items are clearing in the normal course of business. Because of the variety of such accounts, the examiner must develop specific examination procedures to fit the particular account and situation.

Scope of the Examination

Examiners assigned to review ''other liabilities'' are responsible for obtaining the bank's breakdown of those accounts and, when they are to be examined under other sections, they must ensure that examiners in charge of those sections receive the necessary information. The remaining accounts should be reviewed and evaluated by examiners assigned to this section.

The major emphasis in examining this area should be on the adequacy of the controls and procedures employed by the bank in promptly recording the proper amount of liability. Without proper management attention, these accounts may be misstated, either advertently or inadvertently. For instance, fraudulent entries in suspense or interbranch accounts could be rolled over every other day to avoid stale dates, causing shortages of any amount to be effectively concealed for indefinite periods of time.

Like ''other assets,'' ''other liabilities'' accounts with small balances may be significant. Scanning account balances may disclose a recorded liability, but it does not aid in determining whether liability figures are accurate. Therefore, it is important to review information obtained from examiners working with the board of directors' minutes, minutes of committees, and responses from legal counsel handling litigation because these documents might reveal a major understatement of liabilities. Determining accurate balances in ''other liabilities'' accounts requires an in-depth review of source documents or other accounts from which the liability arose.

Other Assets and Other Liabilities
Examination Objectives
Effective date May 1993

Section 2210.2

1. To determine if policies, practices, procedures, and internal controls regarding "other assets" and "other liabilities" are adequate.
2. To determine that bank officers and employees are operating in conformance with established guidelines.
3. To evaluate the validity and quality of all "other assets."
4. To determine that "other liabilities" are properly recorded.
5. To determine the scope and adequacy of the audit function.
6. To determine compliance with laws and regulations.
7. To initiate corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws or regulations have been noted.

1. Complete or update the Internal Control Questionnaire, if selected for implementation.
2. Based on the evaluation of internal controls and the work performed by internal/external auditors, determine the scope of the examination.
3. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examination procedures. Obtain a listing of any deficiencies noted in the latest review done by internal/external auditors from the examiner assigned "Internal Control," and determine if appropriate corrections have been made.
4. Obtain from the examiner assigned "Examination Strategy" the list of "other assets" and "other liabilities" accounts.
5. Obtain a trial balance of "other assets" and "other liabilities" accounts, including a detailed listing of the interbank accounts and:
   a. Agree or reconcile balances to department controls and general ledger.
   b. Review reconciling items for reasonableness.
6. Scan the trial balances for:
   a. Obvious misclassifications of accounts and, if any are noted, discuss reclassification with appropriate bank personnel and furnish a list to appropriate examining personnel.
   b. Large, old, or unusual items and, if any are noted, perform additional procedures as deemed appropriate, being certain to appraise the quality of "other assets."
   c. "Other assets" items that represent advances to related organizations, directors, officers, employees, or their interests, and if any are noted, inform the examiner assigned "Loan Portfolio Management."
7. Determine that amortizing "other assets" accounts are being amortized over a reasonable period correlating to their economic life.
8. If the bank has outstanding customer liability under letters of credit, obtain and forward a list of the names and amounts to the examiner assigned "Loan Portfolio Management."
9. Review the balance of any "other liabilities" owed to officers, directors, or their interests and investigate, by examining applicable supporting documentation, whether they have been used to—
   a. record unjustified amounts; or
   b. record amounts for items unrelated to bank operations.
10. Develop, and note in the workpapers, any special programs considered necessary to properly analyze any remaining "other assets" or "other liabilities" account.
11. Test for compliance with applicable state laws and regulations.
12. For "other assets" items that are determined to be stale, abandoned, uncollectible, or carried in excess of estimated values, and for "other liabilities" items that are determined to be improperly stated, after consulting with the examiner-in-charge, request management to make the appropriate entries on the bank's books.
13. Prepare, in appropriate report form, and discuss with appropriate officer(s):
   a. Violations of laws and regulations.
   b. Criticized "other assets."
   c. The adequacy of written policies relating to "other assets" and "other liabilities."
   d. Recommended corrective action when policies, practices, or procedures are deficient.
14. Update the workpapers with any information that will facilitate future examinations.

Review the bank's internal controls, policies, practices, and procedures concerning "other assets" and "other liabilities." The bank's systems should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used, and other pertinent information.

OTHER ASSETS

Policies and Procedures

1. Has the bank formulated written policies and procedures governing "other assets" accounts?

Records

2. Is the preparation of entries and posting of subsidiary "other assets" records performed or tested by persons who do not also have direct control, either physical or accounting, of the related assets?
3. Are the subsidiary "other assets" records, if any, balanced at least quarterly to the appropriate general ledger accounts by persons who do not also have direct control, either physical or accounting, of the related assets?
4. Is the posting of "other assets" accounts to the general ledger approved prior to posting by persons who do not also have direct control, either physical or accounting, of the related assets?
5. Are worksheets or other supporting records maintained to support prepaid expense amounts?
6. Are supporting documents maintained for all entries to "other assets"?
7. Are the items included in suspense accounts aged and reviewed for propriety regularly by responsible personnel?

Receivables

8. Are receivables billed at regular intervals? (If so, state frequency ____________.)
9. Are receivables reviewed at least quarterly for collectibility by someone other than the originator of the entry?
10. Is approval required to pay credit balances in receivable accounts?
11. Do credit entries to a receivables account, other than payments, require the approval of an officer independent of the entry preparation?

Other Procedures

12. Does charge-off of a nonamortizing "other asset" initiate review of the item by a person not connected with entry authorization or posting?
13. Do review procedures, where applicable, provide for an appraisal of the asset to determine the propriety of the purchase or sale price?

Conclusion

14. Does the foregoing information provide an adequate basis for evaluating internal controls in that deficiencies in areas not covered by this questionnaire do not significantly impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
15. Are internal controls adequate based on a composite evaluation, as evidenced by answers to the foregoing questions?

OTHER LIABILITIES

Policies and Procedures

1. Has the bank formulated written policies and procedures governing the "other liabilities" accounts?

Records

2. Does the bank maintain subsidiary records of items comprising "other liabilities"?

3. Is the preparation of entries and posting of subsidiary ‘‘other liabilities’’ records performed or tested by persons who do not also originate or control supporting data?
4. Are subsidiary records of ‘‘other liabilities’’ balanced at least monthly to appropriate general ledger accounts by persons who do not also originate or control supporting data?
5. Are the items included in suspense accounts aged and reviewed for propriety regularly by responsible personnel?

Other Procedures

6. Does the bank book obligations immediately on receipt of invoices or bills for services received?
7. If the bank uses a Federal Reserve deferred credit account, is the liability for incoming ‘‘Fed’’ cash letters booked immediately upon receipt?
8. Does the bank book dividends that have been declared but are not yet payable?
9. Are invoices and bills proved for accuracy prior to payment?
10. Are invoices and bills verified and approved by designated employees prior to payment?
11. Are procedures established to call attention, within the discount period, to invoices not yet paid?
12. Does the bank have a system of advising the board of directors of the acquisition and status of major ‘‘other liabilities’’ items?
13. Are all payroll tax liabilities agreed to appropriate tax returns and reviewed by an officer to ensure accuracy?

Conclusion

14. Does the foregoing information provide an adequate basis for evaluating internal controls in that deficiencies in areas not covered by this questionnaire do not significantly impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
15. Are internal controls adequate based on a composite evaluation, as evidenced by answers to the foregoing questions?

Deposits are funds that customers place with the bank and that the bank is obligated to repay on demand, after a specific period of time or after expiration of some required notice period. Deposits are the primary funding source for most banks and, as a result, have a significant effect on a bank's liquidity. Banks use deposits in a variety of ways, primarily to fund loans and investments. Management should establish a procedure for determining the volatility and composition of the deposit structure to ensure that funds are employed profitably, while allowing for their potential withdrawal. Therefore, a bank's management should implement programs to retain and prudently expand the bank's deposit base.

Bankers place great significance on the deposit structure because favorable operating results depend, in part, on a core deposit base. Because of competition for funds, the need for most individuals and corporations to minimize idle funds, and the effect of disintermediation (the movement of deposits to other higher-yielding markets) on a bank's deposit base, bank management should adopt and implement a development and retention program for all types of deposits.

DEPOSIT DEVELOPMENT AND RETENTION PROGRAM

Important elements of the examination process are the review of a bank's deposit development and retention program and the methods used to determine the volatility and composition of the deposit structure. A bank's deposit development and retention program should include—

- a marketing strategy,
- projections of deposit structure and associated costs, and
- a formula for comparing results against projections.

To structure a deposit program properly, bank management must consider many factors, some of which include—

- the composition of the market-area economic base,
- the ability to employ deposits profitably,
- the adequacy of current operations (staffing and systems) and the location and size of banking quarters relative to its volume of business,
- the degree of competition from banks and nonbank financial institutions and their programs to attract deposit customers, and
- the effects of the national economy and the monetary and fiscal policies of the federal government on the bank's service area.

The bank's size and the composition of its market determine how formal its deposit program should be. After a bank develops its deposit program, management must continue to monitor the above factors and correlate any findings to determine if adjustments are needed. The long-term success of any deposit program relates directly to the ability of management to make adjustments at the earliest possible time.

DEPOSIT STRUCTURE

Management should look not only at deposit growth, but also at the nature of the deposit structure. To invest deposited funds properly in view of anticipated or potential withdrawals, management must be able to determine what percentage of the overall deposit structure is centered in core deposits, in fluctuating or seasonal deposits, and in volatile deposits. It is important that internal reports with information concerning the composition of the deposit structure be provided to management periodically. Management's lack of such knowledge could lead to an asset/liability mismatch, causing problems at a later date.

In analyzing the deposit structure, information gathered by the various examination procedures should be sufficient to allow the examiner to evaluate the composition of both volatile and core deposits. Ultimately, the examiner should be satisfied with management's efforts to plan for the bank's future.

Examiners must analyze the present and potential effect deposit accounts have on the financial condition of the bank, particularly with regard to the quality and scope of management's planning. The examiner's efforts should be directed to the various types of deposit accounts that the bank uses for its funding base. The examiners assigned to the areas of funds management and to the analytical review of the bank's income and expenses should be informed of any significant change in interest-bearing deposit-account activity.

COST OF FUNDS

Interest paid on deposits is generally the largest expense to a bank. As a result, interest-bearing deposit accounts employed in a marginally profitable manner could have significant and lasting effects on bank earnings. The examiner should consider the following in evaluating the effect of interest-bearing deposit accounts on a bank's earnings:

- an estimated change in interest expense resulting from a change in interest rates on deposit accounts or a shift in funds from one type of account to another
- service-charge income
- projected operating costs
- changes in required reserves
- promotional and advertising costs
- the quality of management's planning

SPECIAL DEPOSIT-RELATED ISSUES

The examiner should keep the following issues in mind during an examination to ensure the bank is in compliance, where applicable.

Abandoned-Property Law

State abandoned-property laws are generally called escheat laws. Although escheat laws vary from state to state, they normally require a bank to remit the proceeds of any deposit account to the state treasurer when—

- the deposit account has been dormant for a certain number of years, and
- the owner of the account cannot be located.

Service charges on dormant accounts should bear a direct relationship to the cost of servicing the accounts, which ensures that the charges are not excessive. A bank's board of directors (or a committee appointed by the board) should review the basis on which service charges on dormant accounts are assessed and should document the review. There have been occasions when excessive servicing charges have resulted in no proceeds being remitted at the time the account became subject to escheat requirements. In these cases, courts have required banks to reimburse the state. (See also the "Dormant Accounts" discussion later in this section.)

Bank Secrecy Act

Examiners should be aware of the Bank Secrecy Act when examining the deposit area and should follow up on any unusual activities or arrangements noted. The act was implemented by the Treasury Department's Financial Recordkeeping and Reporting of Currency and Foreign Transactions Regulation. For further information, see the *Bank Secrecy Act Examination Manual* and section 208.63 of the Federal Reserve's Regulation H.

Banking Hours and Processing of Demand Deposits

The Board's Regulation CC (12 CFR 229), "Availability of Funds and Collection of Checks," and the Uniform Commercial Code (UCC) govern banking-day cutoff hours and the processing of deposits. A "banking day" is that part of a day on which an office of the bank is open to the public for carrying on substantially all of its banking functions. Saturdays, Sundays, and certain specified holidays are not banking days under Regulation CC, although such days might be banking days under the UCC if a bank is open for substantially all its functions on those days.

Regulation CC requires a bank to make deposited funds available for withdrawal within a certain period after the banking day on which they are received. Cash deposits, wire transfers, and certain check deposits that pose little risk to the depositary bank (such as Treasury checks and cashier's checks) generally are to be made available for withdrawal by the business day after the day of deposit. The time when the depositary bank must make other check deposits available for withdrawal depends on whether the check is local or nonlocal to the depositary bank. As of September 1, 1990, proceeds of local and nonlocal checks must be available for withdrawal by the second and fifth business day following deposit, respectively. However, Regulation CC allows a bank to set, within certain limits, cutoff hours, after which the bank will deem funds to be received on the next banking day for purposes of calculating the availability date (12 CFR 229.19). Different cutoff-hour limits apply to different types of deposits.

For the purpose of allowing banks to process checks, the UCC provides that a bank may set a cutoff hour of 2 p.m. or later and that items received after that time will be considered received as of the next banking day (UCC section 4-108). Under both the UCC and Regulation CC, both the banking day on which a bank is deemed to have received a check and the cutoff hour affect the time frames within which a bank must send the check through the forward-collection and return processes.

A bank that fails to set its cutoff hour appropriately, does not make funds available within the appropriate time frames, or processes checks in an untimely manner may be subject to civil liability for not performing its duties in accordance with various provisions of Regulation CC and the UCC.

Foreign-Currency Deposits

Domestic depository institutions are permitted to accept deposits denominated in foreign currency. Institutions should notify customers that such deposits are subject to foreign-exchange risk. The bank should convert such accounts to the U.S. dollar equivalent for purposes of reporting to the Federal Reserve. Examination staff should ascertain that all reports are in order and should evaluate the bank's use of such funds and its management of the accompanying foreign-exchange risk. Accounts denominated in foreign currency are not subject to the requirements of Regulation CC. (See SR-90-03 (IB), "Foreign (Non–U.S.) Currency Denominated Deposits Offered at Domestic Depository Institutions.")

International Banking Facilities

An international banking facility (IBF) is a set of asset and liability accounts segregated on the books of a depository institution. IBF activities are essentially limited to accepting deposits from and extending credit to foreign residents (including banks), other IBFs, and the institutions establishing the IBF. IBFs are not required to maintain reserves against their time deposits or loans. The examiner should follow the special examination procedures in the international section of this manual when examining an IBF.

Pass-Through Deposit Insurance

When deposits from a retirement or employee benefit plan (EBP), such as a 401(k) retirement account, Keogh plan account, corporate pension plan, or profit-sharing program, are entitled to pass-through insurance, the $100,000 limit on Federal Deposit Insurance Corporation (FDIC) insurance does not apply to the entire EBP account balance. Rather, the FDIC insurance "passes through" to each owner or beneficiary, and the deposited funds of each individual EBP participant are insured up to $100,000.

EBP deposits are entitled to pass-through insurance when the depository institution meets certain requirements (set forth in the FDIC's rules at 12 CFR 330.14) that are based primarily on the institution's prompt-corrective-action (PCA) capital category at the time the institution accepts each deposit. Section 330.14 and the provisions it references generally provide that EBP deposits qualify for pass-through insurance when those funds are accepted by a depository institution in the "well-capitalized" category. Deposits accepted by a depository institution in the "adequately capitalized" PCA capital category generally are eligible for pass-through insurance if the institution has (1) obtained a brokered deposit waiver from the FDIC or (2) met each applicable capital standard and provided, at the time of each deposit, a statement to the EBP manager or administrator that such deposits are eligible for pass-through insurance. EBP deposits do not qualify for such insurance when accepted by an institution that is in the "undercapitalized" PCA capital category.

The FDIC's rules require a depository institution to disclose in writing information about EBP deposits when the EBP account is opened, upon the request of the manager or administrator of the EBP, and within 10 days of the time pass-through insurance ceases to be available. Although the specific contents of the three types of notice differ somewhat, they generally include information about the depository institution's

PCA capital category and the availability or nonavailability of pass-through insurance, as appropriate.

Reserve Requirements

The Monetary Control Act of 1980 and the Federal Reserve's Regulation D, ''Reserve Requirements of Depository Institutions,'' establish two categories of deposits for reserve-requirement purposes. The first category is the transaction account, which represents a deposit or account from which the depositor or account holder is permitted to make orders of withdrawals by negotiable instrument, payment orders of withdrawal, telephone transfer, or similar devices for making payments to a third party or others. Transaction accounts include demand deposits, NOW accounts, automatic transfer (ATS) accounts, and telephone or preauthorized transfer accounts. The second category is the nontransaction deposit account, which includes all deposits that are not transaction accounts, such as (1) savings deposits, that is, money market deposit accounts and other savings deposits, and (2) time deposits, that is, time certificates of deposit and time deposits, open account. See Regulation D for specific definitions of the various deposit accounts.

Treasury Tax and Loan Accounts

Member banks may select either the ''remittance-option'' or the ''note-option'' method to forward deposited funds to the U.S. Treasury. With the remittance option, the bank remits the Treasury tax and loan (TT&L) account deposits to the Federal Reserve Bank the next business day after deposit. The remittance portion is not interest-bearing.

The note option permits the bank to retain the TT&L deposits. With the note option, the bank debits the TT&L remittance account for the amount of the previous day's deposit and simultaneously credits the note-option account. Thus, TT&L funds are now purchased funds evidenced by an interest-bearing, variable-rate, open-ended, secured note callable on demand by Treasury. Rates paid are ¼ of 1 percent less than the average weekly rate on federal funds. Interest is calculated on the weekly average daily closing balance in the TT&L note-option account. Although there is no required maximum note-option ceiling, banks may establish a maximum balance by providing written notice to the Federal Reserve Bank. As per 31 CFR 203.24, the TT&L balance requires the bank to pledge collateral to secure these accounts, usually from its investment portfolio. The note option is not included in reserve-requirement computations and is not subject to deposit insurance because it is classified as a demand note issued to the U.S. Treasury, a type of borrowing.

POTENTIAL PROBLEM AREAS

The following types of deposit accounts and related activities have above-average risk and, therefore, require the examiner's special attention.

Bank-Controlled Deposit Accounts

Bank-controlled deposit accounts, such as suspense, official checks, cash-collateral, dealer reserves, and undisbursed loan proceeds, are used to perform many necessary banking functions. However, the absence of sound administrative policies and adequate internal controls can cause significant loss to the bank. To ensure that such accounts are properly administered and controlled, the directorate must ensure that operating policies and procedures are in effect that establish acceptable purpose and use; appropriate entries; controls over posting entries; and the length of time an item may remain unrecorded, unposted, or outstanding. Internal controls that limit employee access to bank-controlled accounts, determine the responsibility for frequency of reconcilement, discourage improper posting of items, and provide for periodic internal supervisory review of account activity are essential to efficient deposit administration.

The deposit suspense account is used to process unidentified, unposted, or rejected items. Characteristically, items posted to such accounts clear in one business day. The length of time an item remains in control accounts often reflects on the bank's operational efficiency. This deposit type has a higher risk potential because the transactions are incomplete and require manual processing to be completed. As a result of the need for human interaction and the exception nature of these transactions, the possibility of misappropriation exists.

Official checks, a type of demand deposit, include bank checks, cashier's checks, expense checks, interest checks, dividend-payment checks, certified checks, money orders, and traveler's checks. Official checks reflect the bank's promise to pay a specified sum upon presentation of the bank's check. Because accounts are controlled and reconciled by bank personnel, it is important that appropriate internal controls are in place to ensure that account reconcilement is segregated from check origination. Operational inefficiencies, such as unrecorded checks that have been issued, can result in a significant understatement of the bank's liabilities. Misuse of official checks may result in substantial losses through theft.

Cash-collateral, dealer differential or reserve, undisbursed loan proceeds, and various loan escrow accounts are also sources of potential loss. The risk lies in inefficiency or misuse if the accounts become overdrawn or if funds are diverted for other purposes, such as the payment of principal or interest on bank loans. Funds deposited to these accounts should be used only for their stated purposes.

Brokered Deposits

Brokered deposits are funds the reporting bank obtains, directly or indirectly, by or through any deposit broker, for deposit into one or more deposit accounts. Thus, brokered deposits include both those in which the entire beneficial interest in a given bank deposit account or instrument is held by a single depositor and those in which the deposit broker pools funds from more than one investor for deposit in a given bank deposit account.

The Federal Deposit Insurance Act (the FDI Act) defines "deposit broker" to mean "(A) any person engaged in the business of placing deposits, or facilitating the placement of deposits, of third parties with insured depository institutions or the business of placing deposits with insured depository institutions for the purpose of selling interests in those deposits to third parties; and (B) an agent or trustee who establishes a deposit account to facilitate a business arrangement with an insured depository institution to use the proceeds of the account to fund a prearranged loan." Exceptions to this definition are allowed for certain fiduciary relationships.

A small or medium-sized bank's dependence on the deposits of customers who reside outside of or who conduct their business outside of the bank's normal service area should be closely monitored by the bank and analyzed by the examiner. Such deposits may be the product of personal relationships or good customer service; however, large out-of-area deposits are sometimes attracted by liberal credit accommodations or significantly higher interest rates than competitors offer. Deposit growth that is due to liberal credit accommodations generally proves costly in terms of the credit risks taken relative to the benefits received from corresponding deposits, which may be less stable. Banks outside dynamic metropolitan areas are limited in growth because they usually can maintain stable deposit growth only as a result of prudent reinvestment in the bank's service area. Deposit development and retention policies should recognize the limits imposed by prudent competition and the bank's service area.

Banking organizations have historically relied to a limited extent on funds obtained through deposit brokers to supplement their traditional funding sources. A concern regarding the activities of deposit brokers is that the ready availability of large amounts of funds through the issuance of insured obligations undercuts market discipline.

The use of brokered deposits by sound, well-managed banks can play a legitimate role in the asset/liability management of a bank and enhance the efficiency of financial markets. However, the use of brokered deposits can also contribute to the weakening of a bank by allowing it to grow at an unmanageable or imprudent pace and can exacerbate the condition of a troubled bank.

Large depositors and deposit brokers with $100,000 or more to invest may divide their deposits into instruments in denominations of less than $100,000. In these situations, repayment no longer depends solely on the financial condition of the depository institution because federal deposit insurance is available for deposits of less than $100,000. As a result, a bank, regardless of its financial or managerial characteristics, could potentially engage in imprudent funding practices such as raising large amounts of volatile funds by purchasing brokered deposits.

To compensate for the high rates typically offered for brokered deposits, institutions holding them tend to seek assets that carry commensurately high yields. These assets can often involve excessive credit risk or cause the bank to take on undue interest-rate risk through a mismatch in the maturity of assets and liabilities.

In light of these concerns, certain restrictions on the use of brokered deposits were developed under section 301 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). Section 301 of FDICIA amended section 29 of FDIA to prohibit undercapitalized institutions from accepting funds obtained, directly or indirectly, by or through any deposit broker for deposit into one or more deposit accounts. Adequately capitalized institutions may accept such funds only if they first obtain a waiver from the FDIC, while well-capitalized institutions may accept such funds without restriction.

The FDIC's regulation implementing section 301 of FDICIA provides the definitions of well-capitalized, adequately capitalized, and undercapitalized institutions, which are tied to percentages of leverage and risk-based capital. Well-capitalized institutions have—

- a ratio of total capital to risk-weighted assets of not less than 10 percent;
- a ratio of tier 1 capital to risk-weighted assets of not less than 6 percent;
- a ratio of tier 1 capital to total book assets of not less than 5 percent; and
- not been notified by their appropriate federal banking agency that they are in a troubled condition.

An undercapitalized institution fails to meet the minimum regulatory capital requirements set by its federal regulatory agency. An adequately capitalized institution is one that is neither well-capitalized nor undercapitalized.

Section 29 of FDIA, as amended, also limits the rates of interest on deposits that may be offered by insured depository institutions that are undercapitalized or adequately capitalized, and requires deposit brokers to notify the FDIC of their status as a broker before soliciting or placing deposits with an insured depository institution.

The FDIC's implementing rule further specifies that an insured depository institution (and its employees) would be considered to be a deposit broker if it were to solicit deposits at more than 75 basis points over the prevailing rates (effective yields) on deposits within the bank's normal market area, or above the "national rate" for deposits outside the normal market area. The "national rate" is 120 percent of the current yield on similar maturity U.S. Treasury obligations when considering insured (retail) deposits, and 130 percent of the aforementioned yield when at least half of the deposits are uninsured due to their size or nature (institutional).

Each examination should include a review for compliance with the FDIC's limitations on the acceptance of brokered deposits and guidelines on interest payments.

The use of brokered deposits should be reviewed during all on-site examinations, even for those institutions not subject to the FDIC's restrictions. In light of the potential risks accompanying the use of brokered deposits, the examination should focus on the—

- rate of growth and the credit quality of the loans or investments funded by brokered deposits;
- corresponding quality of loan files, documentation, and customer credit information;
- ability of bank management to adequately evaluate and administer these credits and manage the resulting growth;
- degree of interest-rate risk involved in the

funding activities and the existence of a possible mismatch in the maturity or rate-sensitivity of assets and liabilities;
- composition and stability of the deposit sources and the role of brokered deposits in the bank's overall funding position and strategy; and
- effect of brokered deposits on the bank's financial condition and whether or not the use of brokered deposits constitutes an unsafe and unsound banking practice.

In light of the preceding discussion, the examiner should identify relevant concerns in the examination report when brokered deposits amount to 5 percent or more of the bank's total deposits.

Check Kiting

Check kiting occurs when—

- a depositor with accounts at two or more banks draws checks against the uncollected balance at one bank to take advantage of the float—that is, the time required for the bank of deposit to collect from the paying bank; and
- the depositor initiates the transaction with the knowledge that sufficient collected funds will not be available to support the amount of the checks drawn on all of the accounts.

The key to this deceptive practice, the most prevalent type of check fraud, is the ability to draw against uncollected funds. However, drawing against uncollected funds in and of itself does not necessarily indicate kiting. Kiting only occurs when the aggregate amount of drawings exceeds the sum of the collected balances in all accounts. Nevertheless, since drawing against uncollected funds is the initial step in the kiting process, management should closely monitor this activity. The requirements of Regulation CC, Availability of Funds and Collection of Checks, increased the risk of check kiting, and should be addressed in a bank's policies and procedures.

By allowing a borrower to draw against uncollected funds, the bank is extending credit that should be subject to an appropriate approval process. Accordingly, management should promptly investigate unusual or unauthorized activity since the last bank to recognize check kiting and pay on the uncollected funds suffers the loss. Check kiting is illegal and all suspected or known check kiting operations should be reported pursuant to established Federal Reserve policy. Banks should maintain internal controls to preclude loss from kiting, and the examiner should remember that in most cases kiting is not covered under Blanket Bond Standard Form 24.

Delayed Disbursement Practices

Although Regulation CC, Availability of Funds and Collection of Checks, stipulates time frames for funds availability and return of items, delayed disbursement practices (also known as remote disbursement practices) can present certain risks, especially concerning cashier's checks, which have next-day availability. Delayed disbursement is a common cash management practice that consists of arrangements designed to delay the collection and final settlement of checks by drawing checks on institutions located substantial distances from the payee or on institutions located outside the Federal Reserve cities when alternate and more efficient payment arrangements are available. Such practices deny depositors the availability of funds to the extent that funds could otherwise have been available earlier. A check drawn on an institution remote from the payee often results in increased possibilities of check fraud and in higher processing and transportation costs for return items.

Delayed disbursement arrangements could give rise to supervisory concerns because a bank may unknowingly incur significant credit risk through such arrangements. The remote location of institutions offering delayed disbursement arrangements often increases the collection time for checks by at least a day. The primary risk is payment against uncollected funds, which could be a method of extending unsecured credit to a depositor. Absent proper and complete documentation regarding the creditworthiness of the depositor, paying items against uncollected funds could be considered an unsafe or unsound banking practice. Furthermore, such loans, even if properly documented, might exceed the bank's legal lending limit for loans to one customer.

Examiners should routinely review a bank's practices in this area to ensure that such practices are conducted prudently. If undue or undocumented credit risk is disclosed or if lending limits are exceeded, appropriate corrective action should be taken.

Deposit Sweep Programs/Master Note Arrangements

Deposit sweep programs/master note arrangements (sweep programs) can be implemented on a bank level or on a parent bank holding company (BHC) level. On a bank level, these sweep programs exist primarily to facilitate the cash-management needs of bank customers, thereby retaining customers who might otherwise move their account to an entity offering higher yields. On a BHC level, the sweep programs are maintained with customers at the bank level, and the funds are upstreamed to the parent as part of the BHC's funding strategy. Sweep programs use an agreement with the bank's deposit customers (typically corporate accounts) that permits these customers to reinvest amounts in their deposit accounts above a designated level in overnight obligations of the parent bank holding company, another affiliate of the bank, or a third party. These obligations include instruments such as commercial paper, program notes, and master note agreements. (See SR-90-31.)

The disclosure agreement regarding the sale of the nondeposit debt obligations should include a statement indicating that these instruments are not federally insured deposits or obligations of or guaranteed by an insured depository institution. In addition, banks and their subsidiaries that have issued or plan to issue nondeposit debt obligations should not market or sell these instruments in any public area of the bank where retail deposits are accepted, including any lobby area of the bank. This requirement exists to convey the impression or understanding that the purchase of such obligations by retail depositors of the subsidiary bank can, in the event of default, result in losses to individuals who believed they had acquired federally insured or guaranteed obligations.

Bank Policies and Procedures

Banking organizations with sweep programs should have adequate policies, procedures, and internal controls in place to ensure that the activity is conducted in a manner consistent with safe and sound banking principles and in accordance with all banking laws and regulations. Bank policies and procedures should further ensure that deposit customers participating in a sweep program are given proper disclosures and information. When a sweep program is used as part of a funding strategy for a BHC or a nonbank affiliate, examiners should ensure that liquidity and funding strategies are carried out in a prudent manner.

Application of Deposit Proceeds

In view of the extremely short-term maturity of most swept funds, banks and BHCs are expected to exercise great care when investing the proceeds. Banks, from whom deposit funds are swept, have a fiduciary responsibility to their customers to ensure that such transactions are conducted properly. Appropriate uses of the proceeds of deposit sweep funds are limited to short-term bank obligations, short-term U.S. government securities, or other highly liquid, readily marketable, investment-grade assets that can be disposed of with minimal loss of principal.[1] When deposit sweep funds are invested in U.S. government securities, appropriate agreements must be in place, required disclosures must be made, and daily confirmations must be provided to the customer in accordance with the requirements of the Government Securities Act of 1986. Use of such proceeds to finance mismatched asset positions, such as those involving leases, loans, or loan participations, can lead to liquidity problems and are not considered appropriate. The absence of a clear ability to redeem overnight or extremely short-term liabilities when they become due should generally be viewed as an unsafe and unsound banking activity.

Funding Strategies

A key principle underlying the Federal Reserve's supervision of banking organizations is that

1. Some banking organizations have interpreted language in a 1987 letter signed by the Secretary of the Board as condoning funding practices that may not be consistent with the principles set forth in a subsequent supervisory letter dated September 21, 1990, as well as with prior Board rulings. The 1987 letter involved a limited set of facts and circumstances that pertained to a particular banking organization; it did not establish or revise Federal Reserve policies on the proper use of the proceeds of short-term funding sources. In any event, banking organizations should no longer rely on the 1987 letter to justify the manner in which they use the proceeds of sweep programs. Banking organizations employing sweep programs are expected to ensure that these programs conform with the policies in this manual section.

BHCs operate in a way that promotes the soundness of their subsidiary banks. BHCs are expected to avoid funding strategies or practices that could undermine public confidence in the liquidity or stability of their banks. Any funding strategy should maintain an adequate degree of liquidity at both the parent level and the subsidiary bank. Bank management should avoid, to the extent possible, allowing sweep programs to serve as a source of funds for inappropriate uses at the BHC or at an affiliate. Concerns exist in this regard because funding mismatches can exacerbate an otherwise manageable period of financial stress and, in the extreme, undermine public confidence in a banking organization's viability.

Funding Programs

In developing and carrying out funding programs, BHCs should give special attention to the use of overnight or extremely short-term liabilities, since a loss of confidence in the issuing organization could lead to an immediate funding problem. Thus BHCs relying on overnight or extremely short-term funding sources should maintain a sufficient level of superior-quality assets (at a level at least equal to the amount of the funding sources') that can be immediately liquidated or converted to cash with minimal loss.

Dormant Accounts

A dormant account is one in which customer-originated activity has not occurred for a predetermined period of time. Because of this inactivity, dormant accounts are frequently the target of malfeasance and should be carefully controlled by a bank. Bank management should establish standards that specifically outline the bank's policy for the effective control of dormant accounts, addressing—

- the types of deposit categories that could contain dormant accounts, including demand, savings, and official checks;
- the length of time without customer-originated activity that qualifies an account to be identified as dormant;
- the controls exercised over the accounts and their signature cards, that is, prohibiting release of funds by a single bank employee; and
- the follow-up by the bank when ordinary bank mailings, such as account statements and advertising flyers, are returned to the bank because of changed addresses or other reasons for failure to deliver.

Employee Deposit Accounts

Historically, examiners have discovered various irregularities and potential malfeasance through review of employee deposit accounts. As a result, bank policy should establish standards that segregate or specially encode employee accounts and encourage periodic internal supervisory review. In light of these concerns, examiners should review related bank procedures and practices, taking appropriate measures when warranted.

Overdrafts

The size, frequency, and duration of deposit account overdrafts are matters that should be governed by bank policy and controlled by adequate internal controls, practices, and procedures. Overdraft charges should be significant enough to discourage abuse. Overdraft authority should be approved in the same manner as lending authority and should never exceed the employee's lending authority. Systems for monitoring and reporting overdrafts should emphasize a secondary level of administrative control that is distinct from other lending functions so account officers who are less than objective do not allow influential customers to exploit their overdraft privileges. A bank's payment of overdrafts of executive officers and directors of the bank is generally prohibited under Regulation O. (See 12 CFR 215.4(e).) It is the board of directors' responsibility to review overdrafts as they would any other extension of credit. In most cases, overdrafts outstanding for more than 30 days, lacking mitigating circumstances, should be considered for charge-off.

Payable-Through Accounts

A payable-through account is an accommodation offered to a correspondent bank or other customer by a U.S. banking organization whereby drafts drawn against client subaccounts at the correspondent are paid upon presentation by the U.S. banking institution. The subaccount holders of the payable-through bank are generally non–U.S. residents or owners of businesses located outside of the United States. Usually the contract between the U.S. banking organization and the payable-through bank purports to create a contractual relationship solely between the two parties to the contract. Under the contract, the payable-through bank is responsible for screening subaccount holders and maintaining adequate records with respect to such holders. The examiner should be aware of the potential effect of money laundering.

Public Funds

Public funds generally represent deposits of the U.S. government, as well as state and political subdivisions, and typically require collateral in the form of securities to be pledged against them. A bank's reliance upon public funds can cause potential liquidity concerns if the aggregate amount, as a percentage of total deposits, is material relative to the bank's asset/liability management practices. Another factor that can cause potential liquidity concerns relates to the volatile nature of these deposits.

This volatility occurs because the volume of public funds normally fluctuates on a seasonal basis due to timing differences between tax collections and expenditures. A bank's ability to attract public funds is typically based upon the government entity's assessment of three key points:

- the safety and soundness of the institution with which the funds have been placed
- the yield on the funds being deposited
- that such deposits are placed with a bank that can provide or arrange the best banking service at the least cost

Additionally, banks that offer competitive interest rates and provide collection, financial advisory, underwriting, and data processing services at competitive costs are frequently chosen as depositories. Public funds deposits acquired through political influence should be regarded as particularly volatile. As a result, an examiner should pay particular attention to assessing the volatility of such funds in conjunction with the review of liquidity.

Zero-Balance Accounts

Zero-balance accounts (ZBAs) are demand deposit accounts used by a bank's corporate customers through which checks or drafts are received for either deposit or payment. The total amount received on any particular day is offset by a corresponding debit or credit to the account before the close of business to maintain the balance at or near zero. ZBAs enable a corporate treasurer to effectively monitor cash receipts and disbursements. For example, as checks arrive for payment, they are charged to a ZBA with the understanding that funds to cover the checks will be deposited before the end of the banking day. Several common methods used to cover checks include—

- wire transfers;
- depository transfer checks, a bank-prepared payment instrument used to transfer money from a corporate account in one bank to another bank;
- concentration accounts, a separate corporate demand deposit account at the same bank used to cover deficits or channel surplus funds relative to the ZBA; or
- extended settlement, a cash-management arrangement that does not require the corporate customer to provide same-day funds for payment of its checks.

Because checks are covered before the close of business on the day they arrive, the bank's exposure is not reflected in the financial statement. The bank, however, assumes risk by paying against uncollected funds, thereby creating unsecured extensions of credit during the day (which is referred to as a daylight overdraft between the account holder and the bank). If these checks are not covered, an overdraft occurs, which will be reflected on the bank's financial statement.

The absence of prudent safeguards and a lack of full knowledge of the creditworthiness of the depositor may expose the bank to large, unwarranted, and unnecessary risks. Moreover, the magnitude of unsecured credit risk may exceed prudent limits. Examiners should routinely review cash management policies and procedures to ensure that banks do not engage in unsafe and unsound banking practices, making appropriate comments in the report of examination, as necessary.

1. To determine if the policies, practices, procedures, and internal controls regarding deposit accounts are adequate.
2. To determine if bank officers and employees are operating in conformance with the bank's established guidelines.
3. To evaluate the deposit structure and determine its characteristics and volatility.
4. To determine the scope and adequacy of the audit function.
5. To determine compliance with applicable laws and regulations.
6. To initiate corrective action when policies, practices, procedures, or internal controls are deficient, or when violations of laws or regulations are noted.

1. Determine the scope of the examination of the deposit-taking function. In so doing, consider the findings of prior examinations, related work prepared by internal and external auditors, deficiencies in internal controls noted within other bank functions, and the requirements of examiners assigned to review the asset/liability management and interest-rate risk aspects of the bank.
2. If required by the scope, implement the Deposit Accounts Internal Control Questionnaire.
3. Test the deposit function for compliance with policies, procedures, and internal controls in conjunction with performing the remaining examination procedures. Also, obtain a listing of any deficiencies noted in the latest internal/external audit review and determine if appropriate corrections have been made.
4. In conducting an examination, the examiner should use available bank copies of printouts plus transactions journals, microfiche, or other visual media to minimize expense to the bank. However, if copies of these reports are not available, the examiner should determine and request the information necessary to complete the examination procedures.

   Obtain or prepare, as applicable, the reports indicated below, which are used for a variety of purposes, including the assessment of deposit volatility and liquidity, adequacy of internal controls, verification of information contained on required regulatory reports, and assessment of loss.

   a. For demand deposits and other transaction accounts:
      - Trial balance;
      - Overdrafts;
      - Unposted items;
      - Nonsufficient funds (NSF) report;
      - Dormant accounts;
      - Public funds;
      - Uncollected funds;
      - Due to banks;
      - Trust department funds;
      - Significant activity;
      - Suspected kiting report;
      - Matured certificates of deposits without an automatic renewal feature; and
      - Large balance report.

   b. For official checks:
      - Trial balance(s); and
      - Exception list.

   c. For savings accounts:
      - Trial balance;
      - Unposted items;
      - Overdrafts;
      - Dormant accounts;
      - Public funds;
      - Trust department funds; and
      - Large balance report.

   d. For other time deposits:
      - Trial balance(s);
      - Large balance report;
      - Unposted items;
      - Public funds;
      - Trust department funds; and
      - Money market accounts.

   e. For certificates of deposit:
      - Trial balance(s);
      - Unposted items;
      - Public funds;
      - Certificates of $100,000 or more;
      - Negotiable certificates of deposit;
      - Maturity reports; and
      - Matured certificates of deposit.

   f. For deposit sweep programs/master note arrangements:
      - List individually by deposit type and amount.

   g. For brokered deposits:
      - List individually by deposit type, including amount and rate.

   h. For bank-controlled accounts:
      - Reconcilement records for all such accounts;
      - Names and extensions of individuals authorized to make entries to such accounts; and
      - Name and phone extension of reconcilement clerk(s).

   i. For foreign currency deposits:
      - List of accounts and currency type; and
      - Copy of the most recent Report of Foreign Currency Deposits, form FR 2915.

5. Review the reconcilement of all types of deposit accounts and verify the balances to department controls and the general ledger, then—
   a. determine if reconciliation items are legitimate and if they clear within a reasonable time frame; and
   a. retain custody of all trial balances until items outstanding are resolved.
6. Review the reconciliation process for bank-controlled accounts, such as official checks and escrow deposits, by—
   a determining if reconciling items are legitimate and if they clear within a reasonable time frame;
   b. scanning activity in such accounts to determine the potential for improper diversion of funds for various uses, such as—
      • political contributions,
      • loan payments (principal and interest), or
      • personal use; and
   c. determine if checks are being processed before their related credits.
7. Review the bank's operating procedures and reconciliation process relative to suspense accounts and determine if—
   a. the disposition process of unidentified items is completed in a timely fashion;
   b. reports are generated periodically to inform management of the type, age, and amount of items in such accounts; and
   c. employees responsible for clearing suspense account items are not shifting the items between accounts.
8. Evaluate the effectiveness of the policies, procedures, and management's reporting methods regarding overdrafts and drawings against uncollected funds.
   a. Concerning overdrafts, determine if—
      • officer-approval limits have been established; and
      • a formal system of review and approval is in effect.
   b. Ascertain the existence of formal overdraft protection, and, if it exists—
      • obtain a master list of all depositors with formal overdraft protection;
      • obtain a trial balance indicating advances outstanding and compare it with the master list to ensure compliance with approved limits;
      • cross-reference the trial balance or master list to examiner loan line sheets; and
      • review credit files on significant formal agreements not cross-referenced above.
   c. Concerning drawings against uncollected funds, determine if—
      • the uncollected funds report reflects balances as uncollected until they are actually received;
      • management is comparing reports of significant changes in balances and activity volume to uncollected funds reports;
      • management knows the reasons why a depositor is frequently drawing against uncollected funds;
      • a reporting system to inform senior management of significant activity in this area has been instituted; and
      • appropriate employees clearly understand the mechanics of drawing against uncollected funds and the risks involved, especially in the area of potential check kiting operations.
   d. Upon completing steps 8.a., 8.b., and 8.c., the examiner should—
      • cross-reference overdraft and uncollected funds reports to examiner loan line sheets;
      • review the credit files of depositors with significant overdrafts, if available, or the credit files of depositors who frequently draw significant amounts against uncollected funds, for those depositors not cross-referenced in the preceding step;
      • request management to charge-off overdrafts deemed to be uncollectible by examiners; and
      • submit a list of the following items to the appropriate examiner:
        — Overdrafts considered loss, indicating borrower and amount.
        — Aggregate amounts overdrawn 30 days or more, for inclusion in past-due statistics.
9. Review the bank's deposit development and retention policy, which is often included in the funds management policy.
   a. Determine if the policy addresses deposit structure and related interest costs, including the percentages of time deposits and demand deposits of—
      • individuals,

- corporations, and
- public entities.

b. Also determine if the policy requires periodic reports to management comparing the accuracy of projections with results.

c. Assess the reasonableness of the policy and ensure that it is routinely reviewed by management.

10. If a deposit sweep program/master note arrangement exists, review the minutes of the board of directors for approval of related policies and procedures.

11. For banks with deposit sweep programs/master note arrangements (sweep programs), compare practices for adherence to approved policies and procedures, including a review of—

a. the purpose of the sweep program: is it strictly a customer accommodation transaction, or is it intended to fund certain assets at the holding company level or at an affiliate? Review funding transactions in light of liquidity and funding needs of the banking organization by referring to the manual section on asset/liability management.

b. the eligibility requirements used by the bank to determine the types of customers and accounts that may participate in a sweep program, including—

- a list of customers participating in sweep programs, with dollar amounts of deposit funds swept on the date of examination.
- the name of the recipient(s) of swept funds and—
  - — if an affiliate of the bank, a schedule of the instruments into which the funds were swept, including the effective maturity of these instruments.
  - — if an unaffiliated third party, determine if the bank adequately evaluates the third party's financial condition at least annually. Also, verify if a fee is received by the bank for the transaction, and if so, that it is disclosed in customer documentation.

c. whether the proceeds of sweep programs are invested only in short-term bank obligations, short-term U.S. government securities, or other highly liquid, readily marketable, investment-grade assets that can be disposed of with minimal loss of principal.

d. whether the bank and its subsidiaries have issued or plan to issue nondeposit debt obligations in any public area of the bank where retail deposits are accepted, including any lobby area of the bank.

e. completed sweep program documents to determine if—

- signed documents boldly disclose that the instrument into which deposit funds will be swept is not insured by the FDIC and is not an obligation of, or guaranteed by, the bank.
- proper authorization for the instrument exists between the customer and an authorized representative of the bank.
- signed documents properly disclose the name of the obligor and type of instrument into which the depositor's funds will be swept. If funds are being swept into U.S. government securities held by the banking organization, verify that adequate confirmations are provided to customers in accordance with the Government Securities Act of 1986. (This act requires that all transactions subject to a repurchase agreement be confirmed in writing at the end of the day of initiation, and that the confirmation confirms specific securities. If any other securities are substituted that result in a change of issuer, maturity date, par amount, or coupon rate, another confirmation must be issued at the end of the day during which the substitution occurred. Because the confirmation or safekeeping receipt must list specific securities, "pooling" of securities for any type of sweep program involving government securities is not permitted. Additionally, if funds are swept into other instruments, similar confirmation procedures should be applied.)
- conditions of the sweep program are stated clearly, including the dollar amount (minimum or maximum amounts, and incremental amounts), time frame of sweep, time of day sweep transaction occurs, fees payable, transaction confirmation notice, prepayment terms, and termination notice.
- the length of any single transaction

under sweep programs in effect has not exceeded 270 days and the amount is $25,000 or more (as stipulated by SEC policy). Ongoing sweep program disclosures should occasionally be sent to the customer to ensure that the terms of the program are updated and the customer understands the terms.

f. samples of advertisements (newspaper, radio, and television spots, etc.) by the bank for sweep programs to determine if the advertisements—
   - boldly disclose that the instrument into which deposit funds are swept is not insured by the FDIC and is not an obligation of, or guaranteed by, the bank.
   - are not enclosed with insured deposit statements mailed to customers.

g. whether the sweep program has had a negative effect on bank liquidity or has the potential to undermine public confidence in the bank. Also—
   - review the bank's fed funds and borrowing activities to ascertain whether borrowings appear high. If so, compare the bank's borrowing activity with daily balances of aggregate sweep transactions on selected dates to see if a correlation exists.
   - if sweep activity is significant, compare the rates being paid on swept deposits with the yields received on the invested funds and with the rates on other overnight funding instruments, such as fed funds, to determine if they are reasonable.

12. Forward the following to the examiner assigned to asset/liability management:
    a. The amount of any deposit decline or deposit increase anticipated by management (the time period will be determined by the examiner performing asset/liability management).
    b. A listing by name and amount of any depositor controlling more than 1 percent of total deposits.
    c. A listing, if available, by name and amount of any deposits held solely because of premium rates paid (brokered deposits).
    d. The aggregate amount of brokered deposits.
    e. A maturity schedule of certificates of deposit, detailing maturities within the next 30, 60, 90, 180, and 360 days.
    f. An assessment of the overall characteristics and volatility of the deposit structure.

13. Analyze UBPR data on deposits and related expense ratios and compare with peer group norms to determine—
    a. variations from the norm; and
    b. trends in the deposit structure with respect to—
       - growth patterns and
       - shifts between deposit categories.

14. Assess the volatility and the composition of the bank's deposit structure.
    a. Review the list of time certificates of deposit of $100,000 or more, and related management reports, including those on brokered deposits, to determine—
       - whether concentrations of maturing deposits exist;
       - whether a concentration of deposits to a single entity exists;
       - the aggregate dollar volume of accounts of depositors outside the bank's normal service area, if significant, and the geographic area(s) from which any significant volume emanates;
       - the aggregate dollar volume of CDs with interest rates higher than current publicly quoted rates within the market;
       - whether the bank is paying current market rates on CDs;
       - the dollar amount of brokered CDs, if any; and
       - the dollar volume of deposits obtained as a result of special promotions.
    b. Review public funds and the bank's method of acquiring such funds to assess whether the bank uses competitive bidding in setting the interest rate paid on public deposits. If so, does the bank consider variables in addition to rates paid by competition in determining pricing for bidding on public deposits?
    c. Review appropriate trial balances for all other deposits (demand, savings, and other time deposits) and/or management reports that relate to large deposits for individuals, partnerships, corporations, and related deposit accounts to determine whether a deposit concentration exists.
       - Select, at a minimum, the 10 largest

accounts to determine if the retention of those accounts depends on—
- — criticizable loan relationships;
- — liberal service accommodations, such as permissive overdrafts and drawings against uncollected funds;
- — interbank correspondent relationships;
- — deposits obtained as a result of special promotions; and
- — a recognizable trend with respect to—
  - frequent significant balance fluctuations,
  - seasonal fluctuations, and
  - nonseasonal increases or decreases in average balances.

d. Elicit management's comments to determine, to the extent possible—
- the potential renewal of large CDs that mature within the next 12 months;
- if public fund deposits have been obtained through political influence;
- if a significant dollar volume of accounts is concentrated in customers engaged in a single business or industry; and
- if there is a significant dollar volume of deposits of customers who do not reside within the bank's service area.

15. Obtain information on competitive pressures and economic conditions from the examiner responsible for the ''Economic Conditions and Competition'' report section, and evaluate that information, along with current deposit trends, to estimate their effect on the bank's deposit structure.
16. Test for compliance with the applicable laws and regulations listed below by performing the following procedures:

a. Regulation O (12 CFR 215), Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks:
- Review the overdraft listing to ensure that the bank has not paid an overdraft on any account of an executive officer or director, unless the payment is made according to—
  - — a written, preauthorized, interest-bearing extension of a credit plan providing for a method of repayment, or
  - — a written, preauthorized transfer from another account of that executive officer or director.

  Payment of inadvertent overdrafts in an aggregate amount of $1,000 or less is not prohibited, provided the account is not overdrawn more than five business days and the executive officer or director is charged the same fee charged other customers in similar circumstances. Overdrafts are extensions of credit and must be included when considering each insider's lending limits and other extensions of credit restrictions, as well as the aggregate lending limit for all outstanding extensions of credit by the bank to all insiders and their related interests.

b. 12 USC 1972(2), Loans to Executive Officers, Directors, and Principal Shareholders of Correspondent Banks:
- Review the overdraft listing to ensure that no preferential overdrafts exist from the bank under examination to the executive officers, directors, or principal shareholders of the correspondent bank.

c. Section 22(e) of the Federal Reserve Act (12 USC 376), Interest on Deposits of Directors, Officers, and Employees:
- Obtain a list of deposit accounts, with account numbers, of directors, officers, attorneys, and employees. Review the accounts for any exceptions to standard policies on service charges and interest rates paid that would suggest self-dealing or preferential treatment.

d. Sections 23A and 23B of the Federal Reserve Act (12 USC 371c):
- Determine the existence of any overdrawn affiliate accounts. If overdrawn accounts are identified, review for compliance with sections 23A and 23B of the act.

e. Section 301 of the Federal Deposit Insurance Corporation Improvement Act of 1991:
- If the bank is undercapitalized, as defined in the regulation implementing section 301 of FDICIA, ensure that it is not accepting brokered deposits.
- If the bank is only adequately capitalized, as defined in the regulation implementing section 301 of FDICIA, and is accepting brokered deposits, ensure that a waiver authorizing acceptance of such deposits has been obtained from the FDIC and that the

bank is in compliance with the interest rate restrictions.

f. Regulation D (12 CFR 204), Reserve Requirements of Depository Institutions:
   - Review the accuracy of the deposit data used in the bank's reserve requirement calculation for the examination date. In cases where a bank issues nondeposit, uninsured obligations that are classified as ''deposits'' in the calculation of reserve requirements, examiners should determine if these items are properly categorized. Ascertain that the TT&L remittance option is included in the computations for reserve requirements.

g. Regulation Q (12 CFR 217), Prohibition Against Payment of Interest on Demand Deposits:
   - Ensure that interest is not being paid on the proceeds of nonautomatically renewable matured certificates of deposit held in demand deposit accounts (as opposed to NOW accounts, which permit the payment of interest).

h. 12 USC 501 and 18 USC 1004, False Certification of Checks:
   - Compare several certified checks by date, amount, and purchaser with depositors' names appearing on uncollected funds and overdraft reports of the same dates to determine that the checks were certified against collected funds.

i. Uniform Commercial Code 4-108, Banking Hours and Processing of Items:
   - Determine the bank's cut-off hour, after which items received are included in the processing for the next ''banking day,'' to ensure that the cut-off hour is not earlier than 2:00 p.m.
   - If the bank's cut-off hour is before 2:00 p.m., advise management that failure to process items received before a 2:00 p.m. cutoff may result in civil liability for delayed handling of those items.

j. Local escheat laws:
   - Determine if the bank is adhering to the local escheat laws with regard to all forms of dormant deposits, including official checks.

17. If applicable, determine if the bank is appropriately monitoring and limiting the foreign exchange risk associated with foreign currency deposits.
18. Discuss overall findings with bank management and prepare report comments on—
    a. policy deficiencies;
    b. noncompliance with policies;
    c. weaknesses in supervision and reporting;
    d. violations of laws and regulations; and
    e. possible conflicts of interest.
19. Update workpapers with any information that will facilitate future examinations.

Review the bank's internal controls, policies, practices, and procedures for demand and time deposit accounts. The bank's systems should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used, and other pertinent information.

For large institutions and/or those institutions with individual demand and time deposit bookkeeping functions, the examiner should consider administering this questionnaire separately for each function, as applicable.

Questions pertain to both demand and time deposits unless otherwise indicated. Negative responses to the questions in this section should be explained, and additional procedures deemed necessary should be discussed with the examiner-in-charge. Items marked with an asterisk require substantiation by observation or testing.

OPENING DEPOSIT ACCOUNTS

*1. Are new account documents prenumbered?
   a. Are they issued in strict numerical sequence?
   b. Are the opening of new accounts and access to unused new account records and certificate of deposit (CD) forms handled by an employee who is not a teller or who cannot make internal entries to customer accounts or general ledger?

*2. Does the institution have a written "know your customer" policy?
   a. Do new account applications require sufficient information to clearly identify the customer?
   b. Are "starter" checks issued only after verification of data on new transaction account applications?
   c. Are checkbooks and statements mailed only to the address of record? If not, is a satisfactory explanation and description obtained for any other mailing address (post office boxes, friend or relative, etc.)?
   d. Are employees responsible for opening new accounts trained to screen depositors for signs of check kiting?

*3. Does the bank perform periodic inventories of new account documents and CDs, and do the inventories include an accountability of numbers issued out of sequence or cancelled prior to issuance?

*4. Are CDs signed by a properly authorized individual?

5. Are new account applications and signature cards reviewed by an officer?

CLOSING DEPOSIT ACCOUNTS

6. Are signature cards for closed accounts promptly pulled from the active account file and placed in a closed file?

7. Are closed account lists prepared? If so, indicate the frequency ___________.

8. Is the closed account list circulated to appropriate management?

9. Is verification of closed accounts, in the form of statements of "goodwill" letters, required? Are such letters mailed under the control of someone other than a teller or an individual who can make internal entries to an account (such as a private banker or branch manager)?

*10. For redeemed CDs:
   a. Are they stamped paid?
   b. Is disposition of proceeds documented to provide a permanent record as well as to provide a clear audit trail?
   c. Are penalty calculations on CDs and other time deposits redeemed prior to maturity rechecked by a second employee?

*11. Are matured CDs that are not automatically renewable classified as demand deposits on the call report and on the Report of Transaction Accounts, Other Deposits and Vault Cash (FR 2900)?

DEPOSIT ACCOUNT RECORDS

*12. Does the institution have documentation supporting a current reconcilement of each deposit account category recorded on its general ledger, including customer accounts and bank-controlled accounts such as dealer reserves, escrow, Treasury tax and loan, etc.? (Prepare separate workpapers for demand and time accounts listing each account, date and frequency of reconcilement, general ledger balance, subsidiary ledger balance, adjustments, and unexplained differences.)

*13. Are reconciliations performed by an individual or group not directly engaged in accepting or preparing transactions or in data entry to customers' accounts?

*14. If the size of the institution precludes full separation of duties between data entry and reconcilement, are reconcilement duties rotated on a formal basis, and is a record maintained to support such action?

*15. Are reconciliations reviewed by appropriate independent management, especially under circumstances where full separation of duties is not evident?

*16. Are periodic reports prepared for management providing an aging of adjustments and differences and detailing the status of significant adjustments and differences?

*17. Has management adequately addressed any significant and/or long outstanding adjustments or differences?

*18. Are the preparation of input and posting of subsidiary demand deposit records performed and/or adequately reviewed by persons who do not also—
  a. accept or generate transactions?
  b. issue official checks and/or handle funds-transfer transactions?
  c. prepare or authorize internal entries (return items, reversals, and direct charges, such as loan payments)?
  d. prepare supporting documents required for disbursements from an account?
  e. perform maintenance on the accounts, such as change of address, stop payments, holds, etc.?

*19. Are in-process, suspense, interoffice, and other accounts related to deposit accounts controlled or closely monitored by persons who do not have posting or reconcilement duties?

*20. Are periodic reports prepared for management on open items in suspense, in-process, interoffice, and other deposit accounts, and do the reports include aging of items and the status of significant items?

21. If the bank's bookkeeping system is not automated, are deposit bookkeepers rotated?

22. Does the bank segregate the deposit account files of—
  a. employees and officers?
  b. directors?
  c. the business interests of, or controlled by, employees and officers?
  d. the business interests of, or controlled by, directors?

*23. Are posting and check filing separated from statement preparation?

24. Are statements mailed or delivered to all customers as required by the bank's deposit account agreement?

*25. Are customer transaction and interest statements mailed in a controlled environment that precludes any individual from receiving any statement not specifically authorized by the customer or the institution's policy (for example, dormant accounts)?

DORMANT ACCOUNTS AND RETURNED MAIL

*26. Does the institution have formal policies and procedures for the handling of customers' transaction and interest statements that are returned by the post office as undeliverable? Does the policy—
  a. require statements be periodically mailed on dormant accounts? If so, how often?
  b. prohibit the handling of such statements by (1) the branch of account, (2) account officer, and (3) other individuals with exclusive control of accounts?
  c. require positive action to follow up on obtaining new addresses?
  d. place statements and signature cards for accounts for which contact cannot be reestablished (the mail is returned more than once or marked ''deceased'') into a controlled environment?
  e. require the bank to change the address on future statements to the department of the bank (controlled environment) designated to receive returned mail?
  f. require a written request from the customer and verification of the customer's signature before releasing an account from the controlled environment?

*27. Are accounts for which contact cannot be reestablished and that do not reflect recent activity removed from active files and clearly classified as dormant?

*28. Before returning a dormant account to active status, are transactions reactivating the account verified, and are independent confirmations obtained directly from the customer?

*29. Does transfer from dormant to active status require approval of an officer who cannot approve transactions on dormant accounts?

INACTIVE ACCOUNTS

30. Are demand accounts that have been inactive for one year and time accounts that have been inactive for three years classified as inactive? If not, state the time period ___________.

31. Does the bank periodically review the inactive accounts to determine if they should be placed in a dormant status, and are decisions to keep such accounts in active files documented?

HOLD MAIL

*32. Does the institution have a formal policy and procedure for handling statements and documents that a customer requests not to be mailed but will be picked up at a location within the institution? Does the policy—
   a. require that statements will not be held by an individual (an account officer, branch manager, bookkeeper, etc.) who could establish exclusive control over entries to, and delivery of, statements for customer accounts?
   b. discourage such arrangements and grant them only after the customer provides a satisfactory reason for the arrangement?
   c. require the customer to sign a statement describing the purpose of the request and the proposed times for pickup, and designate the individuals authorized to pick up the statement?
   d. require maintenance of signature cards for individuals authorized to pick up statements and compare the authorized signatures to those who sign for statements held for pickup?
   e. prohibit the delivery of statements to officers and employees requiring special attention unless it is part of the formal ‘‘hold mail’’ function?

*33. Is a central record maintained in a control area that does not originate entries to customers' accounts, identifying each ‘‘hold mail’’ arrangement, the designated location for pickup, and the scheduled pickup times? Does the control area—
   a. maintain current signature cards of individuals authorized to pick up statements?
   b. obtain signed receipts showing the date of pickup and compare the receipts to the signature cards?
   c. follow up on the status of statements not picked up as scheduled?

*34. Does management review activity in ‘‘hold mail’’ accounts that have not been picked up for extended periods of time (for example, one year), and, where there is no activity, place the accounts in a dormant status?

OVERDRAFTS

*35. Are officer overdraft authorization limits formally established?

*36. Does the bank require an authorized officer to approve overdrafts?

*37. Is an overdraft listing prepared daily for demand deposit and time transaction accounts?

38. For banks processing overdrafts that are not automatically approved (‘‘pay none’’ system), is the nonsufficient funds report circulated among bank officers?

*39. Are overdraft listings circulated among the officers?

40. Are the statements of accounts with large overdrafts reviewed for irregularities?

41. Is a record of large overdrafts included in the monthly report to the board of directors or its committee and does it include the overdraft origination date?

42. Is there an established schedule of service charges?

UNCOLLECTED FUNDS

*43. Does the institution generate a daily report of drawings against uncollected funds for demand deposits and time transaction accounts?

a. Is the computation of uncollected funds positions based on reasonable check collection criteria?

b. Can the reports, or a separate account activity report, reasonably be used to detect potential kiting conditions?

c. If reports are not generated for time transaction accounts, is a system in place to control drawings against uncollected funds?

*44. Do authorized officers review the uncollected funds reports and approve drawings against uncollected funds within established limits?

*45. Are accounts that frequently appear on the uncollected funds and/or kite suspect reports reviewed regardless of account balances? (For example, accounts with simultaneous large debits and credits can reflect low balances.)

OTHER MATTERS

*46. Are account maintenance activities (change of address, status changes, rate changes, etc.) separated from data entry and reconciling duties?

*47. Do all internal entries other than service charges require the approval of appropriate supervisory personnel?

*48. If not included in the internal/external audit program, are employees' and officers' accounts, accounts of their business interests, and accounts controlled by them periodically reviewed for unusual or prohibited activity?

*49. For unidentified deposits:

a. Are deposit slips kept under dual control?

b. Is their disposition approved by an appropriate officer?

*50. For returned checks, unposted items, and other rejects:

a. Are daily listings of such items prepared?

b. Are all items reviewed daily and is disposition of items required within a reasonable time period? Indicate the time period __________.

c. Are reports prepared for management showing items not disposed of within the established time frames?

51. Are customers immediately notified in writing of deposit errors?

52. Does the bank require a customer's signature for stop-payment orders?

53. For automatic transfer accounts:

a. Are procedures in effect that require officer approval for transfers in excess of the savings balance?

b. For nonautomated systems, are transfers made by employees who do not also handle cash, execute external funds transfers, issue official checks singly, or post subsidiary records?

54. For telephone transfer accounts:

a. Do depositors receive an individual identification code for use in making transfers?

b. Are transfers made by employees who do not also handle cash, execute external funds transfers, issue official checks singly, or post subsidiary records?

*55. If not included in the internal/external audit program, are accrual balances for the various types of deposits verified periodically by an authorized official? If so, how often __________?

*56. Are accounts with a "hold-balance" status—those accounts on which court orders have been placed, those pledged as security to customers' loans, those pending the clearing of a large check, those where the owner is deceased, and those where the passbook has been lost—"locked-out" for transactions unless approved by appropriate management?

57. For passbook accounts:

a. Do all entries to passbooks contain teller identification?

b. Under a window-posting system, are recording media and passbooks posted simultaneously?

c. Are tellers prohibited from holding customers' savings passbooks?

d. If customers' passbooks are held, are they maintained under the institutions "hold mail" program and kept under dual control?

e. Are customers prohibited from withdrawing funds without a passbook? If not, state the policy.

58. For withdrawals from savings or other time accounts:

a. Are withdrawal tickets cancelled daily?

b. Are procedures in place to preclude overdrafts?
c. Are procedures in effect to place and to check for holds on withdrawals over a stated amount? Indicate the amount __________.

59. For signature cards on demand and time accounts:
 a. Are procedures in effect to guard against the substitution of false signatures? Describe the procedures.
 b. Are signature cards stored to preclude physical damage?
 c. Are signatures compared for withdrawals and cashed checks? Describe the procedures.

OFFICIAL CHECKS, MONEY ORDERS, AND CERTIFIED CHECKS

*60. Are separate general ledger accounts maintained for each type of official check?

*61. As to the types of checks issued:
 a. Are multicopy checks and certified check forms used? If not, are detailed registers of disbursed checks maintained?
 b. Are all checks prenumbered and issued in sequence?
 c. Is check preparation and issuance separate from recordkeeping?
 d. Is the signing of checks in advance prohibited?
 e. Do procedures prohibit issuance of a check before the credit is processed?

*62. Is the list authorizing bank personnel to sign official checks kept current? Does the list include changes in authorization limits, delete employees who no longer work at the bank, and indicate employees added to the list?

*63. Are appropriate controls in effect over check signing machines (if used) and certification stamps?

*64. Are voided checks and certified check forms promptly defaced and filed with paid checks?

*65. If reconcilements are not part of the overall deposit reconciliation function—
 a. are outstanding checks listed and reconciled regularly to the general ledger? If so, how often __________?
 b. is permanent evidence of reconcilements maintained?
 c. is there clear separation between preparation of checks, data entry, and reconcilement?
 d. are the reconcilements reviewed regularly by an authorized officer?
 e. are reconcilement duties rotated on a formal basis in institutions where size precludes full separation of duties between data entry and reconcilement?
 f. are authorized signatures and endorsements checked by the filing clerk?

*66. For supplies of official checks:
 a. Are records of unissued official checks maintained centrally and at each location storing them?
 b. Are periodic inventories of unissued checks independently performed?
 c. Do the inventories include a description of all checks issued out of sequence?
 d. If users are assigned a supply, is that supply replenished on a consignment basis?

*67. Are procedures in effect to preclude certification of checks drawn against uncollected funds?

TREASURY TAX AND LOAN ACCOUNTS (TREASURY CIRCULAR 92)

68. Do transfers from the remittance option account to the Federal Reserve Bank occur the next business day after deposit?

69. Is the remittance option included in the computation of reserve requirements?

70. When the note option is used, do transfers from the Treasury tax and loan (TT&L) demand deposit account occur the next business day after deposit?

*71. Has the TT&L account reconcilement been completed in a timely manner and approved by a supervisor?

72. Has adequate collateral been pledged to secure the TT&L account?

AUDIT

*73. Are deposit account activities audited on a sufficiently frequent basis?

*74. Does the scope of the audit program require, and do audit records support, substantive testing or quantitative measurements of deposit account activities that, at a minimum, include the matters set forth in this questionnaire?

*75. Does the audit program include a comprehensive confirmation program with customers of each deposit category maintained by the institution?

*76. Do audit department records support the execution of the confirmation program, and do the records reflect satisfactory follow-up of responses and of requests returned as undeliverable?

*77. Are audit and prior examination recommendations for deposit account activities appropriately addressed?

CONCLUSION

*78. Does the foregoing information provide an adequate basis for evaluating internal control in that deficiencies in areas not covered by this questionnaire do not significantly impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.

*79. Are internal controls adequate based on a composite evaluation, as evidenced by answers to the foregoing questions?

Borrowed funds are a common and practical method for banks of all sizes to meet customers' needs and enhance banking operations. For the purposes of this section, borrowings exclude long-term subordinated debt such as capital notes and debentures (discussed in "Assessment of Capital Adequacy," section 3020.1). Borrowings may exist in a number of forms, both on a direct and indirect basis. Common sources of direct bank borrowings include Federal Home Loan Bank credit lines, federal funds purchased, loans from correspondent banks, repurchase agreements, negotiable certificates of deposit, and borrowings from the Federal Reserve discount window. These are discussed in some detail below. Other borrowings include bills payable to the Federal Reserve, interest-bearing demand notes issued to the U.S. Treasury (the Treasury tax and loan note option account), mortgages payable, due bills, and other types of borrowed securities. Indirect forms of borrowings include customer paper rediscounted and assets sold with the bank's endorsement or guarantee or subject to a repurchase agreement.

The primary reasons a bank may borrow include the following:

- To meet the temporary or seasonal loan or deposit withdrawal needs of its customers, if the borrowing period is temporary and the bank is quickly restored to a position in which the quantity of its principal earning assets and cash reserves is in proper relation to the requirements of its normal deposit volume.
- To meet large and unanticipated deposit withdrawals that may arise during periods of economic distress. The examiner should distinguish between "large and unanticipated deposit withdrawals" and a predeterminable contraction of deposits, such as the cessation of activities in a resort community or the withdrawal of funds on which the bank received adequate prior withdrawal notice. Those situations should be met through ample cash reserves and readily convertible assets rather than borrowing.
- To manage liabilities effectively. Generally, the effective use of this type of continuous borrowing is limited to money-center or large regional banks.

It is important to analyze each borrowing on its own merit to determine its purpose, effectiveness, and stability. Some of the more frequently used sources of borrowings are discussed below.

COMMON SOURCES OF BORROWINGS

Federal Home Loan Bank Borrowings

The Federal Home Loan Bank (FHLB) originally served solely as a source of borrowings to savings and loan companies. With the implementation of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), FHLB's lending capacity was expanded to include banks.

Compared with borrowings from the discount window of the Reserve Banks, borrowings from the FHLB have fewer conditions. Both short-term and long-term borrowings, with maturities ranging from overnight to 30 years, are available to institutions at generally competitive interest rates. The flexibility of the facility enables bank management to use this source of funds for the purpose of asset/liability management, and it allows management to secure a favorable interest-rate spread. For example, FHLB borrowings may provide a lower-cost alternative to the conventional deposit, particularly in a highly competitive local market.

Management should be capable of explaining the purpose of the borrowing transaction. The borrowing transaction should then be analyzed to determine whether the arrangement achieved the stated purpose or whether the borrowings are a sign of liquidity deficiencies. Further, the borrowing agreement between the institution and the FHLB should be reviewed to determine the asset collateralizing the borrowings and the potential risks presented by the agreement. In some instances, the borrowing agreement may provide for collateralization by all assets not already pledged for other purposes.

The types of collateral necessary to obtain an FHLB loan include residential mortgage loans and mortgage-backed securities. The composite rating of an institution is a factor in both the approval for obtaining an FHLB loan and the level of collateral required.

Federal Funds Purchased

The day-to-day use of federal funds is a rather common occurrence, and federal funds are considered an important money market instrument. Many regional and money-center banks, acting in the capacity of correspondents to smaller community banks, function as both providers and purchasers of federal funds and, in the process of these transactions, often generate a small return.

A brief review of bank reserves is essential to a discussion of the federal funds market. As a condition of membership in the Federal Reserve System, member banks are required to maintain a portion of their deposits as reserves. Reserves can take the form of vault cash and deposits in the Reserve Bank. The amount of these reserve balances is reported weekly or quarterly, computed on the basis of the daily average deposit balances. For institutions that report their reserves on a weekly basis, required reserves are computed on the basis of daily average balances of deposits and Eurocurrency liabilities during a 14-day period ending every second Monday. Institutions that report their reserves on a quarterly basis compute their reserve requirement on the basis of their daily average deposit balances during a seven-day computation period that begins on the third Tuesday of March, June, September, and December. (See 12 CFR 204.3(c)–(d).)

Since member banks do not receive interest on the reserves, banks prefer to keep excess balances at a minimum to achieve the maximum utilization of funds. To accomplish this goal, banks carefully analyze and forecast their daily reserve position. Changes in the volume of required reserves occur frequently as the result of deposit fluctuations. Deposit increases require member banks to maintain more reserves; conversely, deposit decreases require less reserves.

The most frequent type of federal funds transaction is unsecured, for one day, and repayable the following business day. The rate is usually determined by overall money market rates, as well as by the available supply of and demand for funds. In some instances, when the selling and buying relationship between two banks is quite continuous, something similar to a line of credit may be established on a funds-availability basis. Although the most common federal funds transaction is unsecured, the selling of funds can also be secured and for longer periods of time. Agency-based federal funds transactions are discussed in “Bank Dealer Activities,” section 2030.1.

Loans from Correspondent Banks

Small and medium-sized banks often negotiate loans from their principal correspondent banks. The loans are usually for short periods and may be secured or unsecured.

Repurchase Agreements

The terms “repurchase agreement”[1] (repo) and “reverse repurchase agreement” refer to a type of transaction in which a money market participant acquires immediately available funds by selling securities and simultaneously agreeing to repurchase the securities after a specified time at a given price, which typically includes interest at an agreed-on rate. Such a transaction is called a repo when viewed from the perspective of the supplier of the securities (the borrower), and a reverse repo or matched sale-purchase agreement when described from the point of view of the supplier of funds (the lender).

Frequently, instead of resorting to direct borrowings, a bank may sell assets to another bank or some other party and simultaneously agree to repurchase the assets at a specified time or after certain conditions have been met. Bank securities as well as loans are often sold under repurchase agreements to generate temporary working funds. These kind of agreements are often used because the rate on this type of borrowing is less than the rate on unsecured borrowings, such as federal funds purchased.

The usual terms for the sale of securities under a repurchase agreement require that, after a stated period of time, the seller repurchase the securities at a predetermined price or yield. A repo commonly includes a near-term maturity (overnight or a few days) and is usually arranged in large-dollar amounts. The lender or buyer is entitled to receive compensation for use of the funds provided to its counterparty. The interest rate paid on a repo is negotiated based on the rates on the underlying securities. U.S.

1. Further discussion of repurchase agreements can be found in the Board’s November 1995 policy statement, “Repurchase Agreements Between Depository Institutions and Securities Dealers and Others.”

government and agency securities are the most common type of instruments sold under repurchase agreements, since those types of repos are exempt from reserve requirements.

Although standard overnight and term repo arrangements in Treasury and federally related agency securities are most prevalent, market participants sometimes alter various contract provisions to accommodate specific investment needs or to provide flexibility in the designation of collateral. For example, some repo contracts allow substitutions of the securities subject to the repurchase commitment. These are called ''dollar repurchase agreements'' (dollar rolls), and the initial seller's obligation is to repurchase securities that are substantially similar, but not identical, to the securities originally sold. Another common repo arrangement is called a ''flex repo,'' which, as implied by the name, provides a flexible term to maturity. A flex repo is a term agreement between a dealer and a major customer in which the customer buys securities from the dealer and may sell some of them back before the final maturity date.

Bank management should be aware of certain considerations and potential risks of repurchase agreements, especially when entering into large-dollar-volume transactions with institutional investors or brokers. Both parties in a term repo arrangement are exposed to interest-rate risk. It is a fairly common practice to have the collateral value of the underlying securities adjusted daily to reflect changes in market prices and to maintain the agreed-on margin. Accordingly, if the market value of the repo securities declines appreciably, the borrower may be asked to provide additional collateral. Conversely, if the market value of the securities rises substantially, the lender may be required to return the excess collateral to the borrower. If the value of the underlying securities exceeds the price at which the repurchase agreement was sold, the bank could be exposed to the risk of loss if the buyer is unable to perform and return the securities. This risk would obviously increase if the securities are physically transferred to the institution or broker with which the bank has entered into the repurchase agreement. Moreover, if the securities are not returned, the bank could be exposed to the possibility of a significant write-off, to the extent that the book value of the securities exceeds the price at which the securities were originally sold under the repurchase agreement. For this reason, banks should avoid pledging excessive collateral and obtain sufficient financial information on and analyze the financial condition of those institutions and brokers with whom they engage in repurchase transactions.

''Retail repurchase agreements'' (retail repos)[2] for a time were a popular vehicle for some commercial banks to raise short-term funds and compete with certain instruments offered by nonbanking competitors. For booking purposes, a retail repo is a debt incurred by the issuing bank that is collateralized by an interest in a security that is either a direct obligation of or guaranteed as to principal and interest by the U.S. government or an agency thereof. Retail repos are issued in amounts not exceeding $100,000 for periods of less than 90 days. With the advent of money market certificates issued by commercial banks, the popularity of the retail repo declined.

Both retail and large-denomination, wholesale repurchase agreements are in many respects equivalent to short-term borrowings at market rates of interest. Therefore, banks engaging in repurchase agreements should carefully evaluate their interest-rate-risk exposure at various maturity levels, formulate policy objectives in light of the institution's entire asset and liability mix, and adopt procedures to control mismatches between assets and liabilities. The degree to which a bank borrows through repurchase agreements also should be analyzed with respect to its liquidity needs, and contingency plans should provide for alternative sources of funds.

Negotiable Certificates of Deposit

Certificates of deposit (CDs) have not been legally defined as borrowings and continue to be reflected as deposits for reporting purposes. However, the fundamental distinction between a negotiable money market CD as a deposit or as a borrowing is nebulous at best; in fact, the negotiable money market CD is widely recognized as the primary borrowing vehicle for many banks. Dependence on CDs as sources of funds is discussed in ''Deposit Accounts,'' section 3000.1.

2. Further discussion of retail repurchase agreements can be found in SR-82-25, ''Retail Repurchase Agreement (Retail Repo) Examination Guidelines,'' April 16, 1982.

Borrowings from the Federal Reserve

In accordance with the Board's Regulation A (12 CFR 201), the Federal Reserve Banks generally make credit available through the primary, secondary, and seasonal credit programs to any depository institution that maintains transaction accounts or nonpersonal time deposits.[3] However, the Federal Reserve expects depository institutions to rely on market sources of funds for their ongoing funding needs and to use these credit programs as a backup source of funding rather than a routine one. An institution that borrows primary credit may use those funds to finance sales of federal funds, but secondary and seasonal credit borrowers may not act as the medium or agent of another depository institution in receiving Federal Reserve credit except with the permission of the lending Federal Reserve Bank.

A Federal Reserve Bank is not obligated to extend credit to any depository institution but may lend to a depository institution either by making an advance secured by acceptable collateral or by discounting certain types of paper described in the Federal Reserve Act. Although Reserve Banks now always extend credit in the form of an advance, the Federal Reserve's credit facility nonetheless is known colloquially as the ''discount window.'' Before lending to a depository institution, a Reserve Bank can require any information it believes is appropriate to ensure that the assets tendered as collateral are acceptable. A Reserve Bank also should determine prior to lending whether the borrowing institution is undercapitalized or critically undercapitalized. Operating Circular No. 10, ''Lending,'' establishes the credit and security terms for borrowings from the Federal Reserve.

3. In unusual and exigent circumstances and after consultation with the Board, a Reserve Bank may extend credit to individuals, partnerships, and corporations that are not depository institutions if, in the judgment of the Reserve Bank, credit is not available from other sources and failure to obtain credit would adversely affect the economy. A Reserve Bank may extend credit to a nondepository entity in the form of an advance only if the advance is secured by a direct obligation of the United States or a direct obligation of, or an obligation that is fully guaranteed as to principal and interest by, any agency of the United States. An extension of credit secured by any other type of collateral must be in the form of a discount and must be authorized by an affirmative vote of at least five members of the Board.

Primary Credit

Reserve Banks may extend primary credit on a very short term basis (typically overnight) to depository institutions that the Reserve Banks judge to be in generally sound financial condition. Reserve Banks extend primary credit at a rate above the target federal funds rate of the Federal Open Market Committee. Minimal administrative requirements apply to requests for overnight primary credit, unless some aspect of the credit request appears inconsistent with the conditions of primary credit (for example, if a pattern of behavior indicates strongly that an institution is using primary credit other than as a backup source of funding). Reserve Banks also may extend primary credit to eligible institutions for periods of up to several weeks if such funding is not available from other sources. However, longer-term extensions of primary credit will be subject to greater administration than are overnight loans.

Reserve Banks determine eligibility for primary credit according to a uniform set of criteria that also is used to determine eligibility for daylight credit under the Board's Policy Statement on Payments System Risk. These criteria are based mainly on examination ratings and capitalization, although Reserve Banks also may use supplementary information, including market-based information when available. Specifically, an institution that is at least adequately capitalized and rated CAMELS 1 or 2 (or SOSA 1 and ROCA 1, 2, or 3) almost certainly would be eligible for primary credit. An institution that is at least adequately capitalized and rated CAMELS 3 (or SOSA 2 and ROCA 1, 2, or 3) generally would be eligible. An institution that is at least adequately capitalized and rated CAMELS 4 (or SOSA 1 or 2 and ROCA 4 or 5) would be eligible only if an ongoing examination indicated a substantial improvement in condition. An institution that is not at least adequately capitalized, or that is rated CAMELS 5 (or SOSA 3 regardless of the ROCA rating), would not be eligible for primary credit.

Secondary Credit

Secondary credit is available to institutions that do not qualify for primary credit. Secondary credit is available as a backup source of liquidity on a very short term basis, provided that the loan is consistent with a timely return to a reliance on market sources of funds. Longer-term secondary credit is available if necessary for the orderly resolution of a troubled institution, although any such loan would have to comply with additional requirements for lending to undercapitalized and critically undercapitalized institutions. Unlike the primary credit program, secondary credit is not a minimal administration facility because Reserve Banks must obtain sufficient information about a borrower's financial situation to ensure that an extension of credit complies with the conditions of the program. Secondary credit is available at a rate above the primary credit rate.

Seasonal Credit

Seasonal credit is available under limited conditions to meet the needs of depository institutions that have seasonal patterns of movement in deposits and loans but that lack ready access to national money markets. In determining a depository institution's eligibility for seasonal credit, Reserve Banks consider not only the institution's historical record of seasonal fluctuations in loans and deposits, but also the institution's recent and prospective needs for funds and its liquidity conditions. Generally, only very small institutions with pronounced seasonal funding needs will qualify for seasonal credit. Seasonal credit is available at a flexible rate that takes into account the rate for market sources of funds.

Collateral Requirements

All loans advanced by the Reserve Bank must be secured to the satisfaction of the Reserve Bank. Collateral requirements are governed by Operating Circular No. 8. Reserve Banks require a perfected security interest in all collateral pledged to secure loans. Satisfactory collateral generally includes U.S. government and federal-agency securities, and, if they are of acceptable quality, mortgage notes covering one- to four-family residences; state and local government securities; and business, consumer, and other customer notes. Traditionally, collateral is held in the Reserve Bank vault. Under certain circumstances, collateral may be retained on the borrower's premises under a borrower-in-custody arrangement, or it may be held on the borrower's premises under the Reserve Bank's exclusive custody and control in a field warehouse arrangement. Collateral may also be held at the borrowing institution's correspondent or another third party. All book-entry collateral must be held at the Federal Reserve Bank. Definitive collateral, not in bearer form, must be properly assigned and endorsed.

Lending to Undercapitalized and Critically Undercapitalized Depository Institutions

Credit from any Reserve Bank to an institution that is ''undercapitalized'' may be extended or outstanding for no more than 60 days during which the institution is undercapitalized in any 120-day period.[4] An institution is considered undercapitalized if it is not critically undercapitalized under section 38 of the Federal Deposit Insurance Act (the FDI Act) but is either deemed undercapitalized under that provision and its implementing regulations or has received a composite CAMELS rating of 5 as of the most recent examination. A Reserve Bank may make or have outstanding advances or discounts to an institution that is deemed ''critically undercapitalized'' under section 38 of the FDI Act and its implementing regulations only during the five-day period beginning on the date the institution became critically undercapitalized or after consultation with the Board.

INTERNATIONAL BORROWINGS

International borrowings may be direct or indirect. Common forms of direct international borrowings include loans and short-term call money from foreign banks, borrowings from the Export-Import Bank of the United States, and overdrawn nostro (due from foreign banks—demand) accounts. Indirect forms of borrowing include notes and trade bills rediscounted with the central banks of various countries; notes, acceptances, import drafts, or trade bills sold with the bank's endorsement or guarantee; notes and other obligations sold subject to repurchase agreements; and acceptance pool participations.

4. Generally, a Reserve Bank also may lend to an undercapitalized institution during 60 calendar days after receipt of a certificate of viability from the Chairman of the Board of Governors or after consultation with the Board.

ANALYZING BORROWINGS

If a bank borrows extensively or in large amounts, the examiner should thoroughly analyze the borrowing activity. An effective analysis includes a review of the bank's reserve records, both required and maintained, to determine the frequency of deficiencies at the closing of reserve periods. The principal sources of borrowings, range of amounts, frequency, length of time indebted, cost, and reasons for the borrowings should be explored. The actual use of the funds should be verified.

Examiners should also analyze changes in a bank's borrowing position for signs of deterioration in its borrowing ability and overall creditworthiness. One indication of deterioration is the payment of large fees to money brokers to obtain funds because the bank is having difficulty obtaining access to conventional sources of borrowings. These ‘‘brokered deposits’’ are usually associated with small banks since they do not generally have ready access to alternative sources of funds available to larger institutions through the money and capital markets. Brokered deposits generally carry higher interest rates than alternative sources, and they tend to be particularly susceptible to interest-rate changes in the overall financial market. For further discussion of brokered deposits, see ‘‘Deposit Accounts,’’ section 3000.1.

Other indicators of deterioration in a bank's borrowing ability and overall creditworthiness include, but are not limited to, requests for collateral on previously unsecured credit lines or increases in collateral margins, the payment of above-market interest rates, or a shortening of maturities that is inconsistent with management's articulated balance-sheet strategies. If the examiner finds that a bank's borrowing position is not properly managed, appropriate comments should be included in the report of examination.

Borrowed Funds
Examination Objectives
Effective date May 1996

Section 3010.2

1. To determine if the policies, practices, procedures, and internal controls for borrowed funds are adequate.
2. To determine if bank officers are operating in conformance with the established guidelines.
3. To determine the scope and adequacy of the audit function.
4. To determine compliance with laws and regulations.
5. To initiate corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws or regulations have been noted.

1. If selected for implementation, complete or update the Borrowed Funds section of the Internal Control Questionnaire.
2. Based on the evaluation of internal controls and the work performed by the internal/external auditors, determine the scope of the examination.
3. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examination procedures. Also obtain a listing of any audit deficiencies noted in the latest review done by internal/external auditors from the examiner assigned to ‘‘Internal Control’’ and determine if appropriate corrections have been made.
4. Obtain the listing of accounts related to domestic and international borrowed funds from the examiner assigned to ‘‘Examination Strategy.’’
5. Prepare or obtain a listing of borrowings, by type, and—
   a. agree or reconcile balances to department controls and general ledger, and
   b. review reconciling items for reasonableness.
6. From consultation with the examiners assigned to the various loan areas, determine that the following schedules were reviewed in the lending departments and that there was no endorsement, guarantee, or repurchase agreement which would constitute a borrowing:
   a. participations sold
   b. loans sold in full since the preceding examination
7. Based on the information obtained in steps 5 and and 6, and through observation and discussion with management and other examining personnel, determine that all borrowings are properly reflected on the books of the bank.
8. If the bank engages in any form of borrowing which requires written borrowing agreement(s), complete the following:
   a. Prepare or update a carry-forward workpaper describing the major terms of each borrowing agreement, and determine that the bank is complying with those terms.
   b. Review terms of past and present borrowing agreements for indications of deteriorating credit position by noting—
      - recent substantive changes in borrowing agreements,
      - increases in collateral to support borrowing transactions,
      - general shortening of maturities,
      - interest rates exceeding prevailing market rates,
      - frequent changes in lenders, and
      - large fees paid to money brokers.
   c. If the bank has obtained funds from money brokers (brokered deposits), determine—
      - why such deposits were originally obtained,
      - who the deposits were obtained from,
      - what the funds are used for,
      - the relative cost of brokered deposits in comparison to alternate sources of funds, and
      - the overall effect of the use of brokered deposits on the bank’s condition and whether there appear to be any abuses related to the use of such deposits.
   d. If there is an indication that the bank’s credit position has deteriorated, ascertain why.
9. If the bank engages in the issuance of retail repurchase agreements (retail repos), check for compliance with the disclosure requirements in the Federal Reserve Board’s Policy Statement on the Issuance of Repurchase Agreements, S-2457, April 13, 1982 (*Federal Reserve Regulatory Service* 3–1579).
10. Determine the purpose of each type of borrowing and conclude whether the bank’s borrowing posture is justified in light of its financial condition and other relevant circumstances.
11. Provide the examiner assigned to ‘‘Asset/Liability Management’’ the following information:
    a. A summary and an evaluation of the bank’s borrowing policies, practices, and procedures. The evaluation should give consideration to whether the bank—
       - evaluates interest-rate-risk exposure at various maturity levels;

- formulates policy objectives in light of the entire asset and liability mix, and liquidity needs;
- has adopted procedures to control mismatches between assets and liabilities; and
- has contingency plans for alternate sources of funds in the event of a run-off of current funding sources.

b. An evaluation of the bank’s adherence to established policies and procedures.

c. A repricing maturity schedule of borrowings.

d. A listing of prearranged federal funds lines and other lines of credit. Indicate the amount currently available under those lines, i.e., the unused portion of the lines.

e. The amount of any anticipated decline in borrowings over the next ___________ day period. (The time period will be determined by the examiner assigned to ‘‘Asset/Liability Management.’’)

12. Prepare a list of all borrowings by category, on a daily basis for the period since the last examination. Also, include on the list short-term or overnight money market lending activities such as federal funds sold and securities purchased under resale agreement. For each category on the list, compute for the period between examinations—
    a. high point
    b. low point
    c. average amounts outstanding
    d. frequency of borrowing and lending activity, expressed in terms of number of days
13. Prepare, in appropriate report form, and discuss with appropriate management—
    a. the adequacy of written policies regarding borrowings;
    b. the manner in which bank officers are operating in conformance with established policy;
    c. the existence of any unjustified borrowing practices;
    d. any violation of laws or regulations; and
    e. recommended corrective action when policies, practices, or procedures are deficient; violations of laws or regulations exist; or when unjustified borrowing practices are being pursued.
14. Update the workpapers with any information that will facilitate future examinations.
15. Review the market value of collateral and collateral-control arrangements for repurchase agreements to ensure that excessive collateral has not been pledged and that the bank is not exposed to excessive credit risks.

Review the bank's controls, policies, practices and procedures for obtaining and servicing borrowed funds. The bank's system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used and other pertinent information. Items marked with an asterisk require substantiation by observation or testing.

POLICY

1. Has the board of directors approved a written policy which:
   a. Outlines the objectives of bank borrowings?
   b. Describes the bank's borrowing philosophy relative to risk considerations, i.e., leverage/growth, liquidity/income?
   c. Provides for risk diversification in terms of staggered maturities rather than solely on cost?
   d. Limits borrowings by amount outstanding, specific type or total interest expense?
   e. Limits or restricts execution of borrowings by bank officers?
   f. Provides a system of reporting requirements to monitor borrowing activity?
   g. Requires subsequent approval of transactions?
   h. Provides for review and revision of established policy at least annually?

RECORDS

*2. Does the bank maintain subsidiary records for each type of borrowing, including proper identification of the obligee?

*3. Is the preparation, addition and posting of the subsidiary borrowed funds records performed or adequately reviewed by persons who do not also:
   a. Handle cash?
   b. Issue official checks and drafts?
   c. Prepare all supporting documents required for payment of debt?

*4. Are subsidiary borrowed funds records reconciled with the general ledger accounts at an interval consistent with borrowing activity, and are the reconciling items investigated by persons, who do not also:
   a. Handle cash?
   b. Prepare or post to the subsidiary borrowed funds records?

INTEREST

*5. Are individual interest computations checked by persons who do not have access to cash?

6. Is an overall test of the total interest paid made by persons who do not have access to cash?
7. Are payees on the checks matched to related records of debt, note or debenture owners?
8. Are corporate resolutions properly prepared as required by creditors and are copies on file for reviewing personnel?
9. Are monthly reports furnished to the board of directors reflecting the activity of borrowed funds, including amounts outstanding, interest rates, interest paid to date and anticipated future activity?

CONCLUSION

10. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
11. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

Commercial banks rely on wholesale borrowings obtained from a number of financial intermediaries, including Federal Home Loan Banks, other commercial banks, and securities firms. These borrowings frequently have attractive features and pricing. If properly assessed and prudently managed, they can enhance a bank's funding options and assist in controlling interest-rate and liquidity risks. Some of the reasons that banks use these types of borrowings include the initial low cost of funds when compared with other liabilities with similar maturities. At the same time, certain wholesale borrowings have become more complex, and some structures include various types of embedded options.[1] If not thoroughly assessed and prudently managed, these more complex funding instruments have the potential over time to significantly increase a bank's sensitivity to market and liquidity risks. Maturity mismatches or the embedded options themselves can, in some circumstances, adversely affect a bank's financial condition, especially when the terms and conditions of the borrowings are misunderstood.

A growing use of wholesale borrowings, combined with the risks associated with the complex structures of some of these borrowings, makes it increasingly important for bank supervisors to assess the risks and risk-management processes associated with these sources of funds. The supervisory guidance provided below supplements and expands upon existing general guidance on bank funding and borrowings.[2] Where appropriate, examiners should (1) review the provisions of each significant borrowing agreement between the bank and the wholesale institution, (2) determine what assets collateralize the borrowing (or borrowings), and (3) identify the potential risks presented by the agreement. (See SR-01-8.)

In addition to determining if a bank follows the sound-practice guidance for bank liability management and funding in general, supervisors should take the following steps, as appropriate, when assessing a bank that has material amounts of wholesale borrowings:

- Review the bank's borrowing contracts for embedded options or other features that may affect the bank's liquidity and sensitivity to market risks. In addition, examiners should review the collateral agreements for fees, collateral-maintenance requirements (including triggers for increases in collateral), and other features that may affect the bank's liquidity and earnings.
- Assess the bank's management processes for identifying and monitoring the risks of the various terms of each borrowing contract, including penalties and option features over the expected life of the contract. Examiners should review for evidence that the bank's management, or an independent third party, completed stress tests (1) before the bank entered into the borrowing agreement (or agreements) and (2) periodically thereafter. If the bank relies on independent third-party testing, examiners should verify that management reviewed and accepted the underlying assumptions and test results. In any case, management should not be relying solely on the wholesaler's stress-test results. Also, the stress tests employed should cover a reasonable range of contractual triggers and external events. Such triggers or events include interest-rate changes that may result in the exercise of embedded options or the bank's termination of the agreement, which may entail prepayment penalties. In general, stress-test results should depict the potential impact of these variables on the individual borrowing facility, as well as on the overall earnings and liquidity position of the bank.
- Evaluate management processes for controlling risks, including interest-rate risks arising from the borrowings and liquidity risks. Proper controls include (1) hedges or other plans for minimizing the adverse effects of penalties or interest-rate changes and other triggers for embedded options and (2) contingent funding

1. Wholesale borrowings with embedded options may have variable interest payments or average lives or redemption values that depend on external measures such as reference rates, indexes, or formulas. Embedded options include putable, callable, convertible, and variable rate advances with caps, floors, collars, step-ups, or amortizing features. In addition, these types of borrowings may contain prepayment penalties.

2. See the supervisory guidance for "Borrowed Funds," section 3010.1; "Asset/Liability Management," section 4020.1; and "Interest-Rate Risk Management," section 4090.1. See also the *Trading and Capital-Markets Activities Manual*, sections 2030.1, "Liquidity Risk," and 3010.1, "Interest-Rate Risk Management." In general, this guidance collectively calls for supervisors to analyze the purpose, effectiveness, concentration exposure, and stability of borrowings and to assess bank management's understanding of liquidity and interest-rate risks associated with borrowing and funding strategies.

plans if borrowings or lines are terminated before the original expected maturity.
- Determine whether the asset/liability management committee or board of directors, as appropriate, is fully informed of the risks and ramifications of complex wholesale-borrowing agreements before engaging in the transactions and on an ongoing basis.
- Determine whether funding strategies for wholesale borrowings, especially those with embedded options, are consistent with both the portfolio objectives of the bank and the level of sophistication of the bank's risk management. Banks without the technical knowledge and whose risk-management systems are insufficient to adequately identify, assess, monitor, and control the risks of complex wholesale borrowings should not be using this funding.

Reliance on wholesale borrowings is consistent with safe and sound banking when management understands the risks of these activities and has systems and procedures in place to properly monitor and control the risks. Supervisors and examiners, however, should take appropriate steps to follow up on institutions that use complex funding instruments without adequately understanding their risks or without proper risk-management systems and controls. Examiners should also seek corrective action when funding mechanisms or strategies are inconsistent with prudent funding needs and objectives.

1. To review the terms of wholesale-borrowing contracts to identify embedded options or other features that may affect the bank's liquidity and sensitivity to market risks.
2. To assess management's technical knowledge, systems, and processes for identifying, assessing, monitoring, and controlling the risks (including liquidity risk and interest-rate risk) associated with wholesale borrowing, and to assess the bank's stress-testing practices and contingency-funding plans.
3. To determine if the bank's board of directors or its asset/liability management committee is fully aware of the risks associated with and ramifications of engaging in complex wholesale-borrowing agreements.
4. To ascertain whether the bank's wholesale-borrowing funding and hedging strategies are consistent with its portfolio objectives and the level of management's sophistication.

1. Review the bank's borrowing contracts to identify embedded options or other features that may affect the bank's liquidity and sensitivity to market risks. Also review the collateral agreements to determine what fees, collateral-maintenance requirements (including triggers for increases in collateral), and other agreed-upon features may affect the bank's liquidity and earnings.
2. Assess the bank's management processes for identifying and monitoring the risks of the various terms of each borrowing contract, including penalties and option features over the expected life of the contract.
   a. Obtain and examine evidence to determine whether the bank's management, or an independent third party, completed stress tests before the bank entered into the borrowing agreement (or agreements) and periodically thereafter.
   b. If the bank relies on independent third-party testing, verify that management reviewed and accepted the underlying assumptions and test results.
3. Evaluate the management processes for controlling risks, including (1) interest-rate risks arising from the borrowings and (2) liquidity risks.
4. Determine if the asset/liability management committee or board of directors, as appropriate, is fully informed of the risks and ramifications of complex wholesale-borrowing agreements both before engaging in the transactions and on an ongoing basis.
5. Determine if funding strategies for wholesale borrowings, especially those with embedded options, are consistent with both the portfolio objectives of the bank and the level of sophistication of the bank's risk management.
6. Seek the corrective action taken by the institution when funding mechanisms or strategies are inconsistent with prudent funding needs and objectives.

Although both bank directors and bank regulators must look carefully at the quality of bank assets and management and at the ability of the bank to control costs, evaluate risks, and maintain proper liquidity, capital adequacy is the area that triggers the most regulatory action, especially in view of prompt corrective action. The primary function of capital is to support the bank's operations, act as a cushion to absorb unanticipated losses and declines in asset values that could otherwise cause a bank to fail, and provide protection to uninsured depositors and debt holders in the event of liquidation. A bank's solvency promotes public confidence in the bank and the banking system as a whole by providing continued assurance that the bank will continue to honor its obligations and provide banking services. By exposing stockholders to a larger percentage of any potential loss, higher capital levels also reduce the subsidy provided to banks by the federal safety net. Capital regulation is particularly important because deposit insurance and other elements of the federal safety net provide banks with an incentive to increase their leverage beyond what the market—in the absence of depositor protection—would permit. Additionally, higher capital levels can reduce the need for regulatory supervision, lowering costs to the banking industry and the government.

The Federal Reserve uses two ratios to help assess the capital adequacy of state members: the risk-based capital ratio and the tier 1 leverage ratio. State member banks may also be subject to separate capital requirements imposed by state banking supervisors.

OVERVIEW OF THE RISK-BASED CAPITAL MEASURE FOR STATE MEMBER BANKS

The Federal Reserve's risk-based capital guidelines (the guidelines) focus principally on the credit risk associated with the nature of banks' on- and off-balance-sheet exposures and on the type and quality of banks' capital. The information provided in this section should be used in conjunction with the guidelines, which are found in Regulation H (12 CFR 208), appendix A.

The risk-based capital guidelines provide a definition of capital and a framework for calculating risk-weighted assets by assigning assets and off-balance-sheet items to broad categories of credit risk. A bank's risk-based capital ratio is calculated by dividing its qualifying capital (the numerator of the ratio) by its risk-weighted assets (the denominator). The definition of qualifying capital is outlined below, as are the procedures for calculating risk-weighted assets.

The major objectives of the risk-based capital guidelines are to make regulatory capital requirements more sensitive to differences in credit-risk profiles among banking organizations; to factor off-balance-sheet exposures into the assessment of capital adequacy; to minimize disincentives to holding liquid, low-risk assets; and to achieve greater consistency in the evaluation of the capital adequacy of major banking organizations worldwide.

The guidelines set forth minimum supervisory capital standards that apply to all state member banks on a consolidated basis. Most banks are expected to operate with capital levels above the minimum ratios. Banking organizations that are undertaking significant expansion or that are exposed to high or unusual levels of risk are expected to maintain capital well above the minimum ratios; in such cases, the Federal Reserve may specify a higher minimum requirement. In addition, the risk-based capital ratio is used as a basis for categorizing institutions for purposes of prompt corrective action.[1]

For most institutions, the risk-based capital ratio focuses principally on broad categories of credit risk, although the framework for assigning assets and off-balance-sheet items to risk categories does incorporate elements of transfer risk, as well as limited instances of interest-rate and market risk.[2] The framework incorporates risks arising from traditional banking activities as well as risks arising from nontraditional activities. The ratio does not, however, incorporate other factors that can affect an institution's financial condition. These factors include overall interest-rate exposure; liquidity, funding, and market risks; the quality and level of earnings; investment, loan portfolio, and other concentrations of credit; certain risks arising from nontra-

1. See section 4133.1, ''Prompt Corrective Action.''

2. A small number of institutions are required to hold capital to support their exposure to market risk. For more information, see the ''Market-Risk Measure'' subsection below or the Federal Reserve's *Trading and Capital-Markets Activities Manual*, section 2110.1, ''Capital Adequacy.''

ditional activities; the effectiveness of loan and investment policies; and management's overall ability to monitor and control financial and operating risks, including the risks presented by concentrations of credit and nontraditional activities. An overall assessment of capital adequacy must take into account these other factors, including, in particular, the level and severity of problem and classified assets as well as a bank's exposure to declines in the economic value of its capital due to changes in interest rates. For this reason, the final supervisory judgment on a bank's capital adequacy may differ significantly from conclusions that might be drawn solely from the level of its risk-based capital ratio.

DEFINITION OF CAPITAL

For the purpose of risk-based capital, a bank's total capital consists of two types of components: ''core capital elements'' (which are included in tier 1 capital) and ''supplementary capital elements'' (which are included in tier 2 capital). To qualify as an element of tier 1 or tier 2 capital, a capital instrument must be unsecured and may not contain or be covered by any covenants, terms, or restrictions that are inconsistent with safe and sound banking practices.

Tier 1 capital is generally defined as the sum of core capital elements (common equity, including capital stock, surplus, and undivided profits; qualifying noncumulative perpetual preferred stock; and minority interest in the equity accounts of consolidated subsidiaries) less any amounts of goodwill, other intangible assets, interest-only strips receivables and nonfinancial equity investments that are required to be deducted,[3] and unrealized holding losses in the available-for-sale equity portfolio, as well as any investments in subsidiaries that the Federal Reserve determines should be deducted from tier 1 capital. Tier 1 capital elements represent the highest form of capital, namely, permanent equity.

Tier 2 capital consists of a limited amount of the allowance for loan and lease losses; perpetual preferred stock that does not qualify for inclusion in tier 1 capital; certain other hybrid capital instruments; mandatory convertible securities; long-term preferred stock with an original term of 20 years or more; and limited amounts of term subordinated debt, intermediate-term preferred stock, including related surplus, and unrealized holding gains on qualifying equity securities.

Capital investments in unconsolidated banking and finance subsidiaries, and reciprocal holdings of other banking organizations' capital instruments, are deducted from a bank's capital. The sum of tier 1 and tier 2 capital less any deductions makes up total capital, which is the numerator of the total risk-based capital ratio. The maximum amount of tier 2 capital that may be included in a bank's qualifying total capital is limited to 100 percent of tier 1 capital (net of goodwill, other intangible assets, and interest-only strips receivables and nonfinancial equity investments that are required to be deducted).

RISK WEIGHTING OF ON- AND OFF-BALANCE-SHEET ITEMS

Each asset and off-balance-sheet item (referred to collectively as claims) is assigned to one of four broad risk categories based on the perceived credit risk of the obligor or, if relevant, the guarantor or type of collateral. These risk categories are assigned weights of 0 percent, 20 percent, 50 percent, and 100 percent. The majority of items fall into the 100 percent risk-weight category. A brief explanation of the components of each category follows. For more detailed information, see the capital adequacy guidelines.

Risk Categories

Category 1: Zero Percent

Category 1 includes cash (domestic and foreign) owned and held in all offices of the bank or in transit, as well as gold bullion held in the bank's own vaults or in another bank's vaults on an allocated basis to the extent it is offset by gold bullion liabilities. The category also includes all direct claims on (including securities, loans, and leases), and the portions of claims that are directly and unconditionally guaranteed by, the central governments of the Organization for

3. In this subsection, the words ''required to be deducted'' refer to section II.B. of the capital adequacy guidelines: risk-based measure (Regulation H, appendix A (12 CFR 208, appendix A)).

Economic Cooperation and Development (OECD) countries and U.S. government agencies, as well as all direct local currency claims on, and the portions of local currency claims that are directly and unconditionally guaranteed by, the central governments of non-OECD countries, to the extent that the bank has liabilities booked in that currency. A claim is not considered to be unconditionally guaranteed by a central government if the validity of the guarantee depends on some affirmative action by the holder or a third party. Generally, securities guaranteed by the U.S. government or its agencies that are actively traded in financial markets, such as Government National Mortgage Association (GNMA) securities, are considered to be unconditionally guaranteed. This zero percent category also includes claims collateralized (1) by cash on deposit in the bank or (2) by securities issued or guaranteed by OECD central governments or U.S. government agencies for which a positive margin of collateral is maintained on a daily basis, fully taking into account any change in the bank's exposure to the obligor or counterparty under a claim in relation to the market value of the collateral held in support of that claim.

Category 2: 20 percent

Category 2 includes cash items in the process of collection, both foreign and domestic; short-term claims on (including demand deposits), and the portions of short-term claims that are guaranteed by, U.S. depository institutions and foreign banks; and long-term claims on, and the portions of long-term claims that are guaranteed by, U.S. depository institutions and OECD banks. This category also includes the portions of claims that are conditionally guaranteed by OECD central governments and U.S. government agencies, as well as the portions of local currency claims that are conditionally guaranteed by non-OECD central governments, to the extent that the bank has liabilities booked in that currency. In addition, this category includes claims on, and the portions of claims that are guaranteed by, U.S. government–sponsored agencies and claims on, and the portions of claims guaranteed by, the International Bank for Reconstruction and Development (the World Bank), the International Finance Corporation, the Inter-American Development Bank, the Asian Development Bank, the African Development Bank, the European Investment Bank, the European Bank for Reconstruction and Development, the Nordic Investment Bank, and other multilateral lending institutions or regional development banks in which the U.S. government is a shareholder or contributing member. General obligation claims on, or portions of claims guaranteed by the full faith and credit of, states or other political subdivisions of the United States or other countries of the OECD-based group are also assigned to this category. Category 2 also includes the portions of claims (including repurchase transactions) that are (1) collateralized by cash on deposit in the bank or by securities issued or guaranteed by OECD central governments or U.S. government agencies that do not qualify for the zero percent risk-weight category; (2) collateralized by securities issued or guaranteed by U.S. government–sponsored agencies; or (3) collateralized by securities issued by multilateral lending institutions or regional development banks in which the U.S. government is a shareholder or contributing member.

This risk category also includes claims on,[3a] or guaranteed by, a qualifying securities firm incorporated in the United States or other countries that are members of the OECD-based group of countries[3b] provided that (1) the qualifying securities firm has a long-term issuer credit rating, or a rating on at least one issue of long-term debt, in one of the three highest investment-grade rating categories from a nationally recognized statistical rating organization, or (2) the claim is guaranteed by the firm's parent company and the parent company has such a rating. If ratings are available from more than one rating agency, the lowest rating will be used to determine whether the rating require-

3a. Claims on a qualifying securities firm that are instruments the firm, or its parent company, uses to satisfy its applicable capital requirements are not eligible for this risk weight.

3b. With regard to securities firms incorporated in the United States, qualifying securities firms are those securities firms that are broker-dealers registered with the Securities and Exchange Commission (SEC) and are in compliance with the SEC's net capital rule, 17 CFR 240.15c3-1.With regard to securities firms incorporated in any other country in the OECD-based group of countries, qualifying securities firms are those securities firms that a bank is able to demonstrate are subject to consolidated supervision and regulation (covering their direct and indirect subsidiaries, but not necessarily their parent organizations) comparable to that imposed on banks in OECD countries. Such regulation must include risk-based capital requirements comparable to those applied to banks under the Basel Accord.

ment has been met. This category also includes a collateralized claim on a qualifying securities firm in such a country, without regard to satisfaction of the rating standard, provided that the claim arises under a contract that (1) is a reverse-repurchase/repurchase agreement or securities-lending/borrowing transaction executed using standard industry documentation; (2) is collateralized by debt or equity securities that are liquid and readily marketable; (3) is marked to market daily; (4) is subject to a daily margin-maintenance requirement under the standard industry documentation; and (5) can be liquidated, terminated, or accelerated immediately in bankruptcy or a similar proceeding, and the security or collateral agreement will not be stayed or avoided, under applicable law of the relevant jurisdiction.[3c]

Category 3: 50 percent

Category 3 includes loans fully secured by first liens on one- to four-family residential properties (either owner-occupied or rented), or on multifamily residential properties, that meet certain criteria. To be included in category 3, loans must have been made in accordance with prudent underwriting standards, be performing in accordance with their original terms, and not be 90 days or more past due or carried in nonaccrual status. The following additional criteria must be applied to a loan secured by a multifamily residential property that is included in this category: (1) all principal and interest payments on the loan must have been made on time for at least the year preceding placement in this category, or, in the case of an existing property owner who is refinancing a loan on that property, all principal and interest payments on the loan being refinanced must have been made on time for at least the year preceding placement in this category; (2) amortization of the principal and interest must occur over a period of not more that 30 years, and the minimum original maturity for repayment of principal must not be less than seven years; and (3) the annual net operating income (before debt service) generated by the property during its most recent fiscal year must not be less than 120 percent of the loan's current annual debt service (115 percent if the loan is based on a floating interest rate) or, in the case of a cooperative or other not-for-profit housing project, the property must generate sufficient cash flow to provide comparable protection to the institution. Also included in category 3 are privately issued mortgage-backed securities, provided that (1) the structure of the security meets the criteria described in section III.B.3. of the risk-based measure of the capital guidelines (12 CFR 208, appendix A); (2) if the security is backed by a pool of conventional mortgages on one- to four-family residential or multifamily residential properties, each underlying mortgage meets the criteria described above for eligibility for the 50 percent risk category at the time the pool is originated; (3) if the security is backed by privately issued mortgage-backed securities, each underlying security qualifies for the 50 percent risk category; and (4) if the security is backed by a pool of multifamily residential mortgages, principal and interest payments on the security are not 30 days or more past due. Privately issued mortgage-backed securities that do not meet these criteria or that do not qualify for a lower risk weight are generally assigned to the 100 percent risk category.

Also assigned to category 3 are revenue (nongeneral obligation) bonds or similar obligations, including loans and leases, that are obligations of states or other political subdivisions of the United States (for example, municipal revenue bonds) or other countries of the OECD-based group, but for which the government entity is committed to repay the debt with revenues from the specific projects financed, rather than from general tax funds. Credit-equivalent amounts of derivative contracts involving standard risk obligors (that is, obligors whose loans or debt securities would be assigned to the 100 percent risk category) are included in the 50 percent category, unless they are backed by collateral or guarantees that allow them to be placed in a lower risk category.

Category 4: 100 percent

All assets not included in the categories above are assigned to category 4, which comprises

3c. For example, a claim is exempt from the automatic stay in bankruptcy in the United States if it arises under a securities contract or a repurchase agreement subject to section 555 or 559 of the Bankruptcy Code, respectively (11 USC 555 or 559); a qualified financial contract under section 11(e)(8) of the Federal Deposit Insurance Act (12 USC 1821(e)(8)); or a netting contract between financial institutions under sections 401–407 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (12 USC 4401–4407) or the Board's Regulation EE (12 CFR 231).

standard risk assets. The bulk of the assets typically found in a loan portfolio would be assigned to the 100 percent category.

Category 4 includes long-term claims on, and the portions of long-term claims that are guaranteed by, non-OECD banks, and all claims on non-OECD central governments that entail some degree of transfer risk. This category includes all claims on foreign and domestic private-sector obligors not included in the categories above (including loans to nondepository financial institutions and bank holding companies); claims on commercial firms owned by the public sector; customer liabilities to the bank on acceptances outstanding that involve standard risk claims; investments in fixed assets, premises, and other real estate owned; common and preferred stock of corporations, including stock acquired for debts previously contracted; all stripped mortgage-backed securities and similar instruments; and commercial and consumer loans (except those assigned to lower risk categories due to recognized guarantees or collateral and loans secured by residential property that qualify for a lower risk weight). This category also includes claims representing capital of a qualifying securities firm.

This category also includes industrial-development bonds and similar obligations issued under the auspices of states or political subdivisions of the OECD-based group of countries for the benefit of a private party or enterprise when that party or enterprise, not the government entity, is obligated to pay the principal and interest. All obligations of states or political subdivisions of countries that do not belong to the OECD-based group are also assigned to category 4. The following assets are assigned a risk weight of 100 percent if they have not been deducted from capital: investments in unconsolidated companies, joint ventures, or associated companies; instruments that qualify as capital that are issued by other banking organizations; and any intangibles, including those that may have been grandfathered into capital.

Application of the Risk Weights

The appropriate aggregate dollar value of the amount in each risk category is multiplied by the risk weight associated with that category. The resulting weighted values for each of the risk categories are added together. The resulting sum is the bank's total risk-weighted assets and is the denominator of the risk-based capital ratio.

Off-balance-sheet items are incorporated into the risk-based capital ratio through a two-step process. First, an on-balance-sheet ‘‘credit-equivalent amount’’ is calculated, generally by multiplying the face amount of the item by a credit-conversion factor (except for direct-credit subsitutes and recourse obligations). Most off-balance-sheet items are assigned to one of the four credit-conversion factors, 0 percent, 20 percent, 50 percent, and 100 percent. These factors are intended to reflect the risk characteristics of the activity in terms of an on-balance-sheet equivalent. Once the credit-equivalent amount of the off-balance-sheet item is calculated, that amount is generally categorized in the same manner as on-balance-sheet items, that is, by credit risk.

For derivative contracts, the credit-equivalent amount for each contract is determined by multiplying the notional principal amount of the underlying contract by a credit-conversion factor and adding the resulting product (which is an estimate of potential future exposure) to the positive mark-to-market value of the contract (which is the current exposure). A contract with a negative mark-to-market value is treated as having a current exposure of zero. Where appropriate, a bank may offset positive and negative mark-to-market values of derivative contracts entered into with a single counterparty subject to a qualifying, legally enforceable, bilateral netting arrangement.

As a general rule, if the terms of a claim can change, the claim should be assigned to the risk category appropriate to the highest risk option available under the terms of the claim. For example, in a collateralized loan where the borrower has the option to withdraw the collateral before the loan is due, the loan would be treated as an uncollateralized claim for risk-based capital purposes. Similarly, a commitment that can be drawn down in the form of a loan or a standby letter of credit would be treated as a commitment to make a standby letter of credit, the higher risk option available under the terms of the commitment.

When an item may be assigned to more than one category, that item generally is assigned to the lowest eligible risk category. For example, a mortgage originated by the bank for which a 100 percent Federal Housing Administration guarantee has been obtained would be assigned the 20 percent risk weight that is appropriate to claims conditionally guaranteed by a U.S. government agency, rather than the 100 percent risk weight that is appropriate to high loan-to-value single-family mortgages.

While the primary determinant of the risk category of a particular on-balance-sheet asset or off-balance-sheet credit-equivalent amount is the obligor, collateral or guarantees may be used to a limited extent to assign an item to a lower risk category than would be available to the obligor. The only forms of collateral that are recognized for risk-based capital purposes are cash on deposit in the lending bank;[4] securities issued or guaranteed by the central governments of the OECD-based group of countries,[5] U.S. government agencies, or U.S. government–sponsored agencies; and securities issued by multilateral lending institutions or regional development banks in which the U.S. government is a shareholder or contributing member. In order for a claim to be considered collateralized for risk-based capital purposes, the underlying arrangements must provide that the claim will be secured by recognized collateral throughout its term. A commitment may be considered collateralized for risk-based capital purposes to the extent that its terms provide that advances made under the commitment will be secured throughout their term.

The extent to which qualifying securities are recognized as collateral is determined by their current market value. The full amount of a claim for which a positive margin (that is, greater than 100 percent of the claim) of recognized collateral is maintained daily may qualify for a 0 percent risk weight. The full amount of a claim that is 100 percent secured by recognized col-

4. There is a limited exception to the rule that cash must be on deposit in the lending bank to be recognized as collateral. A bank participating in a syndicated credit secured by cash on deposit in the lead bank may treat its pro rata share of the credit as collateralized, provided that it has a perfected interest in its pro rata share of the collateral.

5. The OECD-based group of countries comprises all full members of the Organization for Economic Cooperation and Development (OECD), as well as countries that have concluded special lending arrangements with the International Monetary Fund (IMF) associated with the Fund’s General Arrangements to Borrow. As of September 1998, the OECD countries were Australia, Austria, Belgium, Canada, the Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States. Saudi Arabia has concluded special lending arrangements with the IMF associated with the Fund’s General Arrangements to Borrow. Any country that has rescheduled its external sovereign debt within the previous five years is not considered to be part of the OECD-based group of countries for risk-based capital purposes. In April 1994, Poland rescheduled its external sovereign debt.

lateral may be assigned to the 20 percent risk category. For partially secured obligations, the secured portion is assigned a 20 percent risk weight. Any unsecured portion is assigned the risk weight appropriate for the obligor or guarantor, if any. The extent to which an off-balance-sheet item is secured by collateral is determined by the degree to which the collateral covers the face amount of the item before it is converted to a credit-equivalent amount and assigned to a risk category. For derivative contracts, this determination is made in relation to the credit-equivalent amount.

The only guarantees that are recognized for risk-based capital purposes are those provided by central or state and local governments of the OECD-based group of countries, U.S. government agencies, U.S. government–sponsored agencies, multilateral lending institutions or regional development banks in which the United States is a shareholder or contributing member, U.S. depository institutions, and foreign banks. If an obligation is partially guaranteed, the portion that is not fully covered is assigned the risk weight appropriate to the obligor or to any collateral. An obligation that is covered by two types of guarantees having different risk weights is apportioned between the two risk categories appropriate to the guarantors.

Implementation

Banks are expected to meet a minimum ratio of capital to risk-weighted assets of 8 percent, with at least 4 percent taking the form of tier 1 capital. Banks that do not meet the minimum risk-based capital ratios, or that are considered to lack sufficient capital to support their activities, are expected to develop and implement capital plans acceptable to the Federal Reserve for achieving adequate levels of capital.[6] Such plans should satisfy the provisions of the guidelines or established arrangements that the Federal Reserve has agreed upon with designated banks. In addition, such banks should avoid any actions, including increased risk-taking or unwarranted expansion, that would lower or further erode their capital positions. In these cases, examiners are to review and comment on banks' capital plans and their progress in meeting minimum risk-based capital requirements.

When assessing the bank's capital adequacy, it is appropriate to include comments on risk-based capital in the open section of the examination report. The bank should be encouraged to establish capital levels and ratios that are consistent with its overall financial profile. Examiner comments should address the adequacy of the bank's plans and progress toward meeting the relevant target ratios.

Market-Risk Measure

In August 1996, the Federal Reserve amended its risk-based capital framework to incorporate a measure for market risk. The market-risk amendment, also known as the market-risk rule, is found in Regulation H (12 CFR 208), appendix E. Under the market-risk rule, certain institutions with significant exposure to market risk must measure that risk using their internal value-at-risk (VAR) measurement model and, subject to parameters in the market-risk rule, hold sufficient levels of capital to cover the exposure. The market-risk rule applies to any insured state member bank whose trading activity (the gross sum of its trading assets and liabilities) equals (1) 10 percent or more of its total assets or (2) $1 billion or more. On a case-by-case basis, the Federal Reserve may require an institution that does not meet these criteria to comply with the market-risk rule if deemed necessary for safety-and-soundness reasons. The Federal Reserve may also exclude an institution that meets the criteria if such exclusion is deemed to be consistent with safe and sound banking practices.

The market-risk amendment is a supplement to the risk-based capital rules for credit risk; an institution applying the market-risk rule remains subject to the requirements of the credit-risk rules, but must adjust its risk-based capital ratio to reflect market risk. A bank that is applying the market-risk rule must hold capital to support its exposure to two types of risk: (1) general market risk arising from broad fluctuations in interest rates, equity prices, foreign-exchange rates, and commodity prices, including risk associated with all derivative positions, and (2) specific risk arising from changes in the market value of debt and equity positions in the trading account due to factors other than broad market movements,

6. Under the prompt-corrective-action framework, banks that do not meet the minimum risk-based capital ratio are considered undercapitalized and must file capital-restoration plans that meet certain requirements.

including the credit risk of an instrument's issuer. A bank's covered positions include all trading-account positions, as well as all foreign-exchange and commodity positions, whether or not they are in the trading account. For a detailed description of the market-risk measure, see the Federal Reserve's *Trading and Capital-Markets Activities Manual*, section 2110.1, "Capital Adequacy."

Documentation

Banks are expected to have adequate systems in place to compute their risk-based capital ratios. Such systems should be sufficient to document the composition of the ratios to be used for regulatory reporting and other supervisory purposes. Generally, supporting documentation will be expected to establish how banks track and report their capital components and on- and off-balance-sheet items that are assigned preferential risk weights, that is, risk weights less than 100 percent. Where a bank has inadequate documentation to support its assignment of a preferential risk weight to a given item, it may be necessary for examiners to assign an appropriate higher weight to that item. Examiners are expected to verify that banks are correctly reporting the information requested on the Reports of Condition and Income, which are used in computing banks' risk-based capital ratios.

SUPERVISORY CONSIDERATIONS FOR CALCULATING AND EVALUATING RISK-BASED CAPITAL

Certain requirements and factors should be considered in assessing the risk-based capital ratios and the overall capital adequacy of banks. Analysis of these requirements and factors may have a material impact on the amount of capital banks must hold to appropriately support certain activities for on- and off-balance-sheet items, and this ananlysis must be used in assessing compliance with the guidelines. The requirements and factors to be considered relate to certain capital elements, capital adjustments, balance-sheet activities, off-balance-sheet activities, and the overall assessment of capital adequacy.

Federal Reserve Review of a Capital Instrument

If the terms and conditions of a particular instrument cause uncertainty as to how the instrument should be treated for capital purposes, it may be necessary to consult with Federal Reserve staff for a final determination. The Federal Reserve will, on a case-by-case basis, determine whether a capital instrument has characteristics that warrant its inclusion in tier 1 or tier 2 capital, as well as any quantitative limit on the amount of an instrument that will be counted as an element of tier 1 or tier 2 capital. In making this determination, the Federal Reserve will consider the similarity of the instrument to instruments explicitly treated in the guidelines, the ability of the instrument to absorb losses while the bank operates as a going concern, the maturity and redemption features of the instrument, and other relevant terms and factors.

Redemptions of Capital

Redemptions of permanent equity or other capital instruments before their stated maturity could have a significant impact on a bank's overall capital structure. Consequently, a bank considering such a step should consult with the Federal Reserve before redeeming any equity or debt capital instrument (before maturity) if its redemption could have a material effect on the level or composition of the institution's capital base.[7]

Capital Elements

This subsection discusses the characteristics of the principal types of capital elements. It also covers terms and conditions that may disqualify an instrument from inclusion in a particular element of capital.

7 Consultation would not ordinarily be necessary if an instrument were redeemed with the proceeds of, or replaced by, a like amount of a similar or higher-quality capital instrument and if the organization's capital position is considered fully adequate by the Federal Reserve.

Common Stockholders' Equity

Common stockholders' equity includes common stock; related surplus; and retained earnings, including capital reserves and adjustments for the cumulative effect of foreign-currency translation, net of any treasury stock. A capital instrument that is not permanent or that has preference with regard to liquidation or the payment of dividends is not deemed to be common stock, regardless of whether it is called common stock. Other preferences may also call into question whether the capital instrument is common stock. Close scrutiny should be paid to the terms of common-stock issues of banks that have issued more than one class of common stock. If preference features are found in one of the classes, that class generally should not be treated as common stock.

From a supervisory standpoint, it is desirable that voting common stockholders' equity remain the dominant form of tier 1 capital. Accordingly, the risk-based capital guidelines state that banks should avoid overreliance on nonvoting equity elements in tier 1 capital. Nonvoting equity elements can arise in connection with common stockholders' equity when a bank has two classes of common stock, one voting and the other nonvoting. Alternatively, one class may have so-called ''super-voting rights'' entitling the holder to substantially more votes per share than the other class. In this case, the super-voting shares may have so many votes per share that the voting power of the other shares is effectively overwhelmed.

Banks that have nonvoting, or effectively nonvoting, common equity and tier 1 perpetual preferred stock in excess of their voting common stock are clearly overrelying on nonvoting equity elements in tier 1 capital. In such cases, it may be appropriate to reallocate some of the nonvoting equity elements from tier 1 capital to tier 2 capital.

Perpetual Preferred Stock

The risk-based capital guidelines define perpetual preferred stock as preferred stock that has no maturity date, cannot be redeemed at the option of the holder, and has no other provisions that will require future redemption of the issue. Perpetual preferred stock qualifies for inclusion in capital only if it can absorb losses while the issuer operates as a going concern and only if the issuer has the ability and legal right to defer or eliminate preferred dividends.

Perpetual preferred stock with a feature permitting redemption at the option of the issuer may qualify for tier 1 or unlimited tier 2 capital only if the redemption is subject to prior approval of the Federal Reserve. An issue that is convertible at the option of the issuer into another issue of perpetual preferred stock or a lower form of capital, such as subordinated debt, is considered to be redeemable at the option of the issuer. Accordingly, such a conversion must be subject to prior Federal Reserve approval.

Banks may include perpetual preferred stock in tier 1 capital only if the stock is noncumulative. A noncumulative issue may not permit the accruing or payment of unpaid dividends in any form, including the form of dividends payable in common stock. Perpetual preferred stock that calls for the accumulation and future payment of unpaid dividends is deemed to be cumulative, regardless of whether it is called noncumulative, and it is generally includable in tier 2 capital.

Perpetual preferred stock (including auction-rate preferred) in which the dividend rate is reset periodically based, in whole or in part, upon the bank's financial condition or credit standing is excluded from tier 1 capital, but may generally be included in tier 2 capital. The obligation under such instruments to pay out higher dividends when a bank's condition deteriorates is inconsistent with the essential precept that capital should provide both strength and loss-absorption capacity to a bank during periods of adversity.

Ordinarily, fixed-rate preferred stock and traditional floating- or adjustable-rate preferred stock—in which the dividend rate adjusts in relation to an independent index based solely on general market interest rates and is in no way tied to the issuer's financial condition—do not raise significant supervisory concerns, especially when the adjustable-rate instrument is accompanied by reasonable spreads and cap rates. Such instruments may generally be included in tier 1 capital, provided they are noncumulative.

Some preferred-stock issues incorporate certain features that raise serious questions about whether these issues will truly serve as a permanent, or even long-term, source of capital. Such features include so-called ''exploding-rate'' or similar mechanisms, in which, after a specified period, the dividend rate automatically increases to a level that could create an incentive for the issuer to redeem the instrument. Perpetual preferred stock with this type of feature could cause the issuing bank to be faced with the higher dividend requirements at a future date when the bank may be experiencing financial difficulties; it is generally not includable in tier 1 capital.

Traditional convertible perpetual preferred stock, which the holder can convert into a fixed number of common shares at a preset price, ordinarily does not raise supervisory concerns and generally qualifies as tier 1 capital, provided the stock is noncumulative. However, forms of preferred stock that the holder must or can convert into common stock at the market price prevailing at the time of conversion do raise supervisory concerns. Such preferred stock may be converted into an increasing number of common shares as the bank's condition deteriorates, and as the market price of the common stock falls. The potential conversion of such preferred stock into common stock could pose a threat of dilution to the existing common shareholders. The threat of dilution could make the issuer reluctant to sell new common stock, or it could place the issuer under strong market pressure to redeem or repurchase the convertible preferred stock. Such convertible preferred stock should generally be excluded from tier 1 capital.

Perpetual preferred stock issues may include other provisions or pricing mechanisms that would provide significant incentives or pressures for the issuer to redeem the stock for cash, especially at a time when the issuer is in a weakened financial condition. As a general matter, an issue that contains such features would be ineligible for tier 1 treatment.

While no formal limit is placed on the amount of noncumulative perpetual preferred stock that may be included in tier 1 capital, the guidelines state that banks should avoid overreliance on preferred stock and other nonvoting equity elements in tier 1 capital. A bank that includes in tier 1 capital perpetual preferred stock in an amount in excess of its voting common stock is clearly overrelying on perpetual preferred stock in tier 1 capital. In such cases, it may be appropriate to reallocate the excess amount of perpetual preferred stock from tier 1 capital to tier 2 capital.

Forward Equity Transactions

Banking organizations have engaged in various types of forward transactions involving the repurchase of their common stock. In these transactions, the banking organization enters into an arrangement with a counterparty, usually an investment bank or another commercial bank, under which the counterparty purchases common shares of the banking organization, either in the open market or directly from the institution. The banking organization agrees that it will repurchase those shares at an agreed-on forward price at a later date (typically three years or less from the execution date of the agreement). These transactions are used to "lock in" stock repurchases at price levels that are perceived to be advantageous, and they are a means of managing regulatory capital ratios.

Some banking organizations have treated shares under forward equity arrangements as tier 1 capital. However, because these transactions can impair the permanence of the shares and typically have certain features that are undesirable from a supervisory point of view, shares covered by these arrangements have qualities that are inconsistent with tier 1 capital status. Accordingly, any common stock covered by forward equity transactions entered into after the issuance of SR-01-27 (November 9, 2001), other than those specified for deferred compensation or other employee benefit plans, will be excluded from the tier 1 capital of a state member bank, even if executed under a currently existing master agreement. The amount to be excluded is equal to the common stock, surplus, and retained earnings associated with the shares. This guidance does not apply to shares covered under traditional stock buyback programs that do not involve forward agreements.

Minority Interest in Equity Accounts of Consolidated Subsidiaries

Minority interest in equity accounts of consolidated subsidiaries is included in tier 1 capital because, as a general rule, it represents equity that is freely available to absorb losses in operating subsidiaries. Banks are expected to avoid using minority interest as an avenue for introducing elements that do not otherwise qualify as tier 1 capital (such as cumulative or auction-rate perpetual preferred stock) or that would, in effect, result in an excessive reliance on preferred stock within tier 1 capital. If a bank uses minority interest in these ways, supervisory concerns may warrant reallocating some of the bank's minority interest in equity accounts of consolidated subsidiaries from tier 1 to tier 2 capital.

Whenever a bank has included perpetual preferred stock of an operating subsidiary in minority interest, a possibility exists that such capital has been issued in excess of the subsidiary's needs, for the purpose of raising cheaper capital for the bank. Stock issued under these circumstances may, in substance if not in legal form, be secured by the subsidiary's assets. If the subsidiary fails, the outside preferred investors would have a claim on the subsidiary's assets that is senior to the claim that the bank, as a common shareholder, has on those assets. Therefore, as a general matter, issuances in excess of a subsidiary's needs do not qualify for inclusion in capital. The possibility that a secured arrangement exists should be considered if the subsidiary on-lends significant amounts of funds to the parent bank, is unusually well capitalized, has cash flow in excess of its operating needs, holds a significant amount of assets with minimal credit risk (for example, U.S. Treasury securities) that are not consistent with its operations, or has issued preferred stock at a significantly lower rate than the parent could obtain for a direct issue.

Some banks may use a nonoperating subsidiary or special-purpose entity (SPE) to issue perpetual preferred stock to outside investors. Such a subsidiary may be set up offshore so a bank can receive favorable tax treatment for the dividends paid on the stock. In such arrangements, a strong presumption exists that the stock is, in effect, secured by the assets of the subsidiary. It has been agreed internationally that a bank may not include in its tier 1 capital minority interest in the perpetual preferred stock of nonoperating subsidiaries. Furthermore, such minority interest may not be included in tier 2 capital unless a bank can conclusively prove that the stock is unsecured. Even if the bank's accountants have permitted the bank to account for perpetual preferred stock issued through an SPE as stock of the bank, rather than as minority interest in the equity accounts of a consolidated subsidiary, the stock may not be included in tier 1 capital and most likely is not includable in tier 2 capital.

Banks may also use operating or nonoperating subsidiaries to issue subordinated debt. As with perpetual preferred stock issued through such subsidiaries, a possibility exists that such debt is in effect secured and therefore not includable in capital.

Minority Interests in Small Business Investment Companies

Minority interests in small business investment companies (SBICs), investment funds that hold nonfinancial equity investments, and subsidiaries engaged in nonfinancial activities are not included in a bank's tier 1 or total capital base if the bank's interest in the company or fund is held under the legal authorities listed in section II.B.5.b. of the capital guidelines (12 CFR 208, appendix A).

Allowance for Loan and Lease Losses

The allowance for loan and lease losses is a reserve that has been established through a charge against earnings to absorb anticipated, but not yet identified, losses on loans or lease-financing receivables. The allowance excludes allocated transfer-risk reserves and reserves created against identified losses. Neither of these two types of reserves is includable in capital. The amount of the allowance for loan and lease losses that is includable in tier 2 capital is limited to 1.25 percent of risk-weighted assets.

Net Unrealized Holding Gains (Losses) on Securities Available for Sale

The Financial Accounting Standards Board's Statement No. 115 (FAS 115), "Accounting for Certain Investments in Debt and Equity Securities," created a new common stockholders' equity account known as "net unrealized holding gains (losses) on securities available for sale." Although this equity account is considered to be part of a bank's GAAP equity capital, this account should not be included in a bank's regulatory capital calculations. There are exceptions, however, to this rule. A bank that legally holds equity securities in its available-for-sale portfolio[8] may include up to 45 percent of the

8. Although banks are generally not allowed to hold equity securities except in lieu of debts previously contracted and certain mutual fund holdings, some banks have grandfathered holdings of equity securities in accordance with provisions in the National Bank Act passed in the 1930s.

pretax net unrealized holding gains on those securities in tier 2 capital. These equity securities must be valued in accordance with generally accepted accounting principles and have readily determinable fair values. Unrealized holding gains may not be included in tier 2 capital if the Federal Reserve determines that the equity securities were not prudently valued. Moreover, if a bank experiences unrealized holding losses in its available-for-sale equity portfolio, these losses must be deducted from tier 1 capital.

Mandatory Convertible Debt Securities

Mandatory convertible debt securities are essentially subordinated-debt securities that receive special capital treatment because a bank has committed to repay the principal from proceeds obtained through the issuance of equity. Banks may include such securities (net of any stock issued that has been dedicated to their retirement) in the form of equity contract notes or equity commitment notes[9] issued before May 15, 1985, as unlimited elements of tier 2 capital, provided that the criteria set forth in 12 CFR 225, appendix B, are met. Consistent with these criteria, mandatory convertible notes are subject to a maximum maturity of 12 years, and a bank must receive Federal Reserve approval before redeeming (or repurchasing) such securities before maturity. The terms of the securities should note that such approval is required.

If a bank has issued common or perpetual preferred stock and dedicated the proceeds to the retirement or redemption of mandatory convertibles,[10] the portion of mandatory convertibles covered by the dedication no longer carries a commitment to issue equity and is effectively rendered into ordinary subordinated debt. Accordingly, the amount of the stock dedicated is netted from the amount of mandatory convertibles includable as unlimited tier 2 capital. The portion of such securities covered by dedications should be included in capital as subordinated debt, subject to amortization in the last five years of its life and limited, together with other subordinated debt and intermediate-term preferred stock, to 50 percent of tier 1 capital. For example, a bank has an outstanding equity contract note for $1 million and issues $300,000 of common stock, dedicating the proceeds to the retirement of the note. The bank would include the $300,000 of common stock in its tier 1 capital. The $700,000 of the equity contract note not covered by the dedication would be treated as an unlimited element of the bank's tier 2 capital. The $300,000 of the note covered by the dedication would be treated as subordinated debt.

In some cases, the indenture of a mandatory convertible debt issue may require the bank to set up segregated trust funds to hold the proceeds from the sale of equity securities dedicated to pay off the principal of the mandatory convertibles at maturity. The portion of mandatory convertible securities covered by the amount of such segregated trust funds is considered secured and may therefore not be included in capital. The maintenance of such a separate segregated fund for the redemption of mandatory convertibles exceeds the requirements of 12 CFR 225, appendix B. Accordingly, if a bank, with the agreement of the debtholders, seeks regulatory approval to eliminate the fund, the approval normally should be given unless supervisory concerns warrant otherwise.

Subordinated Debt and Intermediate-Term Preferred Stock

To qualify as supplementary capital, subordinated debt and intermediate-term preferred stock must have an original average maturity of at least five years. The average maturity of an obligation whose principal is repayable in scheduled periodic payments (for example, a so-called ''serial-redemption issue'') is the weighted average of the maturities of all such scheduled repayments. If the holder has the option to require the issuer to redeem, repay, or repurchase the instrument before the original stated maturity, maturity is defined as the earliest possible date on which the holder can put the instrument back to the issuing bank. This date may be much earlier than the instrument's stated maturity date. In the last five years before the

9. Equity contract notes are debt securities that obligate the holder to take common or perpetual preferred stock for repayment of principal. Equity commitment notes are redeemable only with the proceeds from the sale of common or perpetual preferred stock.

10. Such a dedication generally must be made in the quarter in which the new common or perpetual preferred stock is issued. There are no restrictions on the actual use of the proceeds of dedicated stock. For example, stock issued under dividend-reinvestment plans or issued to finance acquisitions may be dedicated to the retirement of mandatory convertible debt securities.

maturity of a limited-life instrument, the outstanding amount includable in tier 2 capital must be discounted by 20 percent a year. The aggregate amount of subordinated debt and intermediate-term preferred stock that may be included in tier 2 capital is limited to 50 percent of tier 1 capital.

Consistent with longstanding Federal Reserve policy, a bank may not repay, redeem, or repurchase a subordinated debt issue without the prior written approval of the Federal Reserve. The terms of the debt indenture should note that such approval is required. The Federal Reserve requires this approval to prevent a deteriorating institution from redeeming capital at a time when it needs to conserve its resources and to ensure that subordinated debtholders in a failing bank are not paid before depositors.

Close scrutiny should be given to terms that permit the holder to accelerate payment of principal upon the occurrence of certain events. The only acceleration clauses acceptable in a subordinated-debt issue included in tier 2 capital are those that are triggered by the issuer's insolvency, that is, the appointment of a receiver. Terms that permit the holder to accelerate payment of principal upon the occurrence of other events jeopardize the subordination of the debt since such terms could permit debtholders in a troubled institution to be paid out before the depositors. In addition, debt whose terms permit holders to accelerate payment of principal upon the occurrence of events other than insolvency does not meet the minimum five-year maturity requirement for debt capital instruments. Holders of such debt have the right to put the debt back to the issuer upon the occurrence of the named events, which could happen on a date well in advance of the debt's stated maturity.

Close scrutiny should also be given to the terms of those debt issues in which an event of default is defined more broadly than insolvency or a failure to pay interest or principal when due. There is a strong possibility that such terms are inconsistent with safe and sound banking practice, so the debt issue should not be included in capital. Concern is heightened where an event of default gives the holder the right to accelerate payment of principal or where other borrowings exist that contain cross-default clauses. Some events of default, such as issuing jumbo certificates of deposit or making additional borrowings in excess of a certain amount, may unduly restrict the day-to-day operations of the bank. Other events of default, such as change of control of the bank or disposal of a bank subsidiary, may limit the flexibility of management or banking supervisors to work out the problems of a troubled bank. Still other events of default, such as failure to maintain certain capital ratios or rates of return or to limit the amount of nonperforming assets or charge-offs to a certain level, may be intended to allow the debtholder to be made whole before a deteriorating institution becomes truly troubled. Debt issues that include any of these types of events of default are not truly subordinated and should not be included in capital. Likewise, banks should not include debt issues in capital that otherwise contain terms or covenants that could adversely affect the liquidity of the issuer; unduly restrict management's flexibility to run the organization, particularly in times of financial difficulty; or limit the regulator's ability to resolve problem-bank situations.

Debt issues, including mandatory convertible securities, in which interest payments are tied to the financial condition of the borrower should generally not be included in capital. The interest payments may be linked to the financial condition of an institution through various ways, such as (1) an auction-rate mechanism; (2) a preset schedule mandating interest-rate increases, either as the credit rating of the bank declines or over the passage of time;[11] or (3) a term that raises the interest rate if payment is not made in a timely fashion. These debt issues raise concerns because as the financial condition of a bank declines, it faces ever-increasing payments on its credit-sensitive subordinated debt at a time when it most needs to conserve its resources. Thus, credit-sensitive debt does not provide the support expected of a capital instrument to an institution whose financial condition is deteriorating; rather, the credit-sensitive feature can accelerate depletion of the institution's resources and increase the likelihood of default

11. Although payment on debt whose interest rate increases over time may not on the surface appear to be directly linked to the financial condition of the issuing bank, such debt (sometimes referred to as expanding- or exploding-rate debt) has a strong potential to be credit-sensitive in substance. Banks whose financial condition has strengthened are more likely to be able to refinance the debt at a lower rate than that mandated by the preset increase, whereas banks whose condition has deteriorated are less likely to do so. Moreover, just when these latter institutions would be in the most need of conserving capital, they would be under strong pressure to redeem the debt as an alternative to paying higher rates and would therefore accelerate the depletion of their resources.

on the debt. While such terms may be acceptable in perpetual preferred stock qualifying for tier 2 capital, they are not acceptable in a capital debt issue because a bank in a deteriorating financial condition does not have the option available in equity issues of eliminating the higher payments without going into default.

When a bank has included subordinated debt issued by an operating or nonoperating subsidiary in its capital, a possibility exists that the debt is in effect secured, and thus not includable in capital. Further details on arrangements regarding a bank's issuance of capital instruments through subsidiaries are discussed in an earlier subsection, "Minority Interest in Equity Accounts of Consolidated Subsidiaries."

Capital Adjustments

Intangible Assets

Goodwill and other intangible assets. Certain intangible assets are deducted from a bank's capital for the purpose of calculating the risk-based capital ratio.[12] Those assets include goodwill and certain other identifiable assets. These assets are deducted from the sum of the core capital components (tier 1 capital).

The only identifiable intangible assets that are eligible to be included in—that is, not deducted from—a bank's capital are marketable mortgage-servicing assets (MSAs), nonmortgage-servicing assets (NMSAs), and purchased credit-card relationships (PCCRs).[13] The total amount of MSAs and PCCRs that may be included in a bank's capital, in the aggregate, cannot exceed 100 percent of tier 1 capital. The total amount of NMSAs and PCCRs is subject to a separate aggregate sublimit of 25 percent of tier 1 capital. In addition, the total amount of credit-enhancing interest-only strips (I/Os) (both purchased and retained) that may be included in capital cannot exceed 25 percent of tier 1 capital. Amounts of servicing assets, PCCRs, and credit-enhancing I/Os (both retained and purchased) in excess of these limitations, as well as all other identifiable intangible assets, including core deposit intangibles and favorable leaseholds, are to be deducted from a bank's core capital elements in determining tier 1 capital. However, identifiable intangible assets (other than MSAs and PCCRs) acquired on or before February 19, 1992, generally will not be deducted from capital for supervisory purposes, although they will continue to be deducted for applications purposes.

For purposes of calculating the limitations on MSAs, NMSAs, PCCRs, and credit-enhancing I/Os, tier 1 capital is defined as the sum of core capital elements, net of goodwill and net of all identifiable intangible assets other than MSAs, NMSAs, and PCCRs. This calculation of tier 1 is before the deduction of any disallowed MSAs, any disallowed NMSAs, any disallowed PCCRs, any disallowed credit-enhancing I/Os (both purchased and retained), any disallowed deferred tax assets, and any nonfinancial equity investments.

Banks may elect to deduct disallowed servicing assets and disallowed credit-enhancing I/Os (both purchased and retained) on a basis that is net of any associated deferred tax liability. Deferred tax liabilities netted in this manner cannot also be netted against deferred tax assets when determining the amount of deferred tax assets that are dependent on future taxable income.

Banks must review the book value of all intangible assets at least quarterly and make adjustments to these values as necessary. The fair value of MSAs, NMSAs, and PCCRs must also be determined at least quarterly. This determination of fair value should include adjustments for any significant changes in original valuation assumptions, including changes in prepayment estimates or account-attrition rates. Examiners should review both the book value and fair value assigned to these assets, as well as supporting documentation. The Federal Reserve may require, on a case-by-case basis, an independent valuation of a bank's intangible assets.

Value limitation. The amount of eligible servicing assets and PCCRs that a bank may include in capital is further limited to the lesser of 90 percent of their fair value, or 100 percent of their

12. Negative goodwill is a liability and is therefore not taken into account in the risk-based capital framework. Accordingly, a bank may not offset goodwill to reduce the amount of goodwill it must deduct from tier 1 capital.

13. Purchased mortgage-servicing rights (PMSRs) no longer exist under the most recent accounting rules that apply to servicing of assets. Under these rules (Financial Accounting Standards Board statements No. 122, "Accounting for Mortgage Servicing Rights," and No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities"), organizations are required to recognize separate servicing assets (or liabilities) for the contractual obligation to service financial assets that entities have either sold or securitized with servicing retained.

book value, as adjusted for capital purposes in accordance with the instructions in the commercial bank Consolidated Report of Condition and Income (call report). The amount of I/Os that a bank may include in capital shall be its fair value. If both the application of the limits on MSAs, NMSAs, and PCCRs and the adjustment of the balance-sheet amount for these assets would result in an amount being deducted from capital, the bank would deduct only the greater of the two amounts from its core capital elements in determining tier 1 capital.

Consistent with longstanding Federal Reserve policy, banks experiencing substantial growth, whether internally or by acquisition, are expected to maintain strong capital positions substantially above minimum supervisory levels, without significant reliance on intangible assets or credit-enhancing I/Os.

An arrangement whereby a bank enters into a licensing or leasing agreement or similar transaction to avoid booking an intangible asset should be subject to particularly close scrutiny. Normally, such arrangements will be dealt with by adjusting the bank's capital calculation appropriately. In making an overall assessment of a bank's capital adequacy for applications purposes, the institution's quality and composition of capital are considered together with its holdings of tangible and intangible assets.

Credit-enhancing interest-only strips receivables (I/Os). Credit-enhancing I/Os are on-balance-sheet assets that, in form or substance, represent the contractual right to receive some or all of the interest due on transferred assets. I/Os expose the bank to credit risk directly or indirectly associated with transferred assets that exceeds a pro rata share of the bank's claim on the assets, whether through subordination provisions or other credit-enhancement techniques. Such I/Os, whether purchased or retained and including other similar ''spread'' assets, may be included in, that is, not deducted from, a bank's capital subject to the fair value and tier 1 limitations. (See sections II.B.1.d. and e. of the capital guidelines (12 CFR 208, appendix A).)

Both purchased and retained credit-enhancing I/Os, on a non-tax-adjusted-basis, are included in the total amount that is used for purposes of determining whether a bank exceeds the tier 1 limitation. In determining whether an I/O or other types of spread assets serve as a credit enhancement, the Federal Reserve will look to the economic substance of the transaction.

Disallowed Deferred Tax Assets

In response to the Financial Accounting Standards Board's Statement No. 109 (FAS109), ''Accounting for Income Taxes,'' the Federal Reserve adopted a limit on the amount of certain deferred tax assets that may be included in (that is, not deducted from) tier 1 capital for risk-based and leverage capital purposes. Under the rule, certain deferred tax assets can only be realized if an institution earns taxable income in the future. Those deferred tax assets are limited, for regulatory capital purposes, to the amount that the institution expects to realize within one year of the quarter-end report date (based on its projections of future taxable income for that year) or to 10 percent of tier 1 capital, whichever is less.

The reported amount of deferred tax assets, net of any valuation allowance for deferred tax assets, in excess of the lesser of these two amounts is to be deducted from a bank's core capital elements in determining tier 1 capital. For purposes of calculating the 10 percent limitation, tier 1 capital is defined as the sum of core capital elements, net of goodwill and net of all identifiable intangible assets other than MSAs, NMSAs, and PCCRs, but before the deduction of any disallowed MSAs, any disallowed NMSAs, any disallowed PCCRs, any disallowed credit-enhancing I/Os, any disallowed deferred tax assets, and any nonfinancial equity investments.

To determine the amount of expected deferred tax assets realizable in the next 12 months, a bank should assume that all existing temporary differences fully reverse as of the report date. Projected future taxable income should not include net operating-loss carry-forwards to be used during that year or the amount of existing temporary differences a bank expects to reverse within the year. Such projections should include the estimated effect of tax-planning strategies that the organization expects to implement to realize net operating losses or tax-credit carry-forwards that would otherwise expire during the year. A new 12-month projection does not have to be prepared each quarter. Rather, on interim report dates, the future-taxable-income projections may be used for their current fiscal year, adjusted for any significant changes that have occurred or are expected to occur.

Deferred tax assets that can be realized from taxes paid in prior carry-back years or from future reversals of temporary differences are generally not limited. For banks that have a parent, however, this amount may *not* exceed the amount the bank could reasonably expect its parent to refund. The disallowed deferred tax assets are subtracted from tier 1 capital and also from risk-weighted assets.

Nonfinancial Equity Investments

In general, a bank must deduct from its core capital elements the sum of the appropriate percentages (as determined below) of the adjusted carrying value of all nonfinancial equity investments held by it or its direct or indirect subsidiaries. An equity investment includes the purchase, acquisition, or retention of any equity instrument (including common stock, preferred stock, partnership interests, interests in limited-liability companies, trust certificates, and warrants and call options that give the holder the right to purchase an equity instrument), any equity feature of a debt instrument (such as a warrant or call option), and any debt instrument that is convertible into equity.[14] The Federal Reserve may treat any other instrument (including subordinated debt) as an equity investment if, in its judgment, the instrument is the functional equivalent of equity or exposes the state member bank to essentially the same risks as an equity instrument.

A nonfinancial equity investment, subject to the risk-based capital rule (the rule), is an equity investment in a nonfinancial company made under the following authorities:

- the authority to invest in SBICs under section 302(b) of the Small Business Investment Act of 1958 (15 USC 682(b))
- the portfolio investment provisions of Regulation K (12 CFR 211.8(c)(3)), including the authority to make portfolio investments through Edge and agreement corporations

A nonfinancial company is an entity that engages in any activity that has not been determined to be permissible for the bank to conduct directly, or to be financial in nature or incidental to financial activities under section 4(k) of the Bank Holding Company Act (12 USC 1843(k)). The rule does not apply to investments made in companies that engage solely in banking and financial activities, nor does it apply to investments made by a state bank under the authority in section 24(f) of the Federal Deposit Insurance Act (FDI Act). The higher capital charges also do not apply to equity securities acquired and held by a bank as a bona fide hedge of an equity derivatives transaction it entered into lawfully, or to equity securities that are acquired in satisfaction of a debt previously contracted and that are held and divested in accordance with applicable law. The adjusted carrying value of these investments is not included in determining the total amount of nonfinancial equity investments held by the bank. (See SR-02-4 for a general discussion of the risk-based and leverage capital rule changes.)

The bank must deduct from its core capital elements the sum of the appropriate percentages, as stated in table 1, of the adjusted carrying value of all nonfinancial equity investments held by the bank or its direct or indirect subsidiaries. The amount of the percentage deduction increases as the aggregate amount of nonfinancial equity investments held by the bank increases as a percentage of its tier 1 capital.

The ‘‘adjusted carrying value’’ of investments is the aggregate value at which the investments are carried on the balance sheet of the bank, reduced by (1) any unrealized gains on those investments that are reflected in such carrying value but excluded from the bank's tier 1 capital and (2) associated deferred tax liabilities. For example, for investments held as available-for-sale (AFS), the adjusted carrying value of the investments would be the aggregate carrying value of the investments (as reflected on the consolidated balance sheet of the bank) *less* any unrealized gains on those investments that are included in other comprehensive income and not reflected in tier 1 capital, and associated deferred tax liabilities.[15] The total adjusted carrying value of any nonfinancial equity investment that is subject to deduction is excluded from the bank's risk-weighted assets and for purposes of computing the denominator of the bank's risk-based capital ratio.[16] The total adjusted carrying

14. This requirement generally does not apply to investments in nonconvertible senior or subordinated debt.

15. Unrealized gains on AFS equity investments may be included in supplementary capital to the extent permitted by the capital guidelines. In addition, the unrealized losses on AFS equity investments are deducted from tier 1 capital.

16. For example, if 8 percent of the adjusted carrying value of a nonfinancial equity investment is deducted from tier 1 capital, the entire adjusted carrying value of the investment will be excluded from risk-weighted assets when calculating the denominator for the risk-based capital ratio, and from average total consolidated assets when computing the leverage ratio.

Table 1—Deduction for Nonfinancial Equity Investments

Aggregate adjusted carrying value of all nonfinancial equity investments held directly or indirectly by the bank (as a percentage of the tier 1 capital of the bank)[1]	*Deduction from core capital elements (as a percentage of the adjusted carrying value of the investment)*
Less than 15 percent	8 percent
15 percent to 24.99 percent	12 percent
25 percent and above	25 percent

1. For purposes of calculating the adjusted carrying value of nonfinancial equity investments as a percentage of tier 1 capital, tier 1 capital is defined as the sum of core capital elements net of goodwill and net of all identifiable intangible assets other than MSAs, NMSAs, and PCCRs, but before the deduction for any disallowed MSAs, any disallowed NMSAs, any disallowed PCCRs, any disallowed credit enhancing I/Os (both purchased and retained), any disallowed deferred tax assets, and any nonfinancial equity investments.

value is also deducted from average total consolidated assets when computing the leverage ratio.

The deductions are applied on a marginal basis to the portions of the adjusted carrying value of nonfinancial equity investments that fall within the specified ranges of the parent bank's tier 1 capital. The rule sets forth a ''stair-step'' approach under which each tier of capital charges applies, on a marginal basis, to the adjusted carrying value of the bank's aggregate nonfinancial equity investment portfolio that falls within the specified ratios of the organization's tier 1 capital. The stair-step approach reflects the fact that the financial risks to a bank from equity investment activities increase as the level of these activities accounts for a larger portion of the bank's capital, earnings, and activities. For example, if the adjusted carrying value of all nonfinancial equity investments held by a bank equals 20 percent of its tier 1 capital, then the amount of the deduction would be 8 percent of the adjusted carrying value of all investments up to 15 percent of the bank's tier 1 capital, and 12 percent of the adjusted carrying value of all investments in excess of 15 percent of the bank's tier 1 capital.

With respect to consolidated SBICs, some equity investments may be in companies that are consolidated for accounting purposes. For investments in a nonfinancial company that is consolidated for accounting purposes under GAAP, the bank's adjusted carrying value of the investment is determined under the equity method of accounting (net of any intangibles associated with the investment that are deducted from the bank's core). Even though the assets of the nonfinancial company are consolidated for accounting purposes, these assets (as well as the credit-equivalent amounts of the company's off-balance-sheet items) should be excluded from the bank's risk-weighted assets for regulatory capital purposes.

The capital adequacy guidelines for state member banks establish *minimum* risk-based capital ratios. Banks are at all times expected to maintain capital commensurate with the level and nature of the risks to which they are exposed. The risk to a bank from nonfinancial equity investments increases with its concentration in such investments, and strong capital levels above the minimum requirements are particularly important when a bank has a high degree of concentration in nonfinancial equity investments (for example, in excess of 50 percent of tier 1 capital).

The Federal Reserve will monitor banks and apply heightened supervision, as appropriate, to equity investment activities, including where the bank has a high degree of concentration in nonfinancial equity investments, to ensure that each bank maintains capital levels that are appropriate in light of its equity investment activities. In addition, the Federal Reserve may impose capital levels established by the capital adequacy rules, in light of the nature or performance of a particular organization's equity investments or the sufficiency of the organization's policies, procedures, and systems to monitor and control the risks associated with its equity investments.

SBIC investments. Investments may be made by banks in or through SBICs under section 4(c)(5) of the BHC Act and section 302(b) of the Small Business Investment Act. No deduction is required for nonfinancial equity investments that are held by a bank (1) through one or more SBICs that are consolidated with the bank or (2) in one or more SBICs that are not consolidated with the bank, to the extent that all such investments, in the aggregate, do not exceed 15 percent of the bank's tier 1 capital. Any nonfinancial equity investment that is held through or in an SBIC and that is not required to be deducted from tier 1 capital will be assigned a 100 percent risk weight and included in the bank's consolidated risk-weighted assets.[17]

To the extent the adjusted carrying value of all nonfinancial equity investments that a bank holds through one or more SBICs that are consolidated with the bank, or in one or more SBICs that are not consolidated with the bank, exceeds, in the aggregate, 15 percent of the bank's tier 1 capital, the appropriate percentage of such amounts (as set forth in table 1) must be deducted from the bank's core capital elements. In addition, the aggregate adjusted carrying value of *all* nonfinancial equity investments held through a consolidated SBIC and in a nonconsolidated SBIC (including any investments for which no deduction is required) must be included in determining, for purposes of table 1, the total amount of nonfinancial equity investments held by the bank in relation to its tier 1 capital.

Grandfather provisions. No deduction is required to be made for the adjusted carrying value of any nonfinancial equity investment (or portion of such an investment) that the bank made before March 13, 2000, or that the bank made on or after this date pursuant to a binding written commitment[18] entered into before March 13, 2000, provided that in either case the bank has continuously held the investment since the relevant investment date.[19] A nonfinancial equity investment made before March 13, 2000, includes any shares or other interests the bank received through a stock split or stock dividend on an investment made before March 13, 2000, provided the bank provides no consideration for the shares or interests received and the transaction does not materially increase the bank's proportional interest in the company. The exercise on or after March 13, 2000, of options or warrants acquired before March 13, 2000, is *not* considered to be an investment made before March 13, 2000, if the bank provides any consideration for the shares or interests received upon exercise of the options or warrants. Any nonfinancial equity investment (or portion thereof) that is not required to be deducted from tier 1 capital must be included in determining the total amount of nonfinancial equity investments held by the bank in relation to its tier 1 capital for purposes of table 1. In addition, any nonfinancial equity investment (or portion thereof) that is not required to be deducted from tier 1 capital will be assigned a 100 percent risk weight and included in the bank's consolidated

17. If a bank has an investment in an SBIC that is consolidated for accounting purposes but that is not wholly owned by the bank, the adjusted carrying value of the bank's nonfinancial equity investments through the SBIC is equal to the bank's proportionate share of the adjusted carrying value of the SBIC's equity investments in nonfinancial companies. The remainder of the SBIC's adjusted carrying value (that is, the minority interest holders' proportionate share) is excluded from the risk-weighted assets of the bank. If a bank has an investment in an SBIC that is not consolidated for accounting purposes, and the bank has current information that identifies the percentage of the SBIC's assets that are equity investments in nonfinancial companies, the bank may reduce the adjusted carrying value of its investment in the SBIC proportionately to reflect the percentage of the adjusted carrying value of the SBIC's assets that are not equity investments in nonfinancial companies. If a bank reduces the adjusted carrying value of its investment in a nonconsolidated SBIC to reflect financial investments of the SBIC, the amount of the adjustment will be risk-weighted at 100 percent and included in the bank's risk-weighted assets.

18. A ''binding written commitment'' means a legally binding written agreement that requires the bank to acquire shares or other equity of the company, or make a capital contribution to the company, under terms and conditions set forth in the agreement. Options, warrants, and other agreements that give a bank the right to acquire equity or make an investment, but do not require the bank to take such actions, are not considered a binding written commitment for purposes of this provision.

19. For example, if a bank made an equity investment in 100 shares of a nonfinancial company before March 13, 2000, the adjusted carrying value of that investment would not be subject to a deduction. However, if the bank made any additional equity investment in the company after March 13, 2000, such as by purchasing additional shares of the company (including through the exercise of options or warrants acquired before or after March 13, 2000) or by making a capital contribution to the company, and such investment was not made pursuant to a binding written commitment entered into before March 13, 2000, the adjusted carrying value of the additional investment would be subject to a deduction. In addition, if the bank sold and repurchased, after March 13, 2000, 40 shares of the company, the adjusted carrying value of those 40 shares would be subject to a deduction under this provision.

risk-weighted assets. The following example illustrates these calculations.

A bank has $1 million in tier 1 capital and has nonfinancial equity investments with an aggregate adjusted carrying value of $375,000. Of this amount, $100,000 represents the adjusted carrying value of investments made before March 13, 2000, and an additional $175,000 represents the adjusted carrying value of investments made through the bank's wholly owned SBIC. The $100,000 in investments made before March 13, 2000, and $150,000 of the bank's SBIC investments would not be subject to the rule's marginal capital charges. These amounts are considered for purposes of determining the marginal charge that applies to the bank's covered investments (including the $25,000 of nonexempt SBIC investments). In this case, the total amount of the bank's tier 1 capital deduction would be $31,250. This figure is 25 percent of $125,000, which is the amount of the bank's total nonfinancial equity portfolio subject to the rule's marginal capital charges. The average tier 1 capital charge on the bank's entire nonfinancial equity portfolio would be 8.33 percent.

Investments in Unconsolidated Banking and Finance Subsidiaries and Other Subsidiaries

Generally, debt and equity capital investments and any other instruments deemed to be capital in unconsolidated banking and finance subsidiaries[20] are to be deducted from the consolidated capital of the parent bank, regardless of whether the investment is made by the parent bank or its direct or indirect subsidiaries.[21] Fifty percent of the investment is to be deducted from tier 1 capital and 50 percent from tier 2 capital. When tier 2 capital is not sufficient to absorb the portion (50 percent) of the investment allocated to it, the remainder (up to 100 percent) is to be deducted from tier 1 capital.

Advances to banking and finance subsidiaries (that is, loans, extensions of credit, guarantees, commitments, or any other credit exposures) not considered as capital are included in risk-weighted assets at the 100 percent risk weight (unless recognized collateral or guarantees dictate weighting at a lower percentage). However, such advances may be deducted from the parent bank's consolidated capital where examiners find that the risks associated with the advances are similar to the risks associated with capital investments, or if such advances possess risk factors that warrant an adjustment to capital for supervisory purposes. These risk factors could include the absence of collateral support or the clear intention of banks to allow the advances to serve as capital to subsidiaries regardless of form.

Although the Federal Reserve does not automatically deduct investments in other unconsolidated subsidiaries or investments in joint ventures and associated companies,[22] the level and nature of such investments should be closely monitored. Resources invested in these entities support assets that are not consolidated with the rest of the bank and therefore may not be generally available to support additional leverage or absorb losses of affiliated institutions. Close monitoring is also necessary because experience has shown that banks often stand behind the losses of affiliated institutions to protect the reputation of the organization as a whole. In some cases, this support has led to losses that have exceeded the investments in such entities.

Accordingly, for risk-based capital purposes, a bank may be required, on a case-by-case basis, to (1) deduct such investments from total capital; (2) apply an appropriate risk-weighted charge against the bank's pro rata share of the assets of the affiliated entity; (3) consolidate the entity on a line-by-line basis; or (4) operate with a risk-based capital ratio above the minimum. In determining the appropriate capital treatment for such actions, the Federal Reserve will generally take into account whether (1) the bank has significant influence over the financial or managerial policies or operations of the affiliated entity, (2) the bank is the largest investor in the entity, or (3) other circumstances prevail

20. A banking and finance subsidiary is generally defined as any company engaged in banking or finance in which the parent organization holds directly or indirectly more than 50 percent of the outstanding voting stock, or any such company which is otherwise controlled or capable of being controlled by the parent organization.

21. An exception to this deduction is to be made for shares acquired in the regular course of securing or collecting a debt previously contracted in good faith.

22. Such entities are defined in the instructions to the call report. Associated companies and joint ventures are generally defined as companies in which the bank owns 20 to 50 percent of the voting stock.

(such as the existence of significant guarantees from the bank) that appear to closely tie the activities of the affiliated company to the bank.

Reciprocal Holdings of Banking Organizations' Capital Instruments

Reciprocal holdings are intentional cross-holdings resulting from formal or informal arrangements between banking organizations to swap or exchange each other's capital instruments. Such holdings of other banking organizations' capital instruments are to be deducted from the total capital of an organization for the purpose of determining the total risk-based capital ratio. Holdings of other banking organizations' capital instruments taken in satisfaction of debts previously contracted or that constitute stake-out investments that comply with the Federal Reserve's policy statement on non-voting equity investments (12 CFR 225.143) are not deemed to be intentional cross-holdings and are therefore not deducted from a bank's capital.

On-Balance-Sheet Activities

Claims on, and Guaranteed by, OECD Central Governments

The risk-based capital guidelines assign a zero percent risk weight to all direct claims (including securities, loans, and leases) on the central governments of the OECD-based group of countries and U.S. government agencies. Generally, the only direct claims banks have on the U.S. government and its agencies take the form of Treasury securities. Zero-coupon, that is, single-payment, Treasury securities trading under the U.S. Treasury's Separately Traded Registered Interest and Principal (STRIP) program are assigned to the zero percent risk category. A security that has been stripped by a private-sector entity, such as a brokerage firm, is considered an obligation of that entity and is accordingly assigned to the 100 percent risk category.

Claims that are directly and unconditionally guaranteed by an OECD-based central government or a U.S. government agency are also assigned to the zero percent risk category. Claims that are directly but conditionally guaranteed are assigned to the 20 percent risk category. A claim is considered to be conditionally guaranteed by a central government if the validity of the guarantee depends on some affirmative action by the holder or a third party. Generally, securities guaranteed by the U.S. government or its agencies that are actively traded in financial markets are considered to be unconditionally guaranteed. These include Government National Mortgage Association (GNMA or Ginnie Mae) and Small Business Administration (SBA) securities.

A limited number of U.S. government agency–guaranteed loans are deemed to be unconditionally guaranteed and can be assigned to the zero percent risk category. These include most loans guaranteed by the Export-Import Bank (Eximbank),[23] loans guaranteed by the U.S. Agency for International Development (AID) under its Housing Guaranty Loan Program, SBA loans subject to a secondary participation guaranty in accordance with SBA form 1086, and Farmers Home Administration (FmHA) loans subject to an assignment guaranty agreement in accordance with FmHA form 449-36.

Apart from the exceptions noted in the preceding paragraph, loans guaranteed by the U.S. government or its agencies are considered to be conditionally guaranteed. The guaranteed portion of such loans is assigned to the 20 percent risk category. These include, but are not limited to, loans guaranteed by the Commodity Credit Corporation (CCC), the Federal Housing Administration (FHA), the Overseas Private Investment Corporation (OPIC), the Department of Veterans Affairs (VA), and, except as indicated above, the FmHA and SBA. Loan guarantees offered by OPIC often guarantee against political risk. However, only that portion of a loan guaranteed by OPIC against commercial or credit risk may receive a preferential 20 percent risk weight. The portion of government trust certificates issued to provide funds for the refinancing of foreign military sales loans made by the Federal Financing Bank or the Defense Security Assistance Agency that are indirectly guaranteed by the U.S. government also qualify for the 20 percent risk weight.

23. Loans guaranteed under Eximbank's Working Capital Guarantee Program, however, receive a 20 percent risk weight.

Most guaranteed student loans are guaranteed by a state agency or nonprofit organization that does not have the full faith and credit backing of the state. The loans are then indirectly guaranteed or reinsured by the U.S. government's Guaranteed Student Loan Program. Under the program, a minimum percentage of the loan is reinsured, but a higher percentage could be guaranteed if the bank has experienced an overall low default rate on guaranteed student loans. Only the portion of the loan covered by the minimum guarantee under the program may be assigned to the 20 percent risk category; the remainder should be assigned a 100 percent risk weight.

Claims on, or Guaranteed by, a U.S. Government–Sponsored Agency

U.S. government–sponsored agencies are agencies originally established or chartered by the federal government to serve public purposes specified by the U.S. Congress. Such agencies generally carry out functions performed directly by the central government in other countries. The obligations of government-sponsored agencies generally are not explicitly guaranteed by the full faith and credit of the U.S. government. Claims (including securities, loans, and leases) on, or guaranteed by, such agencies are assigned to the 20 percent risk category. U.S. government–sponsored agencies include, but are not limited to, the College Construction Loan Insurance Association, Farm Credit Administration, Federal Agricultural Mortgage Corporation, Federal Home Loan Bank System, Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac), Federal National Mortgage Association (FNMA or Fannie Mae), Financing Corporation (FICO), Postal Service, Resolution Funding Corporation (REFCORP), Student Loan Marketing Association (SLMA or Sallie Mae), Smithsonian Institution, and Tennessee Valley Authority (TVA).

Loans Secured by First Liens on One- to Four-Family Residential Properties and Multifamily Residential Properties

Qualifying loans on one- to four-family residential properties, either owner-occupied or rented (as defined in the instructions to the call report), are accorded a 50 percent risk weight under the guidelines. Also eligible for the 50 percent risk weight are loans to builders with substantial project equity for the construction of one- to four-family residences that have been presold under firm contracts to purchasers who have obtained firm commitments for permanent qualifying mortgage loans and have made substantial earnest-money deposits.

In addition, qualifying multifamily residential loans that meet certain criteria may be assigned to the 50 percent risk category. These criteria are as follows: All principal and interest payments must have been made on time for at least one year preceding placement in the 50 percent risk category, amortization of the principal and interest must occur within 30 years, the minimum original maturity for repayment of principal cannot be less than seven years, and annual net operating income (before debt service) generated by the property during the most recent fiscal year must not be less than 120 percent of the loan's current annual debt service (115 percent if the loan is based on a floating interest rate). In the case of cooperative or other not-for-profit housing projects, the property must generate sufficient cash flow to provide comparable protection to the bank.

To ensure that only qualifying residential mortgage loans are assigned to this preferential risk weight, examiners are to review the one- to four-family and multifamily residential real estate loans that are included in the 50 percent risk category. Such loans are not eligible for preferential treatment unless they meet the following criteria: The loans are made subject to prudent underwriting standards, the loans are performing in accordance with their original terms and are not delinquent for 90 days or more or carried on nonaccrual status, and the loan-to-value ratios are conservative.[24] For the purpose of this last criterion, the loan-to-value ratio should be based on the value of the property determined by the most current appraisal or, if appropriate, the most current evaluation. Normally, this would be the appraisal or evaluation performed at the time the loan was originated.[25]

If a bank has assigned a 50 percent risk weight to residential mortgage loans made for

24. A conservative loan-to-value ratio for loans secured by multifamily residential property must not exceed 80 percent (or 75 percent if the loan is based on a floating interest rate).

25. When both first and junior liens are held by the bank and no intervening liens exist, these transactions are treated as single loans secured by a first lien for the purpose of determining the loan-to-value ratio.

the purpose of speculative real estate development or whose eligibility for such preferential treatment is otherwise questionable, and the amounts of nonqualifying loans are readily identifiable, such loans should be reassigned to the 100 percent risk-weight category. If material evidence exists that a bank has assigned a preferential risk weight to residential mortgage loans of questionable eligibility, but the amount of the inappropriately weighted amount cannot be readily identified, the overall evaluation of the bank's capital adequacy should reflect a higher capital requirement than would otherwise be the case.

Accrued Interest

Banks normally report accrued interest on loans and securities in ''Other Assets'' on the call report. The majority of banks will risk-weight the entire amount of accrued interest at 100 percent. However, for risk-based capital purposes, a bank is permitted to allocate accrued interest among the risk categories associated with the underlying claims, provided it has systems in place to carry out such an allocation accurately.

Off-Balance-Sheet Activities

Off-balance-sheet transactions include recourse obligations, direct-credit substitutes, residual interests, and asset- and mortgage-backed securities. The treatment for direct-credit substitutes, assets transferred with recourse, and securities issued in connection with asset securitizations and structured financings is described below. The terms ''asset securitizations'' or ''securitizations,'' as used in this subsection, include structured financings, as well as asset-securitization transactions.

Assets Sold with Recourse

For risk-based capital adequacy purposes, a bank must hold capital against assets sold with recourse if the bank retains any risk of loss. To qualify as an asset sale with recourse, a transfer of assets must first qualify as a sale according to the GAAP criteria set forth in paragraph 14 of the Financial Accounting Standards Board's Statement No. 140 (FAS 140), ''Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities.'' These criteria are summarized in the definition of ''transfers of financial assets'' in the glossary to the commercial bank call report instructions. If a transfer of assets does not meet these criteria, the assets must remain on the bank's balance sheet and are subject to the standard risk-based capital charge.

If a transfer of assets qualifies as a sale under GAAP, but the bank retains any risk of loss or obligation for payment of principal or interest, then the transfer is considered to be a sale with recourse. A more detailed definition of an asset sale with recourse may be found in the definition of ''sales of assets for risk-based capital purposes'' in the glossary to the commercial bank call report instructions. Although the assets are removed from a bank's balance sheet in an asset sale with recourse, the credit-equivalent amount is assigned to the risk category appropriate to the obligor in the underlying transaction, after considering any associated guaranties or collateral. This assignment also applies when the contractual terms of the recourse agreement limit the seller's risk to a percentage of the value of the assets sold or to a specific dollar amount.

If, however, the risk retained by the seller is limited to some fixed percentage of any losses that might be incurred and there are no other provisions resulting in the direct or indirect retention of risk by the seller, the maximum amount of possible loss for which the selling bank is at risk (the stated percentage times the amount of assets to which the percentage applies) is subject to risk-based capital requirements. The remaining amount of assets transferred would be treated as a sale that is not subject to the risk-based capital requirements. For example, a seller would treat a sale of $1 million in assets with a recourse provision that the seller and buyer proportionately share in losses incurred on a 10 percent and 90 percent basis, respectively, and with no other retention of risk by the seller, as a $100,000 asset sale with recourse and a $900,000 sale not subject to risk-based capital requirements.

There are several exceptions to this general reporting rule for recourse transactions. The first exception applies to recourse transactions for which the amount of recourse the institution is contractually liable for is less than the capital requirement for the assets transferred under the recourse agreement. For such transactions, a bank must hold capital equal to its maximum contractual recourse obligation. For example, assume an institution transfers a $100 pool of commercial loans and retains a recourse obligation of 2 percent. Ordinarily, the bank would be subject to an 8 percent capital charge, or $8. Because the recourse obligation is only 2 percent, however, the bank would be required to hold capital of $2 against the recourse exposure. This capital charge may be reduced further by the balance of any associated noncapital GAAP recourse liability account.

A second exception to the general rule applies to the transfer of small-business loans and the transfer of leases on personal property with recourse. A bank that is considered to be well capitalized according to the Federal Reserve's prompt-corrective-action framework should include in risk-weighted assets only the amount of retained recourse—instead of the entire amount of assets transferred—in connection with a transfer of small-business loans or a transfer of leases on personal property with recourse, provided two conditions are met. First, the transaction must be treated as a sale under GAAP; second, the bank must establish a noncapital reserve that is sufficient to cover the bank's estimated liability under the recourse arrangement. With the Board's approval, this exception may also apply to a bank that is considered to be adequately capitalized under the prompt-corrective-action framework. The total outstanding amount of recourse retained under such transactions may not exceed 15 percent of a bank's total risk-based capital without Board approval.

Definitions

The capital adequacy guidelines provide special treatment for recourse obligations, direct-credit substitutes, residual interests, and asset- and mortgage-backed securities involved in asset-securitization activities. A brief discussion of some of the primary definitions follows.

Recourse. Recourse means an arrangement in which a bank retains, in form or in substance, the credit risk in connection with an asset sale in accordance with GAAP, if the credit risk exceeds a pro rata share of the bank's claim on the assets. The definition of recourse is consistent with the banking agencies' long-standing use of this term, and incorporates existing agency practices regarding retention of risk in asset sales. Second-lien positions do not, in most circumstances, constitute recourse for the bank receiving the third-party enhancement. Second mortgages or home equity loans generally will not be considered recourse arrangements unless they actually function as credit enhancements.

Third-party enhancements (for example, insurance protection) purchased by the originator of a securitization for the benefit of investors also do not generally constitute recourse. The purchase of enhancements for a securitization, when the bank is completely removed from any credit risk, will not, in most instances, constitute recourse. However, if the purchase or premium price is paid over time and the size of the payment is a function of the third-party's loss experience on the portfolio, such an arrangement indicates an assumption of credit risk and would be considered recourse. Recourse may also exist implicitly if a bank provides credit enhancement beyond any contractual obligation to support assets it has sold. The following are examples of recourse arrangements:

- credit-enhancing representations and warranties made on the transferred assets
- loan-servicing assets retained pursuant to an agreement under which the bank will be responsible for credit losses associated with the loans being serviced (mortgage-servicer cash advances that meet the conditions of section III.B.3.a.viii. of the guidelines (12 CFR 208, appendix A) are not recourse arrangements)
- retained subordinated interests that absorb more than their pro rata share of losses from the underlying assets
- assets sold under an agreement to repurchase, if the assets are not already included on the balance sheet
- loan strips sold without contractual recourse, when the maturity of the transferred loan is shorter than the maturity of the commitment under which the loan is drawn
- credit derivatives issued that absorb more than the bank's pro rata share of losses from the transferred assets
- clean-up calls that are greater than 10 percent of the balance of the original pool of transferred loans or of the outstanding principal amount of securities (clean-up calls that are 10 percent or less of the original pool balance or of the outstanding principal amount of securities are not recourse arrangements)

Direct-credit substitutes. The term ''direct-credit substitute'' refers to an arrangement in which a bank assumes, in form or in substance, credit risk associated with an on- or off-balance-sheet asset or exposure that was not previously owned by the bank (third-party asset), and the risk assumed by the bank exceeds the pro rata share of its interest in the third-party asset. If the bank has no claim on the third-party asset, then the bank's assumption of any credit risk on the third-party asset is a direct-credit substitute.

The term direct-credit substitute explicitly includes items such as purchased subordinated interests, agreements to cover credit losses that arise from purchased loan-servicing rights, credit derivatives, and lines of credit that provide credit enhancement. Some purchased subordinated interests, such as credit-enhancing I/O strips, are also residual interests for regulatory capital purposes.

Direct-credit substitutes include, but are not limited to—

- financial standby letters of credit that support financial claims on a third party that exceed a bank's pro rata share of losses in the financial claim;
- guarantees, surety arrangements, credit derivatives, and similar instruments backing financial claims that exceed a bank's pro rata share in the financial claim;
- purchased subordinated interests or securities that absorb more than their pro rata share of losses from the underlying assets;
- credit derivative contracts under which the bank assumes more than its pro rata share of credit risk on a third-party exposure;
- loans or lines of credit that provide credit enhancement for the financial obligations of an account party;
- purchased loan-servicing assets if the servicer is responsible for credit losses or if the servicer makes or assumes credit-enhancing representations and warranties with respect to the loans serviced (mortgage-servicer cash advances that meet the conditions of section III.B.3.a.viii. of the guidelines (12 CFR 208, appendix A) are not direct-credit substitutes); and
- clean-up calls on third-party assets (clean-up calls that are 10 percent or less of the original pool balance or outstanding principal amount of securities and that are exercisable at the option of the bank are not direct-credit substitutes).

Residual interests. Residual interests are defined as any on-balance-sheet asset (1) that represents an interest (including a beneficial interest) created by a transfer that qualifies as a sale (in accordance with GAAP) of financial assets, whether through a securitization or otherwise, and (2) that exposes a bank to any credit risk directly or indirectly associated with the transferred assets that exceeds a pro rata share of the bank's claim on the asset, whether through subordination provisions or other credit-enhancement techniques. Residual interests do not include interests purchased from a third party, except for credit-enhancing I/O strips. Examples of residual interests (assets) include credit-enhancing I/O strips receivables; spread accounts; cash-collateral accounts; retained subordinated interests; accrued but uncollected interest on transferred assets that, when collected, will be available to serve in a credit-enhancing capacity; and similar on-balance-sheet assets that function as a credit enhancement. The functional-based definition reflects the fact that securitization structures vary in the way they use certain assets as credit enhancements. Residual interests therefore include any retained on-balance-sheet asset that functions as a credit enhancement in a securitization, regardless of how a bank refers to the asset in financial or regulatory reports. In addition, due to their similar risk profile, purchased credit-enhancing I/O strips are residual interests for regulatory capital purposes.

In general, the definition of residual interests includes only an on-balance-sheet asset that represents an interest created by a transfer of financial assets treated as a sale under GAAP, in accordance with FAS 140. Interests retained in a securitization or transfer of assets accounted for as a financing under GAAP are generally excluded from the definition of residual interest. In the case of GAAP financings, the transferred assets remain on the transferring bank's balance sheet and are, therefore, directly included in both the leverage and risk-based capital calculations. Further, when a transaction is treated as a financing, no gain is recognized from an accounting standpoint.

Sellers' interests generally do not function as a credit enhancement. Thus, if a seller's interest shares losses on a pro rata basis with investors, such an interest would not be considered a residual interest. However, banks should recognize that sellers' interests that are structured to absorb a disproportionate share of losses will be considered residual interests.

The definition of residual interest also includes overcollateralization and spread accounts because these accounts are susceptible to the potential future credit losses within the loan pools that they support, and thus are subject to valuation inaccuracies. Spread accounts and overcollateralizations that do not meet the definition of credit-enhancing I/O strips generally do not expose a bank to the same level of risk as credit-enhancing I/O strips, and thus are excluded from the concentration limit.

The capital treatment for a residual interest applies when a bank effectively retains the risk associated with that residual interest, even if the residual is sold. The economic substance of the transaction will be used to determine whether the bank has transferred the risk associated with the residual-interest exposure. Banks that transfer the risk on residual interests, either directly through a sale or indirectly through guarantees or other credit-risk-mitigation techniques, and then reassume this risk in any form will be required to hold risk-based capital as though the residual interest remained on the bank's books. For example, if a bank sells an asset that is an on-balance-sheet credit enhancement to a third party and then writes a credit derivative to cover the credit risk associated with that asset, the selling bank must continue to risk-weight, and hold capital against, that asset as a residual interest as if the asset had not been sold.

Spread accounts that function as credit-enhancing interest-only strips. A spread account is an on-balance-sheet asset that functions as a credit enhancement and that can represent an interest in expected interest and fee cash flows derived from assets an organization has sold into a securitization. In those cases, the spread account is considered to be a "credit-enhancing interest-only strip" and is subject to the concentration limit. (See SR-02-16.) However, any portion of a spread account that represents an interest in cash that has already been collected and is held by the trustee is a "residual interest" subject to dollar-for-dollar capital, but is not a credit-enhancing interest-only strip subject to the concentration limit. For example, assume that a bank books a single spread-account asset that is derived from two separate cash-flow streams:

- *A receivable from the securitization trust that represents cash that has already accumulated in the spread account.* In accordance with the securitization documents, the cash will be returned to the bank at some date in the future after having been reduced by amounts used to reimburse investors for credit losses. Based on the date when the cash is expected to be paid out to the bank, the present value of this asset is currently estimated to be $3.
- *A projection of future cash flows that are expected to accumulate in the spread account.* In accordance with the securitization documents, the cash, to the extent collected, will also be returned to the bank at some date in the future after having been reduced by amounts used to reimburse investors for credit losses. Based on the date when the cash is expected to be paid out to the bank, the present value of this asset is currently estimated to be $2.

Both components of the above spread account are considered to be residual interests under the current capital standards because both represent on-balance-sheet assets subject to more than their pro rata share of losses on the underlying portfolio of sold assets. However, the $2 asset that represents the bank's retained interest in future cash flows exposes the organization to a greater degree of risk because the $2 asset presents additional uncertainty as to whether it will ever be collected. This additional uncertainty associated with the recognition of future subordinated excess cash flows results in the $2 asset being treated as a credit-enhancing interest-only strip, a subset of residual interests.

The face amount of all of the bank's credit-enhancing interest-only strips is first subject to a 25 percent of tier 1 capital concentration limit. Any portion of this face amount that exceeds 25 percent of tier 1 capital is deducted from tier 1 capital. This limit will affect both a bank's risk-based and leverage capital ratios. The remaining face amount of the bank's credit-enhancing interest-only strips, as well as the face amount of the spread-account receivable for cash already held in the trust, is subject to the dollar-for-dollar capital requirement established for residual interests, which affects only the risk-based capital ratios.

Credit-enhancing interest-only strips. A credit-enhancing interest-only (I/O) strip is an on-balance-sheet asset that, in form or substance, (1) represents the contractual right to receive some or all of the interest due on transferred assets and (2) exposes the bank to credit risk that exceeds its pro rata claim on the underlying assets, whether through subordination provisions or other credit-enhancing techniques. Thus, credit-enhancing I/O strips include any balance-sheet asset that represents the contractual right to receive some or all of the remaining interest cash flow generated from assets that have been transferred into a trust (or other special-purpose entity), after taking into account trustee and other administrative expenses, interest payments to investors, servicing fees, reimbursements to investors for losses attributable to the beneficial interests they hold, and reinvestment income and ancillary revenues[26] on the transferred assets. Credit-enhancing I/O strips are generally carried on the balance sheet at the present value of the expected net cash flow that the banking organization reasonably expects to receive in future periods on the assets it has securitized, adjusted for some level of prepayments if relevant to that asset class, and discounted at an appropriate market interest rate. Typically, when assets are transferred in a securitization transaction that is accounted for as a sale under GAAP, the accounting recognition given to the credit-enhancing I/O strip on the seller's balance sheet results in the recording of a gain on the portion of the transferred assets that has been sold. This gain is recognized as income, thus increasing the bank's capital position. The economic substance of a transaction will be used to determine whether a particular interest cash flow functions as a credit-enhancing I/O strip, and the Federal Reserve reserves the right to identify other cash flows or spread-related assets as credit-enhancing I/O strips on a case-by-case basis. For example, including some principal payments with interest and fee cash flows will not otherwise negate the regulatory capital treatment of that asset as a credit-enhancing I/O strip. Credit-enhancing I/O strips include both purchased and retained interest-only strips that serve in a credit-enhancing capacity, even though purchased I/O strips generally do not result in the creation of capital on the purchaser's balance sheet.

Credit derivatives. Credit derivative means a contract that allows one party (the protection purchaser) to transfer the credit risk of an asset or off-balance-sheet credit exposure to another party (the protection provider). The value of a credit derivative depends, at least in part, on the credit performance of a ''reference asset.''

Credit-enhancing representations and warranties. When a bank transfers assets, including servicing rights, it customarily makes representations and warranties concerning those assets. When a bank purchases loan-servicing rights, it may also assume representations and warranties made by the seller or a prior servicer. These representations and warranties give certain rights to other parties and impose obligations on the seller or servicer of the assets. To the extent a bank's representations and warranties function as credit enhancements to protect asset purchasers or investors from credit risk, they are considered as recourse or direct-credit substitutes.

The Federal Reserve's risk-based capital adequacy rule is consistent with the agencies' long-standing recourse treatment of representations and warranties that effectively guarantee the performance or credit quality of transferred loans. However, banks typically make a number of factual warranties that are unrelated to the ongoing performance or credit quality of transferred assets. These warranties entail operational risk, as opposed to the open-ended credit risk inherent in a financial guaranty, and are not considered recourse or a direct-credit substitute. Warranties that create operational risk include warranties that assets have been underwritten or collateral appraised in conformity with identified standards, as well as warranties that provide for the return of assets in instances of incomplete documentation, fraud, or misrepresentation.

Warranties can impose varying degrees of operational risk. For example, a warranty that asset collateral has not suffered damage from potential hazards entails a risk that is offset to some extent by prudent underwriting practices requiring the borrower to provide hazard insurance to the bank. A warranty that asset collateral is free of environmental hazards may present acceptable operational risk for certain types of properties that have been subject to environmental assessment, depending on the circumstances. The appropriate limits for these operational risks are monitored through supervision of a bank's loan-underwriting, -sale, and -servicing practices. Also, a bank that provides warranties to loan purchasers and investors must include associated operational risks in its risk management of exposures arising from loan-sale or securitization-related activities.

26. According to FAS 140, ancillary revenues include such revenues as late charges on the transferred assets.

Banks should be prepared to demonstrate to examiners that operational risks are effectively managed.

Recourse or direct-credit-substitute treatment is required for warranties providing assurances about the actual value of asset collateral, including that the market value corresponds to its appraised value or that the appraised value will be realized in the event of foreclosure and sale. Warranties such as these, which make representations about the future value of a loan or related collateral, constitute an enhancement of the loan transferred, and thus are recourse arrangements or direct-credit substitutes. When a seller represents that it ''has no knowledge'' of circumstances that could cause a loan to be other than investment quality, the representation is not recourse. Banks may limit recourse exposure with warranties that directly address the condition of the asset *at the time of transfer* (that is, creation of an operational warranty) and by monitoring compliance with stated underwriting standards. Alternatively, banks might create warranties with exposure caps that would permit it to take advantage of the low-level-recourse rule.

Clean-up calls. A clean-up call is an option that permits a servicer or its affiliate (which may be the originator) to take investors out of their positions in a securitization before all of the transferred loans have been repaid. The servicer accomplishes this by repurchasing the remaining loans in the pool once the pool balance has fallen below some specified level. This option in a securitization raises long-standing agency concerns that a bank may implicitly assume a credit-enhancing position by exercising the option when the credit quality of the securitized loans is deteriorating. An excessively large clean-up call facilitates a securitization servicer's ability to take investors out of a pool to protect them from absorbing credit losses, and thus may indicate that the servicer has retained or assumed the credit risk on the underlying pool of loans.

Generally, clean-up calls (whether or not they are exercised) are treated as recourse and direct-credit substitutes. The purpose of treating large clean-up calls as recourse or direct-credit substitutes is to ensure that a bank is not able to provide credit support to the trust investors by repaying its investment when the credit quality of the pool is deteriorating without holding capital against the exposure. The focus should be on the arrangement itself and not the exercise of the call. Thus, the existence, not the exercise, of a clean-up call that does not meet the requirements of the risk-based capital rule will trigger treatment as a recourse obligation or a direct-credit substitute. A clean-up call can function as a credit enhancement because its existence provides the opportunity for a bank (as servicer or an affiliate of a servicer) to provide credit support to investors by taking an action that is within the contractual terms of the securitization documents.

Because clean-up calls can also serve an administrative function in the operation of a securitization, a limited exemption exists for these options. When an agreement permits a bank that is a servicer or an affiliate of the servicer to elect to purchase loans in a pool, the agreement is not considered a recourse obligation or a direct-credit substitute if the agreement permits the banking organization to purchase the remaining loans in a pool when the balance of those loans is equal to or less than 10 percent of the original pool balance. This treatment will also apply to clean-up calls written with reference to less than 10 percent of the outstanding principal amount of securities. If, however, an agreement permits the remaining loans to be repurchased when their balance is greater than 10 percent of the original pool balance, the agreement is considered to be a recourse obligation or a direct-credit substitute. The exemption from recourse or direct-credit-substitute treatment for a clean-up call of 10 percent or less recognizes the real market need to be able to call a transaction when the costs of keeping it outstanding are burdensome. However, to minimize the potential for using such a feature as a means of providing support for a troubled portfolio, a bank that exercises a clean-up call should not repurchase any loans in the pool that are 30 days or more past due. Alternatively, the bank should repurchase the loans at the lower of their estimated fair value or their par value plus accrued interest.

Banks that repurchase assets pursuant to a clean-up call may do so based on an aggregate fair value for all repurchased assets. Banks do not have to evaluate each individual loan remaining in the pool at the time a clean-up call is exercised to determine fair value. Rather, the overall repurchase price should reflect the aggregate fair value of the assets being repurchased so that the bank is not overpaying for the assets and, in so doing, providing credit support to the trust investors. Examiners will review the terms and conditions relating to the repurchase arrangements in clean-up calls to ensure that transactions are done at the lower of fair value or par value plus accrued interest. Banks should be able to support their fair-value estimates. If the Federal Reserve concludes that a bank has repurchased assets at a price that exceeds the lower of these two amounts, the clean-up call provisions in its future securitizations may be treated as recourse obligations or direct-credit substitutes. Regardless of the size of the clean-up call, the Federal Reserve will closely scrutinize and take appropriate supervisory action for any transaction in which the bank repurchases deteriorating assets for an amount greater than a reasonable estimate of their fair value.

Early-default clauses. Early-default clauses typically give the purchaser of a loan the right to return the loan to the seller if the loan becomes 30 or more days delinquent within a stated period after the transfer, for example, four months after transfer. Once the stated period has expired, the early-default clause will no longer trigger recourse treatment, provided there are no other provisions that constitute recourse.

The definition of credit-enhancing representations and warranties excludes warranties, such as early-default clauses and similar warranties that permit the return of qualifying one- to four-family residential first mortgage loans for a maximum period of 120 days from the date of transfer. To be eligible for exclusion, these warranties must cover only one- to four-family residential mortgage loans that are eligible for the 50 percent risk weight and that were originated within one year of the date of transfer. All other early-default clauses, including those for periods of greater than 120 days on qualifying one- to four-family residential first mortgages, are recourse or direct-credit substitutes until expiration.

A premium-refund clause is a warranty that obligates a seller who has sold a loan at a price in excess of par, that is, at a premium, to refund the premium, either in whole or in part, if the loan defaults or is prepaid within a certain period of time. Although premium-refund clauses can be triggered as a result of prepayments, they can also be triggered by defaults. Accordingly, premium-refund clauses are generally considered to be credit-enhancing representations and warranties. An exception exists, however, for premium-refund clauses on U.S. government–guaranteed loans and qualifying one- to four-family first mortgage loans that impose a refund obligation on a seller for a period not to exceed 120 days from the date of transfer. These types of loans hold significantly reduced credit risk.

Financial standby letters of credit. A financial standby letter of credit means a letter of credit or similar arrangement that represents an irrevocable obligation to a third-party beneficiary—

- to repay money borrowed by, advanced to, or for the account of a second party (the account party), or
- to make payment on behalf of the account party, in the event that the account party fails to fulfill its obligation to the beneficiary.

Loan-servicing arrangements. The definitions of recourse and direct-credit substitute cover loan-servicing arrangements if the bank, as servicer, is responsible for credit losses associated with the serviced loans. However, cash advances made by residential mortgage servicers to ensure an uninterrupted flow of payments to investors or the timely collection of the mortgage loans are specifically excluded from the definitions of recourse and direct-credit substitute, provided the residential mortgage servicer is entitled to reimbursement for any significant advances and this reimbursement is not subordinate to other claims. To be excluded from recourse and direct-credit-substitute treatment, the bank, as servicer, should make an independent credit assessment of the likelihood of repayment of the servicer advance before advancing funds, and should only make such an advance if prudent lending standards are met. Risk-based capital is assessed only against the amount of the cash advance, and the advance is assigned to the risk-weight category appropriate to the party obligated to reimburse the servicer.

If a residential mortgage servicer is not entitled to full reimbursement, then the maximum possible amount of any nonreimbursed advances on any one loan must be contractually limited to an insignificant amount of the outstanding principal on that loan. Otherwise, the servicer's obligation to make cash advances will not be excluded from the definitions of recourse and direct-credit substitute. Banks that act as servicers should establish policies on servicer advances and use discretion in determining what constitutes an "insignificant" servicer advance. The Federal Reserve will exercise its supervisory authority to apply recourse or direct-credit-substitute treatment to servicer cash advances that expose a bank, acting as servicer, to excessive levels of credit risk.

Recourse Obligations, Direct-Credit Substitutes, Residual Interests, and Asset- and Mortgage-Backed Securities

The risk-based capital treatment for recourse obligations, direct-credit substitutes, and asset- and mortgage-backed securities in connection with asset securitizations and structured financings is described below. The capital treatment described in this subsection applies to the bank's own positions.[27] For banks that comply with the market-risk rules, positions in the trading book that arise from asset securitizations, including recourse obligations, residual interests, and direct-credit substitutes, should be treated according to the market-risk rules. However, these banks remain subject to the 25 percent concentration limit for credit-enhancing I/O strips.

Credit-equivalent amount. The credit-equivalent amount for a recourse obligation or direct-credit substitute is the full amount of the credit-enhanced assets for which the bank directly or indirectly retains or assumes credit risk, multiplied by a 100 percent conversion factor. This treatment, however, does not apply to externally rated positions, senior positions not externally rated, residual interests, certain internally rated positions, and certain small-business loans and leases on personal property transferred with recourse.

Risk-weight factor for off-balance-sheet recourse obligations and direct-credit substitutes. To determine the bank's risk-weight factor for off-balance-sheet recourse obligations and direct-credit substitutes, the credit-equivalent amount is assigned to the risk category appropriate to the obligor in the underlying transaction, after considering any associated guarantees or collateral. For a direct-credit substitute that is an on-balance-sheet asset (for example, a purchased subordinated security), a bank must calculate risk-weighted assets using the amount of the direct-credit substitute and the full amount of the assets it supports, that is, all the more senior positions in the structure. Direct-credit substitutes that have been syndicated or in which risk participations have been conveyed or acquired are considered off-balance-sheet items that are converted at a 100 percent conversion factor. (See section III.D.1. of the guidelines (12 CFR 208, appendix A).)

Ratings-Based Approach—Externally Rated Positions

Each loss position in an asset-securitization structure functions as a credit enhancement for the more senior loss positions in the structure. A multilevel, ratings-based approach is used to assess capital requirements on recourse obligations, residual interests (except credit-enhancing I/O strips), direct-credit substitutes, and senior and subordinated securities in asset securitizations. The approach uses credit ratings from the rating agencies to measure relative exposure to credit risk and determine the associated risk-based capital requirement. Using these credit ratings provides a way to use determinations of credit quality that are relied on by investors and other market participants to differentiate the regulatory capital treatment for loss positions representing different gradations of risk.

Under the ratings-based approach, the capital requirement for a position is computed by multiplying the face amount of the position by the appropriate risk weight, determined in accordance with the following tables.[28] Table 2 maps long-term ratings to the appropriate risk weights. Table 3 maps short-term ratings for asset-backed commercial paper to the appropriate risk weights. The Federal Reserve has the authority, however, to override the use of certain ratings or the ratings on certain instruments, either on a case-by-case basis or through broader supervisory policy, if necessary or appropriate to address the risk that an instrument poses to a bank.

The ratings-based approach can be used for certain designated asset-backed securities (includ-

27. This treatment also applies to banks that hold positions in their trading book, but are not otherwise subject to the market-risk rules.

28. The rating designations (for example, AAA, BBB, A-1, and P-1) used in the tables are illustrative only and do not indicate any preference for, or endorsement of, any particular rating-agency designation system.

ing asset-backed commercial paper), recourse obligations, direct-credit substitutes, and residual interests (other than credit-enhancing I/O strips). Credit-enhancing I/O strips have been excluded from the ratings-based approach based on their high risk profile. While the ratings-based approach is available for both traded and untraded positions, the approach applies different requirements to each type of position.

Ratings-Based Qualification for Corporate Bonds or Other Securities

Corporate bonds or other securities not related in any way to a securitization or structured-finance program do not qualify for the ratings-based approach. Only mortgage- and asset-backed securities, recourse obligations, direct-credit substitutes, and residual interests (except credit-enhancing I/O strips) retained, assumed, or issued in connection with a securitization or structured-finance program qualify for the ratings-based approach. Securitization is defined as the pooling and repackaging by a special-purpose entity of assets or other credit exposures that can be sold to investors. A structured-finance program is defined as a program in which receivable interests and asset-backed securities issued by multiple participants are purchased by a special-purpose entity that repackages those exposures into securities that can be sold to investors. Corporate debt instruments, municipal bonds, and other securities that are not related to a securitization or structured-finance program do not meet these definitions, and thus do not qualify for the ratings-based approach.

Traded Positions

A traded position is only required to be rated by one rating agency. A position is defined as ‘‘traded’’ if, at the time it is rated by an external rating agency, there is a reasonable expectation that in the near future (1) the position may be sold to unafffiliated investors relying on the rating, or (2) an unaffiliated third party may enter into a transaction (for example, a loan or repurchase agreement) involving the position, whereby the third party relies on the rating of the position.

For a traded position that has received an external rating on a long-term position that is one grade below investment grade or better, or that has received a short-term rating that is investment grade, the bank multiplies the face amount of the position by the appropriate risk weight, determined in accordance with tables 2 and 3. Stripped mortgage-backed securities and other similar instruments, such as interest-only or principal-only strips that are not credit enhancements, must be assigned to the 100 percent risk category. If a traded position has received more than one external rating, the lowest single rating will apply. Moreover, if a rating changes, the bank must use the new rating.

Table 2—Risk-Weight Assignments for Externally Rated Long-Term Positions

Long-term rating category	*Rating-designation examples*	*Risk weight*
Highest or second-highest investment grade	AAA, AA	20 percent
Third-highest investment grade	A	50 percent
Lowest investment grade	BBB	100 percent
One category below investment grade	BB	200 percent

Table 3—Risk-Weight Assignments for Externally Rated Short-Term Positions

Short-term rating category	*Rating-designation examples*	*Risk weight*
Highest investment grade	A-1, P-1	20 percent
Second-highest investment grade	A-2, P-2	50 percent
Lowest investment grade	A-3, P-3	100 percent

Table 3, for short-term ratings, is not identical to table 2, for long-term ratings, because the rating agencies do not assign short-term ratings using the same methodology as long-term ratings. Each short-term rating category covers a range of longer-term rating categories.[29] For example, a P-1 rating could map to a long-term rating that is as high as Aaa or as low as A3.

Externally Rated, Nontraded Positions

For a rated, but untraded, position to be eligible for the ratings-based approach, it must meet certain conditions. To qualify, the position (1) must be rated by more than one rating agency; (2) must have received an external rating on a long-term position that is one grade below investment grade or better or, for a short-term position, a rating that is investment grade or better by all rating agencies providing a rating; (3) must have ratings that are publicly available; and (4) must have ratings that are based on the same criteria used to rate traded securities. If the ratings are different, the lowest single rating will determine the risk-weight category to which the position will be assigned.

Split or Partially Rated Instruments

For instruments that have been assigned separate ratings for principal and interest (split or partially rated instruments), the Federal Reserve will apply to the entire instrument the risk weight that corresponds to the lowest component rating. For example, a purchased subordinated security whose principal component is rated BBB, but whose interest component is rated B, is subject to the gross-up treatment accorded to direct-credit substitutes rated B or lower. Similarly, if a portion of an instrument is unrated, the entire position will be treated as if it were unrated. In addition to this regulatory capital treatment, the Federal Reserve may also, as appropriate, adversely classify and require write-downs for an other-than-temporary impairment on unrated and below-investment-grade securities, including split or partially rated securities. (See SR-02-16.)

29. See, for example, *Moody's Global Ratings Guide*, June 2001, p.3.

Senior Positions Not Externally Rated

A position that is not externally rated (an unrated position), but that is senior or preferred in all respects (including collateralization and maturity) to a rated position that is traded, is treated as if it had the rating assigned to the rated position. The bank must satisfy the Federal Reserve that such treatment is appropriate. Senior unrated positions qualify for the risk weighting of the subordinated rated positions in the same securitization transaction as long as the subordinated rated position (1) is traded and (2) remains outstanding for the entire life of the unrated position, thus providing full credit support until the unrated position matures.

Recourse obligations and direct-credit substitutes (other than residual interests) that do not qualify for the ratings-based approach (or for the internal-ratings, program-ratings, or computer-program-ratings approaches outlined below) receive "gross-up" treatment, that is, the bank holding the position must hold capital against the amount of the position, plus all more senior positions, subject to the low-level-exposure requirement.[30] This grossed-up amount is placed into a risk-weight category according to the obligor or, if relevant, according to the guarantor or nature of the collateral. The grossed-up amount multiplied by both the risk weight and 8 percent is never greater than the full capital charge that would otherwise be imposed on the assets if they were on the banking organization's balance sheet.[31]

30. Gross-up treatment means that a position is combined with all more senior positions in the transaction. The result is then risk-weighted based on the obligor or, if relevant, the guarantor or the nature of the collateral. For example, if a bank retains a first-loss position (other than a residual interest) in a pool of mortgage loans that qualify for a 50 percent risk weight, the bank would include the full amount of the assets in the pool, risk-weighted at 50 percent, in its risk-weighted assets for purposes of determining its risk-based capital ratio. The low-level-exposure rule provides that the dollar amount of risk-based capital required for assets transferred with recourse should not exceed the maximum dollar amount for which a bank is contractually liable.

31. For assets that are assigned to the 100 percent risk-weight category, the minimum capital charge is 8 percent of the amount of assets transferred, and banking organizations are required to hold 8 cents of capital for every dollar of assets transferred with recourse. For assets that are assigned to the 50 percent risk-weight category, the minimum capital charge is 4 cents of capital for every dollar of assets transferred with recourse.

Residual Interests

Credit-Enhancing I/O Strips

After applying the concentration limit to credit-enhancing I/O strips (both purchased and retained), a bank must maintain risk-based capital for a credit-enhancing I/O strip (both purchased and retained), regardless of the external rating on that position, equal to the remaining amount of the credit-enhancing I/O strip (net of any existing associated deferred tax liability), even if the amount of risk-based capital required to be maintained exceeds the full risk-based capital requirement for the assets transferred. Transactions that, in substance, result in the retention of credit risk associated with a transferred credit-enhancing I/O strip will be treated as if the credit-enhancing I/O strip were retained by the bank and not transferred.

Other Residual Interests

Residual interests that are not eligible for the ratings-based approach receive dollar-for-dollar treatment. Dollar-for-dollar treatment means, effectively, that one dollar in total risk-based capital must be held against every dollar of a residual interest retained on the balance sheet (net of any existing associated deferred tax liability), even if the amount of risk-based capital required to be maintained exceeds the full risk-based capital requirement for the assets transferred. This capital treatment applies to all residual interests, except for credit-enhancing I/O strips that have already been deducted from tier 1 capital under the concentration limit.[32] Transactions that, in substance, result in the retention of credit risk associated with a transferred residual interest will be treated as if the residual interest were retained by the bank and not transferred. When the aggregate capital requirement for residual interests and other recourse obligations in connection with the same transfer of assets exceeds the full risk-based capital requirement for those assets, a bank must maintain risk-based capital equal to the greater of the risk-based capital requirement for the residual interest or the full risk-based capital requirement for the assets transferred.

Accrued Interest Receivables Held on Credit Card Securitizations

In a typical credit card securitization, an institution transfers a pool of credit card receivables to a trust, as well as the rights to receive future payments of principal, interest, and fee income from those receivables. If a securitization transaction qualifies as a sale under FAS 140, the selling institution removes the receivables that were sold from its reported assets and continues to carry any retained interests in the transferred receivables on its balance sheet; the right to these future cash flows should be reported as an accrued interest receivable (AIR) asset.[32a, 32b] Any accrued amounts (cash flows) the institution collects (for example, accrued fees and finance charges) generally must be transferred to the trust and will be used first by the trustee for the benefit of third-party investors to satisfy more senior obligations and for the payment of trust expenses (such as servicing fees, investor-certificate interest, and investor-principal charge-offs). Any remaining excess fee and finance charges will flow back to the seller.

Because the AIR asset constitutes a subordinated residual (retained) interest in the transferred securitized assets, it meets the definition of recourse exposure for risk-based capital purposes. Recourse exposures (such as the AIR asset) require risk-based capital against the full, risk-weighted amount of the assets transferred with recourse, subject to the low-level-recourse rule.[32c] The AIR asset serves as a credit enhancement to protect third-party investors in

32. Residual interests that are retained or purchased credit-enhancing I/O strips are first subject to a capital concentration limit of 25 percent of tier 1 capital. For risk-based capital purposes (but not for leverage capital purposes), once this concentration limit is applied, a banking organization must then hold dollar-for-dollar capital against the face amount of credit-enhancing I/O strips remaining.

32a. The AIR represents fees and finance charges that have been accrued on receivables that the institution has securitized and sold to other investors. For example, in credit card securitizations, this accrued interest receivable asset may include both finance charges billed but not yet collected and finance charges accrued but not yet billed on the securitized receivables.

32b. Some institutions may categorize part or all of this receivable as a loan, a ''due from trust'' account, a retained interest in the trust, or as part of an interest-only strip receivable.

32c. The low-level-recourse rule limits the maximum risk-based capital requirement to the lesser of a banking organization's maximum contractual exposure or the full capital charge against the outstanding amount of assets transferred with recourse.

the securitization from credit losses, and it meets the definition of a residual interest under the risk-based capital adequacy rules for the treatment of recourse arrangements. Under those rules, an institution must hold dollar-for-dollar capital against residual interests, even if that amount exceeds the full equivalent risk-based capital charge on the transferred assets.[32d] The institution is expected to hold risk-based capital in an amount consistent with the subordinated nature of the AIR asset.

In accounting for the sale, the AIR asset is treated as a subordinated retained interest of credit card receivables when computing the gain or loss on sale. Consistent with GAAP, this means that the value of the AIR, at the date of transfer, must be adjusted based on its relative fair (market) value. This adjustment will typically result in the carrying amount of the AIR being lower than its book (face) value prior to securitization. The AIR should be reported in regulatory reports as ''Other Assets'' and not as a loan receivable. (See SR-02-12 and SR-02-22).

Other Unrated Positions

A position (but not a residual interest) maintained in connection with a securitization and that is not rated by a rating agency may be risk-weighted based on the bank's internal determination of the credit rating of the position, as specified in table 4, multiplied by the face amount of the position. The bank may use three approaches to determine the capital requirements for certain unrated direct-credit substitutes and recourse obligations. Under each of these approaches, the bank must satisfy the Federal Reserve that the use of the approach is appropriate for the particular bank and for the exposure being evaluated. The risk weight that may be applied to an exposure under these alternative approaches is limited to a minimum of 100 percent.

32d. For a complete description of the appropriate capital treatment for recourse, residual interests, and credit-enhancing interest-only strips, see ''Recourse, Direct Credit Substitutes, and Residual Interests in Asset Securitizations,'' 66 *Fed. Reg.* 59614 (November 29, 2001).

Internal Risk-Rating Systems for Asset-Backed Commercial Paper Programs

A bank that has a qualifying internal risk-rating system can use that system to apply the ratings-based approach to its unrated direct-credit substitutes in asset-backed commercial paper programs. Internal risk ratings could be used to qualify such a credit enhancement for a risk weight of 100 percent or 200 percent under the ratings-based approach, but not for a risk weight of less than 100 percent.

Most sophisticated banking organizations that participate extensively in the asset-securitization business assign internal risk ratings to their credit exposures, regardless of the form of the exposure. Usually, internal risk ratings more finely differentiate the credit quality of a banking organization's exposures than the categories the banking agencies use to evaluate credit risk during bank examinations (pass, substandard, doubtful, or loss). An individual bank's internal risk ratings may be associated with a certain probability of default, loss in the event of default, and loss volatility.

The credit enhancements that sponsors obtain for their commercial paper conduits are rarely rated or traded. If an internal risk-ratings approach were not available for these unrated credit enhancements, the provider of the enhancement would have to obtain two ratings solely to avoid the gross-up treatment that would otherwise apply to nontraded positions in asset securitizations for risk-based capital purposes. However, before a provider of an enhancement decides whether to provide a credit enhancement for a particular transaction (and at what price), the provider will generally perform its own analysis of the transaction to evaluate the amount of risk associated with the enhancement. An internal risk-ratings approach, therefore, is potentially less costly than a ratings-based approach that relies exclusively on ratings by the rating agencies for the risk weighting of these positions.

Internal risk ratings that correspond to the rating categories of the rating agencies can be mapped to risk weights under the Federal Reserve's capital standards. This mapping can be done in a way that would make it possible to differentiate the riskiness of various unrated direct-credit substitutes in asset-backed commercial paper programs based on credit risk. The use of internal risk ratings, however, may raise

Table 4—Risk-Weight Assignments for Unrated Positions Using the Alternative Approaches[1]

Rating category	*Rating-designation examples*	*Risk weight*
Highest or second-highest investment grade	AAA, AA	100 percent
Third-highest investment grade	A	100 percent
Lowest investment grade	BBB	100 percent
One category below investment grade	BB	200 percent

1. such as the internal-ratings approach

concerns about the accuracy and consistency of the ratings, especially because the mapping of ratings to risk-weight categories will give banks an incentive to rate their risk exposures in a way that minimizes the effective capital requirement. A bank engaged in asset-backed commercial paper securitization activities that wishes to use the internal risk-ratings approach must therefore be able to demonstrate to the satisfaction of the Federal Reserve, before relying on its internal ratings, that the bank's internal credit-risk rating system is adequate. Adequate internal risk-rating systems usually have the following characteristics:

- The internal risk ratings are an integral part of an effective risk-management system that explicitly incorporates the full range of risks arising from the bank's participation in securitization activities. The system must also fully take into account the effect of such activities on the bank's risk profile and capital adequacy.
- The ratings link to measurable outcomes, such as the probability that a position will experience any losses, the expected losses on that position in the event of default, and the degree of variance in losses given default on that position.
- The ratings separately consider the risk associated with the underlying loans and borrowers, as well as the risk associated with the specific positions in a securitization transaction.
- The ratings identify gradations of risk among "pass" assets, and not just among assets that have deteriorated to the point that they fall into "watch" grades. Although it is not necessary for a bank to use the same categories as the rating agencies, its internal ratings must correspond to the ratings of the rating agencies so that the Federal Reserve can determine which internal risk rating corresponds to each rating category of the rating agencies. A bank would be responsible for demonstrating, to the satisfaction of the Federal Reserve, how these ratings correspond with the rating-agency standards that are used as the framework for the asset-securitization portion of the risk-based capital rule. This correlation is necessary so that the mapping of credit ratings to risk-weight categories in the ratings-based approach can be applied to internal ratings.
- The ratings classify assets into each risk grade using clear, explicit criteria, even for subjective factors.
- Independent credit-risk-management or loan-review personnel assign or review the credit-risk ratings. These personnel should have adequate training and experience to ensure that they are fully qualified to perform this function.
- An internal-audit procedure periodically verifies that internal risk ratings are assigned in accordance with the bank's established criteria.[32e]
- The performance of internal ratings is tracked over time to evaluate how well risk grades are being assigned, make adjustments to the rating system when the performance of the rated positions diverges from assigned ratings, and adjust individual ratings accordingly.
- Credit-risk rating assumptions are consistent with, or more conservative than, the credit-risk rating assumptions and methodologies of the rating agencies.

If it determines that a bank's rating system is not adequate, the Federal Reserve may preclude

32e. The audit may be performed by any group within the organization that is qualified to audit the system and is independent of both the group that makes the decision to extend credit to the asset-backed commercial paper program and the groups that develop and maintain the internal credit-risk rating system. (See SR-02-16.)

the bank from applying the internal risk-ratings approach to new transactions for risk-based capital purposes until the deficiencies have been remedied. Additionally, depending on the severity of the problems identified, the Federal Reserve may decline to rely on the internal risk ratings that the bank had applied to previous transactions for purposes of determining its regulatory capital requirements.

Ratings of Specific Unrated Positions in Structured-Financing Programs

A bank may also use a rating obtained from a rating agency for an unrated direct-credit substitute or recourse obligation (other than a residual interest) that is assumed or retained in connection with a structured-finance program, if a rating agency has reviewed the terms of the program (according to the specifications set by the rating agency) and stated a rating for positions associated with the program. If the program has options for different combinations of assets, standards, internal credit enhancements, and other relevant factors, and if the rating agency specifies ranges of rating categories to them, the bank may apply the rating category that corresponds to the bank's position. To rely on a program rating, the bank must demonstrate to the Federal Reserve's satisfaction that the credit-risk rating assigned to the program meets the same standards generally used by rating agencies for rating traded positions.

The bank must also demonstrate to the Federal Reserve's satisfaction that the criteria underlying the rating agency's assignment of ratings for the structured-financing program are satisfied for the particular position. If a bank participates in a securitization sponsored by another party, the Federal Reserve may authorize the bank to use this approach based on a programmatic rating obtained by the sponsor of the program.

Banks with limited involvement in securitization activities may find the above alternative to be useful. In addition, some banks extensively involved in securitization activities already rely on ratings of the credit-risk positions under their securitization programs as part of their risk-management practices. Such banks can rely on these ratings for regulatory capital purposes if the ratings are part of a sound overall risk-management process and the ratings reflect the risk of nontraded positions to the banks.

This approach in a structured-financing program can be used to qualify a direct-credit substitute or recourse obligation (but not a residual interest) for a risk weight of 100 percent or 200 percent of the face value of the position under the ratings-based approach, but not for a risk weight of less than 100 percent.

Credit-Assessment Computer Programs

A bank (particularly a bank with limited involvement in securitization activities) may use an internal-ratings-based approach if it is using an acceptable credit-assessment computer program, developed by a rating agency, to determine the rating of a direct-credit substitute or a recourse obligation (but not a residual interest) issued in connection with a structured-finance program. To be used by a bank for risk-based capital purposes, a computer program must have been developed by a rating agency. Further, the bank must demonstrate to the satisfaction of the Federal Reserve that the computer program's credit assessments correspond credibly and reliably to the rating standards of the rating agencies for traded positions in securitizations and with the rating of traded positions in the financial markets. The latter would generally be shown if investors and other market participants significantly used the computer program for risk-assessment purposes. In addition, the bank must demonstrate to the Federal Reserve's satisfaction that the program was designed to apply to its particular direct-credit substitute or recourse exposure and that it has properly implemented the computer program. In general, sophisticated banks with extensive securitization activities should use this approach only if the computer program is an integral part of their risk-management systems and if the bank's systems fully capture the risks from its securitization activities. This computer-program approach can be used to qualify a direct-credit substitute or recourse obligation (but not a residual interest) for a risk weight of 100 percent or 200 percent of the face value of the position under the ratings-based approach, but not for a risk weight of less than 100 percent.

Limitations on Risk-Based Capital Requirements

Low-level exposure. If a bank's maximum contractual exposure to loss retained or assumed in connection with a recourse obligation or a direct-credit substitute, except for a residual interest, is less than the effective risk-based capital requirement for the enhanced assets, the risk-based capital requirement is limited to the maximum contractual exposure, less any recourse liability account established in accordance with GAAP. This limitation does not apply when a bank provides credit enhancement beyond any contractual obligation to support assets it has sold.

Mortgage-related securities or participation certificates retained in a mortgage loan swap. If a bank holds a mortgage-related security or a participation certificate as a result of a mortgage loan swap with recourse, capital is required to support the recourse obligation plus the percentage of the mortgage-related security or participation certificate that is not covered by the recourse obligation. The total amount of capital required for the on-balance-sheet asset and the recourse obligation, however, is limited to the capital requirement for the underlying loans, calculated as if the bank continued to hold the loans as on-balance-sheet assets.

Related on-balance-sheet assets. If a recourse obligation or direct-credit substitute also appears as a balance-sheet asset, the balance-sheet asset is not included in a bank's risk-weighted assets to the extent the value of the balance-sheet asset is already included in the off-balance-sheet credit-equivalent amount for the recourse obligation or direct-credit substitute. In the case of loan-servicing assets and similar arrangements with embedded recourse obligations or direct-credit substitutes, both the on-balance-sheet assets and the related recourse obligations and direct-credit substitutes must be separately risk-weighted and incorporated into the risk-based capital calculation.

Other Types of Transactions

Distinction Between Financial and Performance Standby Letters of Credit

For risk-based capital purposes, the vast majority of standby letters of credit a bank issues are considered financial in nature. On the one hand, in issuing a financial standby letter of credit, a bank guarantees that the account party will fulfill a contractual financial obligation that involves payment of money. On the other hand, in issuing a performance standby letter of credit, a bank guarantees that the account party will fulfill a contractual nonfinancial obligation, that is, an obligation that does not entail the payment of money. For example, a standby letter of credit that guarantees that an insurance company will pay as required under the terms of a policy is deemed to be financial and is converted at 100 percent, while a letter of credit that guarantees a contractor will pave a street according to certain specifications is deemed to be performance-related and is converted at 50 percent. Financial standby letters of credit have a higher conversion factor in large part because, unlike performance standby letters of credit, they tend to be drawn down only when the account party's financial condition has deteriorated.

Participations of Off-Balance-Sheet Transactions

If a standby letter of credit or commitment has been participated to other institutions in the form of a syndication, as defined in the instructions to the call report, that is, if each bank is responsible only for its pro rata share of loss and there is no recourse to the originating bank, each bank includes only its pro rata share of the standby or commitment in its risk-based capital calculation.

The treatment differs, however, if the participation takes the form of a conveyance of a risk participation. In such a participation, the originating bank remains liable to the beneficiary for the full amount of the standby or commitment if the institution that has acquired the participation fails to pay when the instrument is drawn. Under this arrangement, the originating bank is exposed to the credit risk of the institution that has acquired the conveyance rather than that of the account party. Accordingly, for risk-based capital purposes, the originating bank should convert the full amount of the standby or commitment to an on-balance-sheet credit-equivalent amount. The credit-equivalent amount of the portion of the credit that has not been conveyed is assigned to the risk category appropriate to the obligor, after giving effect to any collateral or guarantees. The portion that has been conveyed is assigned either to the same risk category as the obligor or to the risk category appropriate to the institution acquiring the participation, whichever category carries the lower risk weight. Any remainder is assigned to the risk category appropriate to the obligor, guarantor, or collateral. For example, the pro rata share of the full amount of the assets supported, in whole or in part, by a direct-credit substitute conveyed as a risk participation to a U.S. domestic depository institution or foreign bank is assigned to the 20 percent risk category. Risk participations with a remaining maturity of over one year that are conveyed to non-OECD banks are to be assigned to the 100 percent risk category, unless a lower risk category is appropriate to the obligor, guarantor, or collateral.

Commitments to Make Off-Balance-Sheet Transactions

As specified in the instructions to the call report, a commitment to make a standby letter of credit is considered to be a standby letter of credit. Accordingly, such a commitment should be converted to an on-balance-sheet credit-equivalent amount at 100 percent if it is a commitment to make a financial standby letter of credit or at 50 percent if it is a commitment to make a performance standby letter of credit.

A commitment to make a commitment is treated as a single commitment whose maturity is the combined maturity of the two commitments. For example, a 6-month commitment to make a 1-year commitment is considered to be a single 18-month commitment. Since the maturity is over one year, such a commitment would receive the 50 percent conversion factor appropriate to long-term commitments, rather than the zero percent conversion factor that would be accorded to separate unrelated short-term commitments of six months and one year.

A commitment to make a commercial letter of credit may be treated either as a commitment or as a commercial letter of credit, whichever results in the lower conversion factor. Normally, this would mean that a commitment under one year to make a commercial letter of credit would be treated as a commitment and converted at zero percent, while a similar commitment of over one year would be treated as a commercial letter of credit and converted at 20 percent.

If a commitment facility is structured so that it can be drawn down in several forms, such as a standby letter of credit, a loan, or a commercial letter of credit, the entire facility should be treated as a commitment to extend credit in the form that incurs the highest capital charge. Thus, if a facility could be drawn down in any of the three forms just cited, the entire facility would be treated as a commitment to issue a standby letter of credit and would be converted at 100 percent, rather than treated as a commitment to make a loan or commercial letter of credit, which would have a lower conversion factor.

Unused Commitments

Unused commitments, including underwriting commitments, and commercial and consumer credit commitments that have an original maturity of one year or less are converted at zero percent. Facilities that are unconditionally cancellable (without cause) at any time by the bank are not deemed to be commitments, provided that a separate credit decision is made before each drawing under the facility.

Unused commitments that have an original maturity of over one year are converted at 50 percent. For this purpose, original maturity is defined as the length of time between the date the commitment is issued and the earliest date on which (1) the bank has the permanent ability to, at its option, unconditionally cancel[33] (without cause) the commitment,[34] and (2) the bank is scheduled to (and as a normal practice actually does) review the facility to determine whether the unused commitment should be extended. (It should be noted that the term of any loan advances that can be made under a commitment is not taken into account in determining the commitment's maturity.) Under this definition of original maturity, commitments with a nominal original maturity of more than one year can be treated as having a maturity of one year or less for risk-based capital purposes only if the issuing bank (1) has full and unconditional discretion to cancel the commitment without cause and without notice on each and every day after the first year and (2) conducts at least annually a formal credit review of the commitment, including an assessment of the credit quality of the obligor.

It should be noted that a bank is not deemed able to unconditionally cancel a commitment if it is required to give, or is presumed to be required to give, any advance notice of cancellation. Accordingly, so-called ‘‘evergreen commitments,’’ which require the bank to give advance notice of cancellation to the obligor or which permit the commitment to roll over automatically (that is, on the same terms and without a thorough credit review) unless the bank gives notice otherwise, are not unconditionally cancellable. Thus, any such commitment whose term from date of issuance could exceed one year is subject to the 50 percent conversion factor.

A bank may issue a commitment that expires within one year, with the understanding that the commitment will be renewed upon expiration subject to a thorough credit review of the obligor. Such a commitment may be converted at zero percent only if (1) the renegotiation process is carried out in good faith, involves a full credit assessment of the obligor, and allows the bank flexibility to alter the terms and conditions of the new commitment; (2) the bank has absolute discretion to decline renewal or exten-

33. A bank's option to cancel a commitment under a material adverse change clause is not considered to be an option to unconditionally cancel a commitment.

34. In the case of consumer home equity or mortgage lines of credit secured by liens on one- to four-family residential properties, the bank is deemed able to unconditionally cancel the commitment for the purpose of this criterion if, at its option, it can prohibit additional extensions of credit, reduce the credit lines, and terminate the commitment to the full extent permitted by relevant federal law.

sion of the commitment; and (3) the renegotiated commitment expires within 12 months from the time it is made. Some commitments contain unusual renegotiation arrangements that would give the borrower a considerable amount of advance notice that a commitment would not be renewed. Provisions of this kind can have the effect of creating a rolling commitment arrangement that should be treated for risk-based capital purposes as a long-term commitment and should therefore be converted to a credit-equivalent amount at 50 percent. Normally, the renegotiation process should take no more than six to eight weeks, and in many cases it should take a shorter period of time. The renegotiation period should immediately precede the expiration date of the commitment and should be reasonably short and appropriate to the complexity of the transaction. The reasons for provisions in a commitment arrangement that would appear to allow for a protracted renegotiation period should be thoroughly documented by the bank and reviewed by the examiner.

As mentioned above, a commitment to make a commitment is treated as a single commitment whose maturity is the combined maturity of the two commitments. Although such commitments whose combined maturity is in excess of one year are generally considered long-term, if the customer has a bona fide business reason for requesting a new commitment to supersede the unexpired one, such as an unanticipated increase in the volume of business or a change in the customer's cash flow and credit needs, then the commitment would not automatically be considered long-term. However, if the bank exhibits a pattern and practice of extending short-term commitments before their expiration—either for one customer or more broadly within the bank—then such extended commitments would be viewed as long-term. This treatment generally would apply to all commitments, including traditional commercial paper liquidity lines.

Other criteria for determining whether a facility is short- or long-term include the actual level of risk associated with the transaction and whether that level of risk is more characteristic of a long-term (as opposed to a short-term) commitment. Liquidity facilities issued in connection with asset-backed commercial paper programs, when judged by these criteria, seem to possess risk characteristics that are less than those associated with typical short-term commercial loan commitments. One of these characteristics is the short-term nature of the securitized receivables. The receivables that are securitized in asset-backed commercial paper programs tend to be of very short average maturity—often in the range of 30 to 60 days. Advances under asset-backed commercial paper liquidity facilities generally are very rare, and when such advances are made, it is against pools of very high-quality performing receivables that would generally liquidate very quickly. These facilities are further protected against credit risk by significant amounts of overcollateralization, as well as other credit enhancements.

A series of short-term commitments would generally be treated as a single commitment whose original maturity is the combined maturities of the individual commitments in the series. Also, a commitment may be structured to be drawn down in a number of tranches, some exercisable in one year or less and others exercisable in over one year. The full amount of such a commitment is deemed to be over one year and converted at 50 percent. Some long-term commitments may permit the customer to draw down varying amounts at different times to accommodate, for example, seasonal borrowing needs. The 50 percent conversion factor should be applied to the maximum amount that could be drawn down under such commitments.

Credit-Equivalent Computations for Derivative Contracts

Applicable derivative contracts. Credit-equivalent amounts are computed for each of the following off-balance-sheet contracts:

- interest-rate contracts
  - — single-currency interest-rate swaps
  - — basis swaps
  - — forward rate agreements
  - — interest-rate options purchased (including caps, collars, and floors purchased)
  - — any other instrument linked to interest rates that gives rise to similar credit risks (including when-issued securities and forward deposits accepted)
- exchange-rate contracts
  - — cross-currency interest-rate swaps
  - — forward foreign-exchange-rate contracts
  - — currency options purchased
  - — any other instrument linked to exchange rates that gives rise to similar credit risks
- equity derivative contracts
  - — equity-linked swaps

— equity-linked options purchased
— forward equity-linked contracts
— any other instrument linked to equities that gives rise to similar credit risks
- commodity (including precious metal) derivative contracts
  — commodity-linked swaps
  — commodity-linked options purchased
  — forward commodity-linked contracts
  — any other instrument linked to commodities that gives rise to similar credit risks
- credit derivatives
  — credit-default swaps
  — total-rate-of-return swaps
  — other types of credit derivatives

Exceptions. Exchange-rate contracts with an original maturity of 14 or fewer calendar days and derivative contracts traded on exchanges that require daily receipt and payment of cash-variation margin may be excluded from the risk-based ratio calculation. Gold contracts are accorded the same treatment as exchange-rate contracts, except that gold contracts with an original maturity of 14 or fewer calendar days are included in the risk-based ratio calculation. Over-the-counter options purchased are included and treated in the same way as other derivative contracts.

Calculation of credit-equivalent amounts. The credit-equivalent amount of a derivative contract (excluding credit derivatives) that is not subject to a qualifying bilateral netting contract is equal to the sum of—

- the current exposure (sometimes referred to as the replacement cost) of the contract, and
- an estimate of the potential future credit exposure of the contract.

The current exposure is determined by the mark-to-market value of the contract. If the mark-to-market value is positive, then the current exposure is equal to that mark-to-market value. If the mark-to-market value is zero or negative, then the current exposure is zero. Mark-to-market values are measured in dollars, regardless of the currency or currencies specified in the contract, and should reflect changes in the underlying rates, prices, and indexes, as well as in counterparty credit quality.

The potential future credit exposure of a contract, including a contract with a negative mark-to-market value, is estimated by multiplying the notional principal amount of the contract by a credit-conversion factor. Banks should use, subject to examiner review, the effective rather than the apparent or stated notional amount in this calculation. The conversion factors (in percent) are in table 5. The Board has noted that these conversion factors, which are based on observed volatilities of the particular types of instruments, are subject to review and modification in light of changing volatilities or market conditions.

Table 5—Conversion-Factor Matrix

Remaining maturity	*Interest-rate*	*Foreign-exchange-rate and gold*	*Equity*	*Precious metals (excluding gold)*	*Other commodity (excluding precious metals*
One year or less	0.0	1.0	6.0	7.0	10.0
Over one to five years	0.5	5.0	8.0	7.0	12.0
Over five years	1.5	7.5	10.0	8.0	15.0

For a contract that is structured such that on specified dates any outstanding exposure is settled and the terms are reset so that the market value of the contract is zero, the remaining maturity is equal to the time until the next reset date. Such resetting interest-rate contracts must have a minimum conversion factor of 0.5 percent.

For a contract with multiple exchanges of principal, the conversion factor is multiplied by the number of remaining payments in the contract. A derivative contract not included in the definitions of interest-rate, exchange-rate, equity, or commodity contracts is included in the risk-based capital calculation and is subject to the same conversion factors as a commodity, excluding precious metals.

No potential future credit exposure is calculated for a single-currency interest-rate swap in which payments are made based on two floating-rate indexes, so-called floating/floating or basis swaps. The credit exposure on these contracts is evaluated solely on the basis of their mark-to-market values.

Avoidance of double counting. In certain cases, credit exposures arising from derivative contracts may be reflected, in part, on the balance sheet. To avoid double counting these exposures in the assessment of capital adequacy and, perhaps, assigning inappropriate risk weights, examiners may need to exclude counterparty credit exposures arising from the derivative instruments covered by the guidelines from balance-sheet assets when calculating a bank's risk-based capital ratios. This exclusion will eliminate the possibility that an organization could be required to hold capital against both an off-balance-sheet and on-balance-sheet amount for the same item. This treatment is not accorded to margin accounts and accrued receivables related to interest-rate and exchange-rate contracts.

The aggregate on-balance-sheet amount excluded from the risk-based capital calculation is equal to the lower of—

- each contract's positive on-balance-sheet amount, or
- its positive market value included in the off-balance-sheet risk-based capital calculation.

For example, a forward contract that is marked to market will have the same market value on the balance sheet as is used in calculating the credit-equivalent amount for off-balance-sheet exposures under the guidelines. Therefore, the on-balance-sheet amount is not included in the risk-based capital calculation. When either the contract's on-balance-sheet amount or its market value is negative or zero, no deduction from on-balance-sheet items is necessary for that contract.

If the positive on-balance-sheet asset amount exceeds the contract's market value, the excess (up to the amount of the on-balance-sheet asset) should be included in the appropriate risk-weight category. For example, a purchased option will often have an on-balance-sheet amount equal to the fee paid until the option expires. If that amount exceeds market value, the excess of carrying value over market value would be included in the appropriate risk-weight category for purposes of the on-balance-sheet portion of the calculation.

Netting of swaps and similar contracts. Netting refers to the offsetting of positive and negative mark-to-market values in the determination of a current exposure to be used in the calculation of a credit-equivalent amount. Any legally enforceable form of bilateral netting (that is, netting with a single counterparty) of derivative contracts is recognized for purposes of calculating the credit-equivalent amount provided that—

- the netting is accomplished under a written netting contract that creates a single legal obligation, covering all included individual contracts, with the effect that the organization would have a claim to receive, or an obligation to receive or pay, only the net amount of the sum of the positive and negative mark-to-market values on included individual contracts if a counterparty, or a counterparty to whom the contract has been validly assigned, fails to perform due to default, insolvency, liquidation, or similar circumstances;
- the bank obtains written and reasoned legal opinions that in the event of a legal challenge—including one resulting from default, insolvency, liquidation, or similar circumstances—the relevant court and administrative authorities would find the bank's exposure to be such a net amount under—
  - the law of the jurisdiction in which the counterparty is chartered or the equivalent location in the case of noncorporate entities, and if a branch of the counterparty is involved, then also under the law of the jurisdiction in which the branch is located;
  - the law that governs the individual contracts covered by the netting contract; and
  - the law that governs the netting contract;
- the bank establishes and maintains procedures to ensure that the legal characteristics of netting contracts are kept under review in light of possible changes in relevant law; and
- the bank maintains documentation in its files

that is adequate to support the netting of rate contracts, including a copy of the bilateral netting contract and necessary legal opinions.

A contract containing a walkaway clause is not eligible for netting for purposes of calculating the credit-equivalent amount.

By netting individual contracts for the purpose of calculating credit-equivalent amounts of derivative contracts, a bank represents that it has met the requirements of the risk-based measure of the capital adequacy guidelines for bank holding companies and that all the appropriate documents are in the organization's files and available for inspection by the Federal Reserve. The Federal Reserve may determine that a bank's files are inadequate or that a netting contract, or any of its underlying individual contracts, may not be legally enforceable. If such a determination is made, the netting contract may be disqualified from recognition for risk-based capital purposes, or underlying individual contracts may be treated as though they are not subject to the netting contract.

The credit-equivalent amount of contracts that are subject to a qualifying bilateral netting contract is calculated by adding—

- the current exposure of the netting contract (net current exposure), and
- the sum of the estimates of the potential future credit exposures on all individual contracts subject to the netting contract (gross potential future exposure), adjusted to reflect the effects of the netting contract.

The net current exposure of the netting contract is determined by summing all positive and negative mark-to-market values of the individual contracts included in the netting contract. If the net sum of the mark-to-market values is positive, then the current exposure of the netting contract is equal to that sum. If the net sum of the mark-to-market values is zero or negative, then the current exposure of the netting contract is zero. The Federal Reserve may determine that a netting contract qualifies for risk-based capital netting treatment even though certain individual contracts may not qualify. In these instances, the nonqualifying contracts should be treated as individual contracts that are not subject to the netting contract.

Gross potential future exposure (A_{gross}) is calculated by summing the estimates of potential future exposure for each individual contract subject to the qualifying bilateral netting contract. The effects of the bilateral netting contract on the gross potential future exposure are recognized through the application of a formula that results in an adjusted add-on amount (A_{net}). The formula, which employs the ratio of net current exposure to gross current exposure (NGR), is expressed as—

$$A_{net} = (0.4 \times A_{gross}) + 0.6(\text{NGR} \times A_{gross})$$

The NGR may be calculated in accordance with either the counterparty-by-counterparty approach or the aggregate approach. Under the counterparty-by-counterparty approach, the NGR is the ratio of the net current exposure for a netting contract to the gross current exposure of the netting contract. The gross current exposure is the sum of the current exposures of all individual contracts subject to the netting contract. Net negative mark-to-market values for individual netting contracts with the same counterparty may not be used to offset net positive mark-to-market values for other netting contracts with the same counterparty.

Under the aggregate approach, the NGR is the ratio of the sum of all the net current exposures for qualifying bilateral netting contracts to the sum of all the gross current exposures for those netting contracts (each gross current exposure is calculated in the same manner as in the counterparty-by-counterparty approach). Net negative mark-to-market values for individual counterparties may not be used to offset net positive current exposures for other counterparties.

A bank must consistently use either the counterparty-by-counterparty approach or the aggregate approach to calculate the NGR. Regardless of the approach used, the NGR should be applied individually to each qualifying bilateral netting contract to determine the adjusted add-on for that netting contract.

In the event a netting contract covers contracts that are normally excluded from the risk-based ratio calculation—for example, exchange-rate contracts with an original maturity of 14 or fewer calendar days or instruments traded on exchanges that require daily payment and receipt of cash-variation margin—an institution may elect to either include or exclude all mark-to-market values of such contracts when determining net current exposure, provided the method chosen is applied consistently.

Examiners should review the netting of off-balance-sheet derivative contracts used by banks when calculating or verifying risk-based capital ratios to ensure that the positions of such contracts are reported gross, unless the net positions of those contracts reflect netting arrangements that comply with the netting requirements listed previously.

Credit Derivatives

Credit derivatives are off-balance-sheet arrangements that allow one party (the beneficiary) to transfer credit risk of a reference asset—which the beneficiary may or may not own—to another party (the guarantor).[35] Many banks increasingly use these instruments to manage their overall credit-risk exposure. In general, credit derivatives have three distinguishing features:

- the transfer of the credit risk associated with a reference asset through contingent payments based on events of default and, usually, the prices of instruments before, at, and shortly after default (reference assets most often take the form of traded sovereign and corporate debt instruments or syndicated bank loans)
- the periodic exchange of payments or the payment of a premium rather than the payment of fees customary with other off-balance-sheet credit products, such as letters of credit
- the use of an International Swap Derivatives Association (ISDA) master agreement and the legal format of a derivatives contract

For risk-based capital purposes, total-rate-of-return swaps and credit-default swaps generally should be treated as off-balance-sheet direct-credit substitutes.[36] The notional amount of a contract should be converted at 100 percent to determine the credit-equivalent amount to be included in the risk-weighted assets of a guarantor.[37] A bank that provides a guarantee through a credit derivative transaction should assign its credit exposure to the risk category appropriate to the obligor of the reference asset or any collateral. On the other hand, a bank that owns the underlying asset upon which effective credit protection has been acquired through a credit derivative may, under certain circumstances, assign the unamortized portion of the underlying asset to the risk category appropriate to the guarantor (for example, the 20 percent risk category if the guarantor is an OECD bank).

Whether the credit derivative is considered an eligible guarantee for purposes of risk-based capital depends on the actual degree of credit protection. The amount of credit protection actually provided by a credit derivative may be limited depending on the terms of the arrangement. In this regard, for example, a relatively restrictive definition of a default event or a materiality threshold that requires a comparably high percentage of loss to occur before the guarantor is obliged to pay could effectively limit the amount of credit risk actually transferred in the transaction. If the terms of the credit derivative arrangement significantly limit the degree of risk transference, then the beneficiary bank cannot reduce the risk weight of the “protected” asset to that of the guarantor bank. On the other hand, even if the transfer of credit risk is limited, a bank providing limited credit protection through a credit derivative should hold appropriate capital against the underlying exposure while it is exposed to the credit risk of the reference asset.

A bank providing a guarantee through a credit derivative may mitigate the credit risk associated with the transaction by entering into an offsetting credit derivative with another counterparty—a so-called back-to-back position. A bank that has entered into such a position may treat the first credit derivative as being guaranteed by the offsetting transaction for risk-based capital purposes. Accordingly, the notional amount of the first credit derivative may be assigned to the risk category appropriate to the counterparty providing credit protection through the offsetting credit derivative arrangement (for example, the 20 percent risk category if the counterparty is an OECD bank).

35. Credit derivatives generally fall into three basic transaction types: total-rate-of-return swaps, credit-default swaps, and credit-default or credit-linked notes. For a more in-depth description of these types of credit derivatives, see the Federal Reserve’s *Trading and Capital-Markets Activities Manual*, section 4350.1, “Credit Derivatives,” as well as SR-96-17.

36. Unlike total-rate-of-return swaps and credit-default swaps, credit-linked notes are on-balance-sheet assets or liabilities. A guarantor bank should assign the on-balance-sheet amount of the credit-linked note to the risk category appropriate to either the issuer or the reference asset, whichever is higher. For a beneficiary bank, cash consideration received in the sale of the note may be considered as collateral for risk-based capital purposes.

37. A guarantor bank that has made cash payments representing depreciation on reference assets may deduct such payments from the notional amount when computing credit-equivalent amounts for capital purposes.

In some instances, the reference asset in the credit derivative transaction may not be identical to the underlying asset for which the beneficiary has acquired credit protection. For example, a credit derivative used to offset the credit exposure of a loan to a corporate customer may use as the reference asset a publicly traded corporate bond of that customer, with the credit quality of the bond serving as a proxy for the on-balance-sheet loan. In such a case, the underlying asset would still generally be considered guaranteed for capital purposes, as long as both the underlying asset and the reference asset are obligations of the same legal entity and have the same level of seniority in bankruptcy. In addition, a bank offsetting credit exposure in this manner would be obligated to demonstrate to examiners that (1) there is a high degree of correlation between the two instruments; (2) the reference instrument is a reasonable and sufficiently liquid proxy for the underlying asset so that the instruments can be reasonably expected to behave in a similar manner in the event of default; and (3) at a minimum, the reference asset and underlying asset are subject to mutual cross-default provisions. A bank that uses a credit derivative that is based on a reference asset that differs from the protected underlying asset must document the credit derivative being used to offset credit risk, and must link it directly to the asset or assets whose credit risk the transaction is designed to offset. The documentation and the effectiveness of the credit derivative transaction are subject to examiner review. A bank providing credit protection through such an arrangement must hold capital against the risk exposures that are assumed.

Some credit derivative transactions provide credit protection for a group or basket of reference assets and call for the guarantor to absorb losses on only the first asset in the group that defaults. Once the first asset in the group defaults, the credit protection for the remaining assets covered by the credit derivative ceases. If examiners determine that the credit risk for the basket of assets has effectively been transferred to the guarantor and the beneficiary banking organization owns all of the reference assets included in the basket, then the beneficiary may assign the asset with the smallest dollar amount in the group—if less than or equal to the notional amount of the credit derivative—to the risk category appropriate to the guarantor. Conversely, a bank extending credit protection through a credit derivative on a basket of assets must assign the contract's notional amount of credit exposure to the highest risk category appropriate to the assets in the basket.

In addition to holding capital against credit risk, a bank that is subject to the market-risk rule (see "Market-Risk Measure" earlier in this section) must hold capital against market risk for credit derivatives held in its trading account. (For a description of market-risk capital requirements for credit derivatives, see SR-97-18.)

Using Credit Derivatives to Synthetically Replicate Collateralized Loan Obligations

Credit derivatives can be used to synthetically replicate collateralized loan obligations (CLOs). Banking organizations (BOs) can use CLOs and their synthetic variants to manage their balance sheets and, in some instances, transfer credit risk to the capital markets. Such transactions allow economic capital to be more efficiently allocated, resulting in, among other things, improved shareholders' returns.

The issue for BOs is how synthetic CLOs should be treated under the risk-based and leverage capital guidelines.[38] Supervisors and examiners need to fully understand these complex structures, and identify the relative degree of transference and retention of the securitized portfolio's credit risk. They must determine whether the institution's regulatory capital is adequate given the retained credit exposures.

A CLO is an asset-backed security that is usually supported by a variety of assets, including whole commercial loans, revolving credit facilities, letters of credit, banker's acceptances, or other asset-backed securities. In a typical CLO transaction, the sponsoring banking organization (SBO) transfers the loans and other assets to a bankruptcy-remote special-purpose vehicle (SPV), which then issues asset-backed securities consisting of one or more classes of debt. This type of transaction represents a so-called "cash-flow CLO." It enables the sponsoring institution (SI) to reduce its leverage and risk-based capital requirements, improve its liquidity, and manage credit concentrations.

The first synthetic CLO (issued in 1997) used credit-linked notes (CLNs).[39] Rather than trans-

38. See SR-99-32 and its November 15, 1999, attachment, an FRB-OCC capital interpretation on synthetic CLOs.

39. CLNs are obligations whose principal repayment is

ferring assets to the SPV, the sponsoring bank issued CLNs to the SPV, individually referencing the payment obligation of a particular company, or "reference obligor." The notional amount of the CLNs issued equaled the dollar amount of the reference assets the sponsor was hedging on its balance sheet. Other structures have evolved that use credit-default swaps to transfer credit risk and create different levels of risk exposure, but that hedge only a portion of the notional amount of the overall reference portfolio.[40]

Traditional CLO structures usually transfer assets into the SPV. In synthetic securitizations, the underlying exposures that make up the reference portfolio remain in the institution's banking book.[41] The credit risk is transferred into the SPV through credit-default swaps or CLNs. The institution is thus able to maintain client confidentiality and avoid sensitive client-relationship issues that arise from loan-transfer-notification requirements, loan-assignment provisions, and loan-participation restrictions.

Corporate credits are assigned to the 100 percent risk-weighted asset category. In the case of high-quality investment-grade corporate exposures, the associated 8 percent capital requirement may exceed the economic capital that the sponsoring bank sets aside to cover the credit risk of the transaction. Therefore, one of the apparent motivations behind CLOs and other securitizations is to more closely align the SI's regulatory capital requirements with the economic capital required by the market.

Synthetic CLOs can raise questions about their capital treatment when calculating the risk-based and leverage capital ratios. Capital treatments for three synthetic CLO transactions follow. They are discussed from the perspective of the investors and the SBOs.

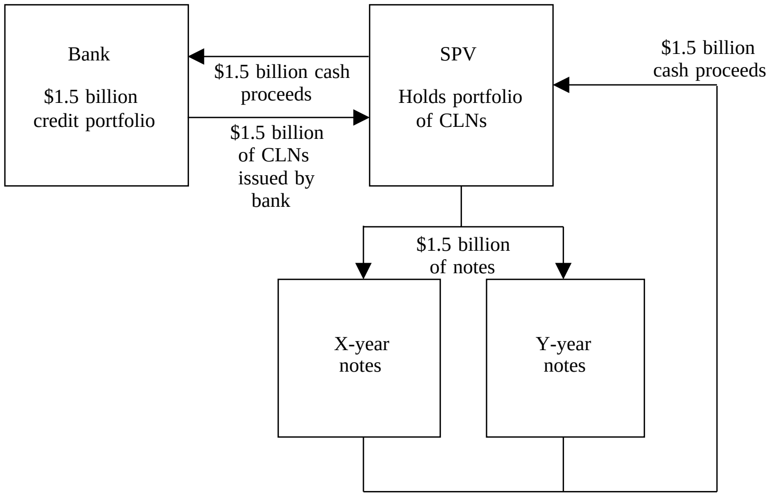
Transaction 1—Entire notional amount of the reference portfolio is hedged. In the first type of synthetic securitization, the SBO, through a synthetic CLO, hedges the entire notional amount of a reference asset portfolio. An SPV acquires the credit risk on a reference portfolio by purchasing CLNs issued by the SBO. The SPV funds the purchase of the CLNs by issuing a series of notes in several tranches to third-party investors. The investor notes are in effect col-

conditioned upon the performance of a referenced asset or portfolio. The assets' performance may be based on a variety of measures, such as movements in price or credit spread, or the occurrence of default.

40. A credit-default swap is similar to a financial standby letter of credit in that the institution writing the swap provides, for a fee, credit protection against credit losses associated with a default on a specified reference asset or pool of assets.

41. "Banking book" refers to nontrading accounts. See the definition of "trading accounts" in the glossary for the instructions to the bank call report.

Figure 1—Transaction 1



lateralized by the CLNs. Each CLN represents one obligor and the bank's credit-risk exposure to that obligor, which could take the form of bonds, commitments, loans, and counterparty exposures. Since the noteholders are exposed to the full amount of credit risk associated with the individual reference obligors, all of the credit risk of the reference portfolio is shifted from the sponsoring bank to the capital markets. The dollar amount of notes issued to investors equals the notional amount of the reference portfolio. In the example shown in figure 1, this amount is $1.5 billion.

If any obligor linked to a CLN in the SPV defaults, the SI will call the individual CLN and redeem it based on the repayment terms specified in the note agreement. The term of each CLN is set so that the credit exposure (to which it is linked) matures before the maturity of the CLN, which ensures that the CLN will be in place for the full term of the exposure to which it is linked.

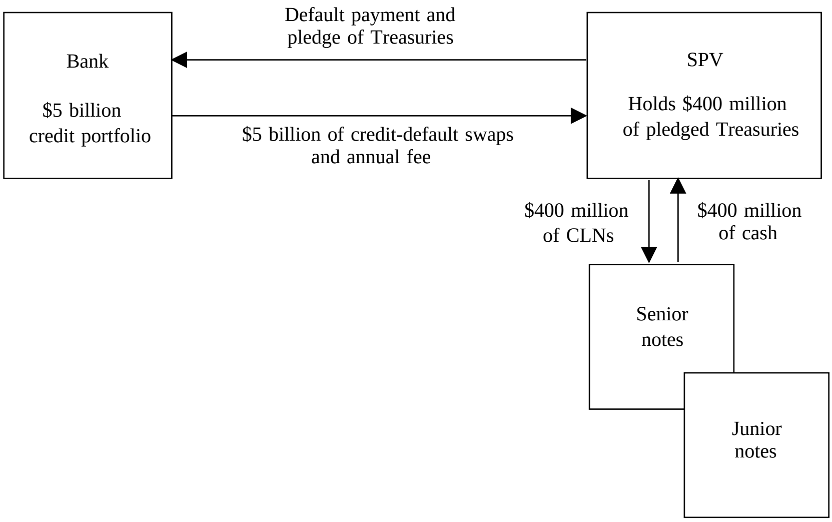
An investor in the notes issued by the SPV is exposed to the risk of default of the underlying reference assets, as well as to the risk that the SI will not repay principal at the maturity of the notes. Because of the linkage between the credit quality of the SI and the issued notes, a downgrade of the sponsor's credit rating most likely will result in the notes also being downgraded. Thus, a BO investing in this type of synthetic CLO should assign the notes to the higher of the risk categories appropriate to the underlying reference assets or the issuing entity.

For purposes of risk-based capital, the SBOs may treat the cash proceeds from the sale of CLNs that provide protection against underlying reference assets as cash collateralizing these assets.[42] This treatment would permit the reference assets, if carried on the SI's books, to be assigned to the zero percent risk category to the extent that their notional amount is fully collateralized by cash. This treatment may be applied even if the cash collateral is transferred directly into the general operating funds of the institution and is not deposited in a segregated account. The synthetic CLO would not confer any benefits to the SBO for purposes of calculating its tier 1 leverage ratio because the reference assets remain on the organization's balance sheet.

Transaction 2—High-quality, senior risk position in the reference portfolio is retained. In the second type of synthetic CLO transaction, the SBO hedges a portion of the reference port-

42. The CLNs should not contain terms that would significantly limit the credit protection provided against the underlying reference assets, for example, a materiality threshold that requires a relatively high percentage of loss to occur before CLN payments are adversely affected, or a structuring of CLN post-default payments that does not adequately pass through credit-related losses on the reference assets to investors in the CLNs.

Figure 2—Transaction 2



folio and retains a high-quality, senior risk position that absorbs only those credit losses in excess of the junior-loss positions. In some recent synthetic CLOs, the SBO has used a combination of credit-default swaps and CLNs to essentially transfer to the capital markets the credit risk of a designated portfolio of the organization's credit exposures. Such a transaction allows the SI to allocate economic capital more efficiently and to significantly reduce its regulatory capital requirements.

In the structure illustrated in figure 2, the SBO purchases default protection from an SPV for a specifically identified portfolio of banking-book credit exposures, which may include letters of credit and loan commitments. The credit risk on the identified reference portfolio (which continues to remain in the sponsor's banking book) is transferred to the SPV through the use of credit-default swaps. In exchange for the credit protection, the SI pays the SPV an annual fee. The default swaps on each of the obligors in the reference portfolio are structured to pay the average default losses on all senior unsecured obligations of defaulted borrowers.

To support its guarantee, the SPV sells CLNs to investors and uses the cash proceeds to purchase U.S. government Treasury notes. The SPV then pledges the Treasuries to the SBO to cover any default losses.[43] The CLNs are often issued in multiple tranches of differing seniority and in an aggregate amount that is significantly less than the notional amount of the reference portfolio. The amount of notes issued typically is set at a level sufficient to cover some multiple of expected losses, but well below the notional amount of the reference portfolio being hedged.

There may be several levels of loss in this type of synthetic securitization. The first-loss position may consist of a small cash reserve, sufficient to cover expected losses. The cash reserve accumulates over a period of years and is funded from the excess of the SPV's income (that is, the yield on the Treasury securities plus the credit-default-swap fee) over the interest paid to investors on the notes. The investors in the SPV assume a second-loss position through their investment in the SPV's senior and junior notes, which tend to be rated AAA and BB, respectively. Finally, the SBO retains a high-quality, senior risk position that would absorb any credit losses in the reference portfolio that exceed the first- and second-loss positions.

Typically, no default payments are made until the maturity of the overall transaction, regardless of when a reference obligor defaults. While operationally important to the SBO, this feature has the effect of ignoring the time value of money. Thus, the Federal Reserve expects that when the reference obligor defaults under the terms of the credit derivative and when the reference asset falls significantly in value, the SBO should, in accordance with GAAP, make appropriate adjustments in its regulatory reports to reflect the estimated loss that takes into account the time value of money.

For risk-based capital purposes, BOs investing in the notes must assign them to the risk weight appropriate to the underlying reference assets.[44] The SBO for such transactions must include in its risk-weighted assets its retained senior exposure in the reference portfolio, to the extent these underlying assets are held in its banking book. The portion of the reference portfolio that is collateralized by the pledged Treasury securities may be assigned a zero percent risk weight. Unless the SBO meets the stringent minimum conditions for transaction 2 that are outlined in the minimum conditions explanation below, the remainder of the portfolio should be risk-weighted according to the obligor of the exposures.

When the SI has virtually eliminated its credit-risk exposure to the reference portfolio through the issuance of CLNs, and when the other stringent minimum conditions are met, the institution may assign the uncollateralized portion of its retained senior position in the reference portfolio to the 20 percent risk weight. However, to the extent that the reference portfolio includes loans and other on-balance-sheet assets, an SBO involved in such a synthetic securitization would not realize any benefits in the determination of its leverage ratio.

In addition to the three stringent minimum conditions, the Federal Reserve may impose other requirements as it deems necessary to ensure that the SI has virtually eliminated all of its credit exposure. Furthermore, the Federal Reserve retains the discretion to increase the risk-based capital requirement assessed against

43. The names of corporate obligors included in the reference portfolio may be disclosed to investors in the CLNs.

44. Under this type of transaction, if a structure exposes investing BOs to the creditworthiness of a substantive issuer, for example, the SI, then the investing institutions should assign the notes to the higher of the risk categories appropriate to the underlying reference assets or the SI.

the retained senior exposure in these structures, if the underlying asset pool deteriorates significantly.

Federal Reserve staff will make a case-by-case determination, based on a qualitative review, as to whether the senior retained portion of an SBO's synthetic securitization qualifies for the 20 percent risk weight. The SI must be able to demonstrate that virtually all the credit risk of the reference portfolio has been transferred from the banking book to the capital markets. As they do when BOs are engaging in more traditional securitization activities, examiners must carefully evaluate whether the institution is fully capable of assessing the credit risk it retains in its banking book and whether it is adequately capitalized given its residual risk exposure. The Federal Reserve will require the SBO to maintain higher levels of capital if it is not deemed to be adequately capitalized given the retained residual risks. In addition, an SI involved in synthetic securitizations must adequately disclose to the marketplace the effect of the transaction on its risk profile and capital adequacy.

The Federal Reserve may consider an SBO's failure to require the investors in the CLNs to absorb the credit losses that they contractually agreed to assume to be an unsafe and unsound banking practice. In addition, such a failure generally would constitute ‘‘implicit recourse’’ or support to the transaction, which would result in the SBO's losing preferential capital treatment on its retained senior position.

If an SBO of a synthetic securitization does not meet the stringent minimum conditions, it may still reduce the risk-based capital requirement on the senior risk position retained in the banking book by transferring the remaining credit risk to a third-party OECD bank through the use of a credit derivative. Provided the credit derivative transaction qualifies as a guarantee under the risk-based capital guidelines, the risk weight on the senior position may be reduced from 100 percent to 20 percent. Institutions may not enter into nonsubstantive transactions that transfer banking-book items into the trading account to obtain lower regulatory capital requirements.[45]

Minimum conditions. The following stringent minimum conditions are those that SIs must meet to use the synthetic securitization capital treatment for transaction 2. The Federal Reserve may impose additional requirements or conditions as deemed necessary to ascertain that the SBO has sufficiently isolated itself from the credit-risk exposure of the hedged reference portfolio.

- *Condition 1—Demonstration of transfer of virtually all of the risk to third parties.* Not all transactions structured as synthetic securitizations transfer the level of credit risk needed to receive the 20 percent risk weight on the retained senior position. To demonstrate that a transfer of virtually all of the risk has been achieved, institutions must—
  - — produce credible analyses indicating a transfer of virtually all of the credit risk to substantive third parties;
  - — ensure the absence of any early-amortization or other credit performance–contingent clauses;[46]
  - — subject the transaction to market discipline through the issuance of a substantive amount of notes or securities to the capital markets;
  - — have notes or securities rated by a nationally recognized credit rating agency;
  - — structure a senior class of notes that receives the highest possible investment-grade rating, for example, AAA, from a nationally recognized credit rating agency;
  - — ensure that any first-loss position retained by the SI in the form of fees, reserves, or other credit enhancements—which effectively must be deducted from capital—is no greater than a reasonable estimate of expected losses on the reference portfolio; and
  - — ensure that the SI does not reassume any credit risk beyond the first-loss position through another credit derivative or any other means.
- *Condition 2—Demonstration of ability to evaluate remaining banking-book risk exposures and provide adequate capital support.* To ensure that the SI has adequate capital for the credit risk of its unhedged exposures, an

45. For instance, a lower risk weight would not be applied to a nonsubstantive transaction in which the SI (1) enters into a credit derivative transaction to pass the credit risk of the senior retained portion held in its banking book to an OECD bank, and then (2) enters into a second credit derivative transaction with the same OECD bank, in which it reassumes into its trading account the credit risk initially transferred.

46. Early-amortization clauses may generally be defined as features that are designed to force a wind-down of a securitization program and rapid repayment of principal to asset-backed securities investors if the credit quality of the underlying asset pool deteriorates significantly.

institution is expected to have adequate systems that fully account for the effect of those transactions on its risk profiles and capital adequacy. In particular, its systems should be capable of fully differentiating the nature and quality of the risk exposures an institution transfers from the nature and quality of the risk exposures it retains. Specifically, to gain capital relief institutions are expected to—

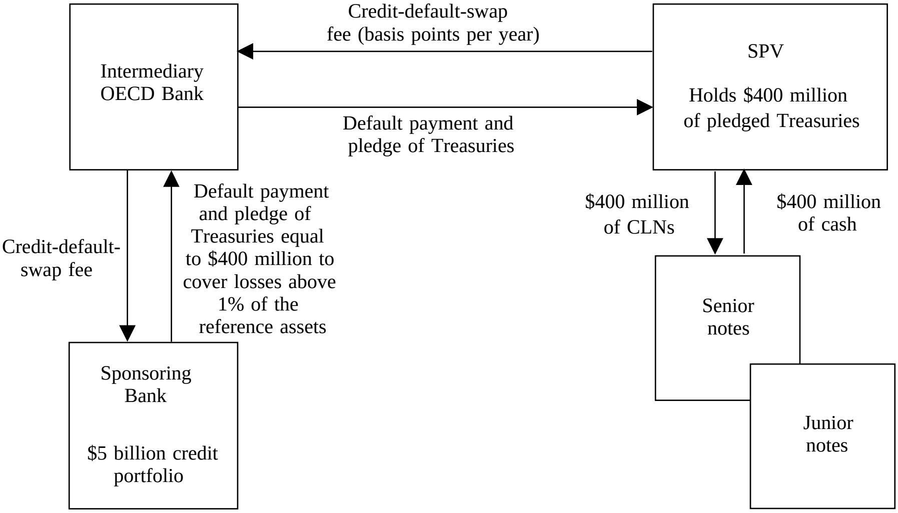
- — have a credible internal process for grading credit-risk exposures, including (1) adequate differentiation of risk among risk grades, (2) adequate controls to ensure the objectivity and consistency of the rating process, and (3) analysis or evidence supporting the accuracy or appropriateness of the risk-grading system;
- — have a credible internal economic capital-assessment process that defines the institution to be adequately capitalized at an appropriate insolvency probability and that readjusts, as necessary, its internal economic capital requirements to take into account the effect of the synthetic-securitization transaction. In addition, the process should employ a sufficiently long time horizon to allow necessary adjustments in the event of significant losses. The results of an exercise demonstrating that the organization is adequately capitalized after the securitization transaction must be presented for examiner review;
- — evaluate the effect of the transaction on the nature and distribution of the nontransferred banking-book exposures. This analysis should include a comparison of the banking book's risk profile and economic capital requirements before and after the transaction, including the mix of exposures by risk grade and business or economic sector. The analysis should also identify any concentrations of credit risk and maturity mismatches. Additionally, the bank must adequately manage and control the forward credit exposure that arises from any maturity mismatch. The Federal Reserve retains the flexibility to require additional regulatory capital if the maturity mismatches are substantive enough to raise a supervisory concern. Moreover, as stated above, the SBO must demonstrate that it meets its internal economic capital requirement subsequent to the completion of the synthetic securitization; and
- — perform rigorous and robust forward-looking stress testing on nontransferred exposures (remaining banking-book loans and commitments), transferred exposures, and exposures retained to facilitate transfers (credit enhancements). The stress tests must demonstrate that the level of credit enhancement is sufficient to protect the sponsoring bank from losses under scenarios appropriate to the specific transaction.

- *Condition 3—Provide adequate public disclosures of synthetic CLO transactions regarding their risk profile and capital adequacy.* In their 10-K and annual reports, SIs must adequately disclose to the marketplace the accounting, economic, and regulatory consequences of synthetic CLO transactions. In particular, institutions are expected to disclose—
  - — the notional amount of loans and commitments involved in the transaction;
  - — the amount of economic capital shed through the transaction;
  - — the amount of reduction in risk-weighted assets and regulatory capital resulting from the transaction, both in dollar terms and in terms of the effect in basis points on the risk-based capital ratios; and
  - — the effect of the transaction on the distribution and concentration of risk in the retained portfolio by risk grade and sector.

Transaction 3—Retention of a first-loss position. In the third type of synthetic transaction, the SBO may retain a subordinated position that absorbs first losses in a reference portfolio. The SBO retains the credit risk associated with a first-loss position and, through the use of credit-default swaps, passes the second- and senior-loss positions to a third-party entity, most often an OECD bank. The third-party entity, acting as an intermediary, enters into offsetting credit-default swaps with an SPV, thus transferring its credit risk associated with the second-loss position to the SPV.[47] The SPV then issues CLNs to the capital markets for a portion of the reference portfolio and purchases Treasury collateral to

47. Because the credit risk of the senior position is not transferred to the capital markets but remains with the intermediary bank, the SBO should ensure that its counterparty is of high credit quality, for example, at least investment grade.

Figure 3—Transaction 3



cover some multiple of expected losses on the underlying exposures. (See figure 3.)

Two alternative approaches could be used to determine how the SBO should treat the overall transaction for risk-based capital purposes. The first approach employs an analogy to the low-level capital rule for assets sold with recourse. Under this rule, a transfer of assets with recourse that contractually is limited to an amount less than the effective risk-based capital requirements for the transferred assets is assessed a total capital charge equal to the maximum amount of loss possible under the recourse obligation. If this rule were applied to an SBO retaining a 1 percent first-loss position on a synthetically securitized portfolio that would otherwise be assessed 8 percent capital, the SBO would be required to hold dollar-for-dollar capital against the 1 percent first-loss risk position. The SI would not be assessed a capital charge against the second and senior risk positions.[48]

The second approach employs a literal reading of the capital guidelines to determine the SBO's risk-based capital charge. In this instance, the one percent *first-loss position* retained by the SI would be treated as a guarantee, that is, a direct-credit substitute, which would be assessed an 8 percent capital charge against its face value of one percent. The *second-loss position*, which is collateralized by Treasury securities, would be viewed as fully collateralized and subject to a zero percent capital charge. The senior-loss position guaranteed by the intermediary bank would be assigned to the 20 percent risk category appropriate to claims guaranteed by OECD banks.[49]

It is possible that the second approach may result in a higher risk-based capital requirement than the dollar-for-dollar capital charge imposed by the first approach. This depends on whether the reference portfolio consists primarily of loans to private obligors or undrawn long-term commitments, which generally have an effective risk-based capital requirement that is one-half of the requirement for loans, since such commitments are converted to an on-balance-sheet credit-equivalent amount using the 50 percent

48. A BO that sponsors this type of synthetic securitization would not realize any benefits with respect to the determination of its leverage ratio since the reference assets remain on the SI's balance sheet.

49. If the intermediary is a BO, then it could place both sets of credit-default swaps in its trading account and, if subject to the Federal Reserve's' market-risk capital rules, use its general-market-risk model and, if approved, specific-risk model to calculate the appropriate risk-based capital requirement. If the specific-risk model has not been approved, then the SBO would be subject to the standardized specific-risk capital charge.

conversion factor. If the reference pool consists primarily of drawn loans to private obligors, then the capital requirement on the senior-loss position would be significantly higher than if the reference portfolio contained only undrawn long-term commitments. As a result, the capital charge for the overall transaction could be greater than the dollar-for-dollar capital requirement set forth in the first approach.

SIs will be required to hold capital against a retained first-loss position in a synthetic securitization equal to the higher of the two capital charges resulting from application of the first and second approaches, as discussed above. Further, although the SBO retains only the credit risk associated with the first-loss position, it still should continue to monitor all the underlying credit exposures of the reference portfolio to detect any changes in the credit-risk profile of the counterparties. This is important to ensure that the institution has adequate capital to protect against unexpected losses. Examiners should determine whether the sponsoring bank has the capability to assess and manage the retained risk in its credit portfolio after the synthetic securitization is completed. For risk-based capital purposes, BOs investing in the notes must assign them to the risk weight appropriate to the underlying reference assets.[50]

Reservation of Authority

The Federal Reserve reserves its authority to determine, on a case-by-case basis, the appropriate risk weight for assets and credit-equivalent amounts and the appropriate credit-conversion factor for off-balance-sheet items. The Federal Reserve's exercise of this authority may result in a higher or lower risk weight for an asset or credit-equivalent amount, or in a higher or lower credit-conversion factor for an off-balance-sheet item. This reservation of authority explicitly recognizes that the Federal Reserve retains sufficient discretion to ensure that banks, as they develop novel financial assets, will be treated appropriately under the regulatory capital standards. Under this authority, the Federal Reserve reserves its right to assign risk positions in securitizations to appropriate risk categories on a case-by-case basis, if the credit rating of the risk position is determined to be inappropriate.

Overall Assessment of Capital Adequacy

The following factors should be taken into account in assessing the overall capital adequacy of a bank.

Capital Ratios

Capital ratios should be compared with regulatory minimums and with peer-group averages. Banks are expected to have a minimum total risk-based capital ratio of 8 percent. However, because risk-based capital does not take explicit account of the quality of individual asset portfolios or the range of other types of risks to which banks may be exposed, such as interest-rate, liquidity, market, or operational risks, banks are generally expected to operate with capital positions above the minimum ratios. Institutions with high or inordinate levels of risk are also expected to maintain capital well above the minimum levels.

The minimum tier 1 leverage ratio is 3 percent. However, an institution operating at or near these levels is expected to have well-diversified risk, including no undue interest-rate risk exposure, excellent asset quality, high liquidity, and good earnings, and to generally be considered a strong banking organization, rated composite 1 under the CAMELS rating system of banks. For all but the most highly rated banks meeting the above conditions, the minimum tier 1 leverage ratio is 3 percent plus an additional cushion of at least 100 to 200 basis points.

Impact of Management

Strategic planning. One of management's most important functions is to lead the organization by designing, implementing, and supporting an effective strategic plan. Strategic planning is a long-term approach to integrating asset deployment, funding sources, capital formation, management, marketing, operations, and information systems to achieve success. Strategic planning helps the organization more effectively

50. Under this type of transaction, if a structure exposes investing BOs to the creditworthiness of a substantive issuer, for example, the SI, then the investing institutions should assign the notes to the higher of the risk categories appropriate to the underlying reference assets or the SI.

anticipate and adapt to change. Management must also ensure that planning information as well as corporate goals and objectives are effectively communicated throughout the organization. Effective strategic planning allows the institution to be more proactive than reactive in shaping its own future. The strategic plan should clearly outline the bank's capital base, anticipated capital expenditures, desirable capital level, and external capital sources. Each of these areas should be evaluated in consideration of the degree and type of risk that management and the board of directors are willing to accept.

Growth. Capital is necessary to support a bank's growth; however, it is the imposition of required capital ratios that controls growth. Because a bank has to maintain a minimum ratio of capital to assets, it will only be able to grow so fast. For example, a rapid growth in a bank's loan portfolio may be a cause of concern, for it could indicate that a bank is altering its risk profile by reducing its underwriting standards.

Dividends. Examiners should review historical and planned cash-dividend payout ratios to determine whether dividend payments are impairing capital adequacy.[51] Excessive dividend payouts may result from several sources:

- If the bank is owned by a holding company, the holding company may be requiring excessive dividend payments from the bank to fund the holding company's debt-repayment program, expansion goals, or other cash needs.
- The bank's board of directors may be under pressure from individual shareholders to provide funds to repay bank stock debt or to use for other purposes.
- Dividends may be paid or promised to support a proposed equity offering.

Access to additional capital. Banks that do not generate sufficient capital internally may require external sources of capital. Large, independent institutions may solicit additional funding from the capital markets. Smaller institutions may rely on a bank holding company or a principal shareholder or control group to provide additional funds, or on the issuance of new capital instruments to existing or new investors. Current shareholders may resist efforts to obtain additional capital by issuing new capital instruments because of the diluting effect of the new capital. In deciding whether to approve obtaining additional capital in this manner, shareholders must weigh the dilution against the possibility that, without the additional funds, the institution may fail.

Under Federal Reserve policy, a bank holding company is expected to serve as a source of strength to its subsidiary banks. A bank holding company can fulfill this obligation by having enough liquidity to inject funds into the bank or by having access to the same sources of additional capital, that is, current or existing shareholders, as outlined above.

Financial Considerations

Capital levels and ratios should be evaluated in view of the bank's overall financial condition, including the following areas.

Asset quality. The final supervisory judgment on a bank's capital adequacy may differ significantly from conclusions that may be drawn solely from the level of a bank's risk-based capital ratio. Generally, the main reason for this difference is the evaluation of asset quality. Final supervisory judgment of a bank's capital adequacy should take into account examination findings, particularly those on the severity of problem and classified assets and investment or loan portfolio concentrations, as well as on the adequacy of the bank's allowance for loan and lease losses.

Balance-sheet composition. A bank whose earning assets are not diversified or whose credit culture is more risk-tolerant is generally expected to operate with higher capital levels than a similar-sized institution with well-diversified, less risky investments.

Earnings. An adequately capitalized, growing bank should have a consistent pattern of capital augmentation by earnings retention. Poor earnings can have a negative effect on capital adequacy in two ways. First, any losses absorbed by capital reduce the ability of the remaining capital to fulfill that function. Second, the impact of losses on capital is magnified by the fact that a bank generating losses is incapable of replenishing its capital accounts internally.

Funds management. A bank with undue levels

51. See also "Dividends," section 4070.1.

of interest-rate risk should be required to strengthen its capital positions, even though it may meet the minimum risk-based capital standards. Assessments of capital adequacy should reflect banks' appropriate use of hedging instruments. Other things being equal, banks that have appropriately hedged their interest-rate exposure will be permitted to operate with lower levels of capital than those banks that are vulnerable to interest-rate changes. While the Federal Reserve does not want to discourage the use of legitimate hedging vehicles, some instruments, in particular interest-only strips (IOs) and principal-only strips (POs), raise concerns. IOs and POs have highly volatile price characteristics as interest rates change, and they are generally not considered appropriate investments for most banks. However, some sophisticated banks may have the expertise and systems to appropriately use IOs and POs as hedging vehicles.

Off-balance-sheet items and activities. Once funded, off-balance-sheet items become subject to the same capital requirements as on-balance-sheet items. A bank's capital levels should be sufficient to support the quality and quantity of assets that would result from a significant portion of these items being funded within a short time.

Adequacy of and Compliance with Capital-Improvement Plans

Capital-improvement plans are required for banks operating with capital ratios below regulatory minimums as required by the prompt-corrective-action part of the Federal Deposit Insurance Act, as well as for some banks operating under supervisory actions. Examiners should review any such plans and determine their adequacy and reasonableness, keeping in mind that banks may meet required capital-to-asset ratios in three ways:

- They may issue more capital. In doing so, banks must weigh the need for additional capital against the dilution of market value that will result.
- They may retain earnings rather than paying them out as dividends.
- They may sell assets. By reducing the amount of total assets, a bank reduces the amount of capital necessary to meet the required ratios.

Inadequate Allowance for Loan and Lease Losses

An inadequate allowance for loan and lease losses (ALLL) will require an additional charge to current income. Any charge to current income will reduce the amount of earnings available to supplement tier 1 capital. Because the amount of the ALLL that can be included in tier 2 capital is limited to 1.25 percent of gross risk-weighted assets, an additional provision may increase the ALLL level above this limit, thereby resulting in the excess portion being excluded from tier 2 capital.

Ineligible Collateral and Guarantees

The risk-based capital guidelines recognize only limited types of collateral and guarantees. Other types of collateral and guarantees may support the asset mix of the bank, particularly within its loan portfolio. Such collateral or guarantees may serve to substantially improve the overall quality of a loan portfolio and other credit exposures, and should be considered in the overall assessment of capital adequacy.

Market Value of Bank Stock

Examiners should review trends in the market price of the bank's stock and whether stock is trading at a reasonable multiple of earnings or a reasonable percentage (or multiple) of book value. A bank's low stock price may merely be an indication that it is undervalued, or it may be indicative of regional or industry-wide problems. However, a low-valued stock may also indicate that investors lack confidence in the institution; such lack of support could impair the bank's ability to raise additional capital in the capital markets.

Subordinated Debt in Excess of Limits

The total of term subordinated debt and intermediate-term preferred stock that may be included in tier 2 capital is limited to 50 percent of tier 1 capital. Amounts issued or outstanding in excess of this limit are not included in the risk-based capital calculation but should be taken into consideration when assessing the bank's funding and financial condition.

Unrealized Asset Values

Banks often have assets on their books that are carried at significant discounts below current market values. The excess of the market value over the book value (historical cost or acquisition value) of assets such as investment securities or banking premises may represent capital to the bank. These unrealized asset values are not included in the risk-based capital calculation but should be taken into consideration when assessing capital adequacy. Particular attention should be given to the nature of the asset, the reasonableness of its valuation, its marketability, and the likelihood of its sale.

TIER 1 LEVERAGE RATIO FOR STATE MEMBER BANKS

The Federal Reserve has adopted a minimum ratio of tier 1 capital to average total assets to assist in the assessment of the capital adequacy of state member banks. The principal objective of this measure (which is intended to be used as a supplement to the risk-based capital measure) is to place a constraint on the maximum degree to which a state member bank can leverage its equity capital base.

The guidelines implementing the tier 1 leverage ratio are found in Regulation H (12 CFR 208), appendix B, and apply to all state member banks on a consolidated basis. The ratio is to be used in the examination and supervisory process, as well as in the analysis of applications acted on by the Federal Reserve.

A bank's tier 1 leverage ratio is calculated by dividing its tier 1 capital (the numerator of the ratio) by its average total consolidated assets (the denominator of the ratio). For purposes of calculating this ratio during an examination, examiners may use the bank's average total assets as of the last call report date. The ratio will be calculated using period-end assets whenever necessary, on a case-by-case basis. For the purpose of this leverage ratio, the definition of tier 1 capital as set forth in the risk-based capital guidelines contained in appendix A of the Federal Reserve's Regulation H is used. Average total consolidated assets are defined as the quarterly average total assets (defined net of the allowance for loan and lease losses) reported on the bank's Reports of Condition and Income (call reports), less goodwill; amounts of mortgage-servicing assets, nonmortgage-servicing assets, and purchased credit-card relationships that, in the aggregate, are in excess of 100 percent of tier 1 capital; amounts of nonmortgage-servicing assets and purchased credit-card relationships that, in the aggregate, are in excess of 25 percent of tier 1 capital; amounts of credit-enhancing interest-only strips that are in excess of 25 percent of tier 1 capital; all other identifiable intangible assets; any investments in subsidiaries or associated companies that the Federal Reserve determines should be deducted from tier 1 capital; deferred tax assets that are dependent on future taxable income, net of their valuation allowance, in excess of the limitations set forth in section II.B. of appendix A of Regulation H; and the amount of the total adjusted carrying value of nonfinancial equity investments that is subject to a deduction from tier 1 capital.

Under the tier 1 leverage ratio guidelines, the minimum level of tier 1 capital to total assets for strong state member banks is 4 percent, unless they are rated composite 1 under the UFIRS (CAMELS) rating system of banks. Institutions not meeting these characteristics, as well as institutions with supervisory, financial, or operational weaknesses, are expected to operate well above minimum capital standards. Institutions experiencing or anticipating significant growth are also expected to maintain capital ratios, including tangible capital positions, well above the minimum levels. Moreover, higher capital ratios may be required for any banking institution if warranted by its particular circumstances or risk profile. In all cases, institutions should hold capital commensurate with the level and nature of the risks, including the volume and severity of problem loans, to which they are exposed.

A bank that does not have a 4 percent leverage ratio (3 percent if it is rated a composite CAMELS 1) is considered undercapitalized under the prompt-corrective-action framework and must file a capital-restoration plan that meets certain requirements.

De Novo Banks

Initial capital in a de novo state member bank should be reasonable in relation to the bank's location, business plan, competitive environment, and state law. At a minimum, however, a de novo bank must maintain a tangible tier 1 leverage ratio (core capital elements minus all intangible assets divided by average total assets minus all intangible assets) of 9 percent for the first three years of operations. The applicant must provide projections of asset growth and earnings performance that reasonably support the bank's ability to maintain this ratio without reliance on additional capital injections. Even though a 9 percent tangible leverage ratio is not required after the third year, de novo banks are expected to maintain capital ratios that are commensurate with ongoing safety-and-soundness concerns, and that are generally well in excess of regulatory minimums.

1. To determine the adequacy of capital.
2. To determine compliance with the risk-based and tier 1 leverage capital adequacy guidelines.
3. To determine if the policies, practices, and procedures with regard to the capital adequacy guidelines are adequate.
4. To determine if the bank's officers and employees are operating in conformity with the Board's established capital adequacy guidelines.
5. To evaluate the propriety and consistency of the bank's present and planned level of capitalization in light of the risk-based and leverage capital guidelines, as well as existing conditions and future plans.
6. To initiate corrective action when policies, procedures, or capital are deficient.
7. To evaluate whether—
   a. the institution is fully capable of assessing the credit risk associated with the collateralized loan obligations (CLOs) it retains in its banking book (nontrading accounts); and
   b. the institution is adequately capitalized given its residual risk exposure involving CLOs.

VERIFICATION OF THE RISK-BASED CAPITAL RATIO

Examiners should verify that the bank has adequate systems in place to compute and document its risk-based capital ratios. Small banks with capital ratios well in excess of established minimums may not have a system explicitly designed to capture risk-based capital information. In addition, depending on a bank's current capital structure and ratios, all procedures may not apply.

1. Verify that the bank is correctly reporting risk-based capital information requested on its Reports of Condition and Income.

For the qualifying components of capital:

2. Determine if management is adhering to the underlying terms of any currently outstanding stock issues.
3. Review common stock to ensure that the bank is in compliance with the terms of any underlying agreement(s) and to determine if more than one class exists. When more than one class exists, review the terms for any preference or nonvoting features. If the terms include such features, determine whether the class of common stock qualifies for inclusion in tier 1 capital.
4. Review any perpetual and long-term preferred stock for the following:
   a. Compliance with terms of the underlying agreement(s) carefully noting—
      - adherence to the cumulative or noncumulative nature of the stock, and
      - adherence to any conversion rights.
   b. Proper categorization as tier 1 or tier 2 for capital adequacy purposes, noting the following requirements:
      - Tier 1 perpetual preferred stock must have the following characteristics:
        — no maturity date
        — cannot be redeemed at the option of the holder
        — unsecured
        — ability to absorb losses
        — ability and legal right for issuer to defer or eliminate dividends
        — any issuer redemption feature must be subject to Federal Reserve prior approval
        — noncumulative
        — fixed rate or traditional floating or adjustable rate
        — must not contain features which would require or create an incentive for the issuer to redeem or repurchase the instrument, such as an "exploding rate," an auction-rate pricing mechanism, or a feature that allows the stock to be converted into increasing numbers of common shares.
      - Perpetual preferred stock, includable within tier 2 capital without a sublimit, must have characteristics (a) through (f) listed above for tier 1 perpetual preferred stock, but does not otherwise qualify for inclusion in tier 1 capital. For example, cumulative or auction-rate perpetual preferred stock, which do not qualify for tier 1 capital, may be includable in tier 2 capital.
5. Verify that minority interest in equity accounts of consolidated subsidiaries included in tier 1 capital consists of tier 1 capital elements. Determine whether any perpetual preferred stock of a subsidiary that is included in minority interest is secured by the subsidiary's assets; if so, that stock may not be included in capital.
6. Review the intermediate-term preferred stock and subordinated debt instruments included in capital for the following:
   a. Compliance with terms of the underlying agreement(s), noting that subordinated debt containing the following terms may not be included in capital:
      - interest payments tied to the bank's financial condition
      - acceleration clauses or broad conditions of events of default that are inconsistent with safe and sound banking practices.
   b. Compliance with restrictions on the inclusion of such instruments in capital by verifying that the aggregate amount of both types of instruments does not exceed 50 percent of tier 1 capital (net

of goodwill) and that the portions includable in tier 2 capital possess the following characteristics:
- unsecured
- minimum five-year original weighted average maturity
- in the case of subordinated debt, contains terms stating that the debt (1) is not a deposit, (2) is not insured by a federal agency, (3) cannot be redeemed without prior approval from the Federal Reserve, and (4) is subordinated to depositors and general creditors.

c. Appropriate amortization, if the instruments have a remaining maturity of less than five years.

7. Determine, through review of minutes of the board of directors meetings, if a stock offering or subordinated debt issue is being considered. If so, determine that management is aware of the risk-based capital requirements for inclusion in capital.
8. Review any mandatory convertible debt securities for the following:
   a. Compliance of the terms with the criteria set forth in 12 CFR 225 (Regulation Y), appendix B.
   b. Notification in the terms of agreement that the redemption or repurchase of such securities before maturity is subject to prior approval from the Federal Reserve.
   c. The treatment of the portions of such securities covered by the issuance of common or perpetual preferred stock dedicated to the repayment of the securities, bearing in mind the following:
      - the amount of the security covered by dedicated stock should be treated as subordinated debt and is subject, together with other subordinated debt and intermediate-term preferred stock, to a sublimit within tier 2 capital of 50 percent of tier 1 capital, as well as to amortization in the last five years of life.
      - the portion of a mandatory convertible security that is not covered by dedication qualifies for inclusion in tier 2 capital without any sublimit and without being subject to amortization in the last five years of life.
9. Verify that the amount of the allowance for loan and lease losses included in tier 2 capital has been properly calculated.

For the calculation of risk-weighted assets:

10. Verify that each on- and off-balance-sheet item has been assigned to the appropriate risk category in accordance with the risk-based capital guidelines. Close attention should be paid to the underlying obligor, collateral, and guarantees, and to assignment to a risk category based upon the terms of a claim. The claim should be assigned to the risk category appropriate to the highest risk option available under the terms of the transaction. Verify that the bank's documentation supports the assignment of preferential risk weights. If necessary, recalculate the value of risk-weighted assets.
11. Verify that all off-balance-sheet items have been converted properly to credit-equivalent amounts based on the risk-based capital guidelines. Close attention should be paid to the proper reporting of assets sold with recourse, financial and performance standby letters of credit, participations of off-balance-sheet transactions, and commitments.

VERIFICATION OF THE TIER 1 LEVERAGE RATIO

12. Verify that the bank has correctly calculated tier 1 capital in accordance with the definition of tier 1 capital for year-end 1992 as set forth in the risk-based capital guidelines.
13. Verify that the bank has properly calculated average total consolidated assets, which are defined as the quarterly average total assets as reported on the call report, less goodwill and any other intangible assets and any investments in subsidiaries that the Federal Reserve determines should be deducted from tier 1 capital.

OVERALL ASSESSMENT OF CAPITAL ADEQUACY

14. For banks that do not meet the minimum risk-based tier 1 leverage capital standards or that are otherwise considered to lack sufficient capital to support their activities,

examine the bank's capital plans for achieving adequate levels of capital and determine whether they are acceptable to the Federal Reserve in conjunction with the Reserve Bank's management. Review and comment on these plans and any progress achieved in meeting the requirements.

15. The review processes entailed in ''Overall Conclusions Regarding Condition of the Bank,'' section 5020.1, require an evaluation of the propriety and consistency of the bank's present and planned level of capitalization in light of existing conditions and future plans. In this regard, the examiner assigned to assessing capital adequacy should—
    a. Using the latest Uniform Bank Performance Report (UBPR), analyze applicable ratios involving capital funds, comparing these ratios with those of the bank's peer group and investigating trends or significant variations from peer-group averages.
    b. Determine that capital is sufficient to compensate for any instabilities or deficiencies in asset and liability mix and quality mentioned in the ''funds management'' paragraph (''Financial Considerations'' subsection).
    c. Determine if the bank's earnings performance enables it to fund its expansion adequately, to remain competitive in the market, and to replenish and/or increase its capital funds as needed.
    d. Analyze trends in the bank's deposit and borrowed funds structure to determine whether capital is maintained at a level sufficient to sustain depositor and lender confidence.
    e. If the reserve for loan losses is determined to be inadequate, analyze the impact of current and potential losses on the bank's capital structure. See ''Analytical Review and Income and Expense,'' section 4010.1.
    f. Consider the impact of any management deficiencies on present and projected capital.
    g. Determine if there are any assets or contingent accounts whose quality represents an actual or potential serious weakening of capital.
    h. Consider the potential impact, should approval be given, of any proposed changes in controlling ownership on the projected capital position.
    i. Analyze assets which are considered undervalued on the balance sheet and carried at below-market values. The excess of market value over cost may represent an additional cushion to the bank.
    j. Consider the cushion for absorbing losses that may be provided by any subordinated debt or intermediate-term preferred stock not included in tier 2 capital because of the 50 percent of tier 2 capital limitation or that is not included in capital for tier 1 leverage ratio purposes.
    k. Analyze any collateral and guarantees supporting assets that may not be taken into account for risk-based or tier 1 leverage capital purposes and consider these in the overall assessment of capital adequacy.
    l. Evaluate the bank's overall asset quality and determine whether the bank needs to strengthen its capital position based on the following:
        - the severity of problem and classified assets
        - investment or loan portfolio concentrations
        - the adequacy of loan-loss reserves
    m. Analyze the bank's interest-rate risk and use of hedging instruments. Determine if the bank should strengthen its capital position based on undue levels of risk. Review hedging instruments for use of IOs and POs (which raise concerns), and management's expertise in using hedging instruments.
    n. Determine whether the sponsoring bank is able to assess and manage the retained risk in its credit portfolio after the issuance of synthetic collateralized loan obligations.
    o. If the bank has used the special risk-based regulatory capital treatment for synthetic CLOs, verify that the stringent minimum conditions have been met for that treatment.

16. Review capital adjustments such as goodwill and intangible assets by performing the following procedures:
    a. Verify the existence of adequate documentation concerning original and carrying values and the amortization method.
    b. Verify that intangibles are being reduced in accordance with the amortization

method, and that if the carrying amount exceeds the value, the intangible is written down or off.
   c. Determine if the bank is performing a quarterly review of the level and quality of all intangibles.
   d. Verify that goodwill and nonqualifying identifiable intangibles are deducted from tier 1 capital.
   e. Determine the proper inclusion of other identifiable intangibles included in tier 1 capital by verifying that the criteria outlined in the risk-based capital guidelines are met.
17. In light of the analysis conducted in step 15, and in accordance with the Federal Reserve's capital adequacy guidelines, determine any appropriate supervisory action with regard to the bank's capital adequacy.
18. Review the following items with the examiner-in-charge in preparation for discussion with appropriate management:
   a. all deficiencies noted with respect to the capital accounts
   b. adequacy of present and projected capital
19. Ascertain through minutes, reports, etc., or through discussions with management, how the future plans of the bank (for example, growth through commercial lending, retail operations, etc.) will affect the bank's asset quality, capital position, and other areas of its balance sheet.
20. Prepare comments for the examination report on the bank's capital position, including any deficiencies noted.
21. Update the workpapers with any information that will facilitate future examinations.

Review the bank's internal controls, policies, practices, and procedures concerning capital. The bank's system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used, and other pertinent information. Items marked with an asterisk require substantiation by observation or testing.

GENERAL

1. Has the bank established procedures to ensure that—
   a. all components of capital are accurately categorized and reported for purposes of the risk-based and leverage capital measures?
   b. all on-and off-balance-sheet items are accurately risk-weighted and reported for purposes of the risk-based capital measures?
   c. categorization of on- and off-balance-sheet items and capital for purposes of the risk-based capital measures is adequately documented?
   d. the bank is in compliance with the terms of any contractual agreements underlying capital instruments?
   e. management and the board of directors consider the requirements of the risk-based capital guidelines for inclusion in capital of stock or debt prior to issuance?
2. Does the bank prepare a periodic analysis of its risk-based and leverage capital positions to assess capital adequacy for both current and anticipated needs?

*3. Has the board of directors authorized specific bank officers to—
   a. sign stock certificates?
   b. maintain custody of unissued stock certificates?
   c. maintain stock journals and records?

*4. Are capital transactions verified by more than one person before stock certificates are issued?

*5. Are stock certificates and debentures handled by persons who do not also record those transactions?

*6. Does the bank maintain a stock certificate book with certificates serially numbered by the printer?

*7. Is the stock certificate book maintained under dual control?

*8. Does the bank's policy prohibit the signing of blank stock certificates?

*9. Does the bank maintain a shareholders' ledger that shows the total number of shares owned by each stockholder?

*10. Does the bank maintain a stock transfer journal disclosing names, dates, and amounts of transactions?

*11. Does the bank cancel surrendered stock certificates?

*12. Are inventories of unissued notes or debentures—
   a. maintained under dual control?
   b. counted periodically by someone other than the person responsible for their custody?

*13. When transfers are made—
   a. are notes or debentures surrendered and promptly cancelled?
   b. are surrendered notes or debentures inspected to determine that proper assignment has been made and that new notes or debentures agree in amount?

CONCLUSION

14. Indicate additional procedures used in arriving at conclusions.
15. Are internal controls of capital adequate based on a composite evaluation, as evidenced by answers to the foregoing questions?

[Reserved]

INTRODUCTION

This section is designed to help the examiner develop an overview of a bank's financial condition and results of operations through the use of analytical review techniques. It also provides procedures to assist in evaluating the reasonableness and reliability of the bank's income and expense accounts. (However, no analytical view of a bank's operating results is complete without due consideration of the stability and probable continuity of the earnings. In this regard, the examiner must remain cognizant of the inextricable links between liquidity and earnings and the implications of a bank's funds-management decisions, particularly those dealing with interest-rate risk.

GENERAL EXAMINATION APPROACH

The review and analysis of the bank's financial condition and results of operations should begin during the pre-examination analysis of the bank (see ''Examination Strategy and Risk-Focused Examinations,'' section 1000). Pre-examination analysis is meant to determine potential problem areas so that proper staff levels and appropriate examination procedures can be used. The analysis will be performed using the most recent Uniform Bank Performance Report (UBPR). (See ''Federal Reserve System Surveillance Program,'' section 1020.)

Questions raised during the preliminary review should be answered and substantiated soon after commencing the examination, while performing the more comprehensive analytical review. The analytical review should use the UBPR financial statements and reports, detail trial balances, analyses of accounts, financial budgets, statistical information, and any other relevant data available at the bank. Explanations for unusual conditions identified during the review, and work performed to substantiate such explanations, should be documented in the examination workpapers.

If internal or external auditors have not performed adequate audit procedures relating to income and expenses, the examiner should test check computations for accuracy and trace entries to appropriate accounts. (See ''Internal Control,'' section 1010, for a discussion of procedures to use in reviewing the audit work of others.)

ANALYTICAL REVIEW

Analytical review involves a comparison of detail balances or statistical data on a period-to-period basis in an effort to substantiate reasonableness without systematic examination of the transactions that make up the account balances. Analytical review is based on the assumption that comparability of period-to-period balances and ratios shows them to be free from significant error. A well-performed analytical review not only benefits the examination by providing an understanding of the bank's operations, but also highlights matters of interest and potential problem situations which, if detected early, might avert more serious problems.

Analytical Tools

The basic analytical tools available to the examiner are the UBPR and the bank's financial statements. Internally prepared statements and supplemental schedules, if available, are excellent additions to an in-depth analytical review. The information from those schedules may give the examiner considerable insight into the interpretation of the bank's basic financial statements. However, internally prepared information alone is not sufficient to adequately analyze the financial condition of the bank. To properly understand and interpret financial and statistical data, the examiner should be familiar with current economic conditions and with any secular, cyclical, or seasonal factors in the nation, region, and local area, including general industry conditions. Economic and industry information, reports, and journals are an important source for knowledge of industry conditions. Finally, the examiner should be knowledgeable about new banking laws and pending legislation that could have a material impact on financial institutions.

Review of Financial Statements

An analytical review of a bank's financial statements requires professional judgment and an inquiring attitude. During the analysis, the examiner should avoid details not specifically related to his or her objective so that excessive time is not spent analyzing relatively immaterial amounts.

Generally, it is more efficient to review financial data that have been rounded to the nearest thousand. Undue precision in computing and reviewing ratios should be avoided. An evaluation of the meaning of the ratios and amounts being compared is important; little can be gained by computing ratios for totally unrelated items. When comparing bank data to peer-group data, the examiner should consider whether the bank is typical of its peer group (a group of banks of similar size and reporting characteristics). For example, the bank might be of comparable size to its peers, but still be atypical because its earning assets are composed principally of agricultural loans or mortgage loans. The age of the institution should also be taken into account when using peer-group data, as newly chartered de novo banks tend to produce distorted ratios (versus the peer group).

Alternative accounting treatments for similar transactions among peer banks also should be considered because they may produce significantly different results. The analytical review must be based on figures derived under valid accounting practices consistently applied, particularly in the accrual areas. Accordingly, during the analytical review, the examiner should determine any material inconsistencies in the application of accounting principles.

The examiner also should be aware of the difficulty of interpreting the cash basis accounting method. Any required adjustments should be documented and explained in the workpapers and examination report.

UBPR

Another analytical tool available to the examiner is the UBPR. The user's guide for the UBPR explains how a structured approach to financial analysis should be followed. This approach breaks down the income stream into its major components of interest margin performance, overhead, noninterest income, loan-loss provisions, tax factors, and extraordinary items. These major components can then be broken down into various subcomponents. Also, the balance-sheet composition, along with economic conditions, must be analyzed to explain the income stream and its possible future variability.

In addition to UBPR analysis and review of bank financial statements, the examiner should incorporate a review of management's budget and/or projections into his or her analysis. A review of projections and individual variances from the operating budget can often provide valuable insight into an institution's prior and future earnings. The examiner should also verify the reasonableness of the budgeted amounts, frequency of budget review by bank management and the board of directors, and level of involvement of key bank personnel in the budget process.

The primary source of information used to prepare UBPRs are the Consolidated Reports of Condition and Income, which are filed quarterly. The content and frequency of these reports are sufficient to allow the reviewer of the UBPR to detect unusual or significantly changed circumstances within a bank, and they normally will be adequate for the purposes of analytical review. Accordingly, the examiner must check these consolidated reports to ensure the resulting accuracy of the UBPRs.

Frequently, the examiner may be interested in a more detailed and current review of the bank than that provided by the UBPR system. Under certain circumstances, UBPR procedures may need to be supplemented because—

- asset-quality information must be linked to the income stream;
- more detailed information is necessary on asset-liability maturities and matching;
- more detailed information is necessary on other liquidity aspects, as they may affect earnings;
- yield or cost information, which may be difficult to interpret from the report, is needed;
- certain income or expense items may need clarification, as well as normal examination validation;
- volume information, such as the number of demand deposits, certificates of deposit, and other accounts, is not reported, and vulnerability in a bank subject to concentrations normally should be considered;
- components of interest and fees on loans are not reported separately by category of loan; thus, adverse trends in the loan portfolio may not be detected (For example, the yield of a particular bank's loan portfolio may be similar to those of its peer group, but the examiner

may detect an upward trend in yields for a specific category of loans. That upward trend might be partially or wholly offset by a downward trend of yields in another category of loans, and the examiner should consider further investigating the circumstances applicable to each of those loan categories. A change in yields could be a result of a change in the bank's "appetite" for certain types of loans or may indicate a change in loan underwriting standards.); or
- income or expense resulting from a change in the bank's operations, such as the opening of a new branch or starting of a mortgage banking activity or trust department, may skew performance ratios. (When there has been a significant change in a bank's operations, the examiner should analyze the potential impact of the change on future bank earnings.)

Written Analysis

After the examiner has completed the analytical review of income and expense, he or she should prepare a written analysis to be submitted to the examiner-in-charge. This evaluation should include, but is not limited to, a review of the bank's—

- quality and future prospects for core income;
- ability to cover losses and maintain adequate capital, including compliance with the minimum capital standard;
- earnings levels and trends;
- composition of earnings and sustainability of the various earnings components (This may include a discussion of balance-sheet composition, particularly the volume and type of earning assets and off-balance-sheet items, if applicable.);
- peer-group comparisons;
- vulnerability to interest-rate and other market or price risks;
- income and expense accounts, and their reliability, including applicable accounting practices, internal controls, and audit methods;
- compliance with laws and regulations relating to earnings and dividends; and
- budgeting process and the levels of management involved in it.

Examiners should consider the adequacy of provisions to the loan-loss reserve. If the examiners conducting the asset quality review determine that the loan-loss reserve is inadequate, the bank's earnings are inflated and should be restated accordingly. In turn, this determination should be factored into the examiner's assessment of management, including its responsibility to maintain an adequate loan-loss reserve.

Consideration should also be given to the interrelationships that exist between the dividend-payout ratio, the rate of growth of retained earnings, and the adequacy of bank capital. Examiners should consider the extent to which extraordinary items, securities transactions, and taxes affect net income. The links between earnings and liquidity and the implications of a bank's funds management decisions, particularly with respect to interest-rate sensitivity, should also be fully analyzed.

1. To detect significantly changed circumstances before or as early as possible during the examination so that any impact on the determination of the scope and conduct of the examination may be assessed.
2. To analyze the financial position and operations of the bank and to investigate any unusual fluctuations.
3. To assist in determining the reliability of the bank's financial information and the consistency of the application of accounting principles.
4. To determine if accounting policies, practices, procedures, and internal controls relating to income and expenses are adequate.
5. To determine the scope and adequacy of the audit function.
6. To determine compliance with laws and regulations relating to income and expenses to the extent that such compliance is not covered elsewhere in the examination.
7. To initiate corrective action when deficiencies or violations of law or regulation have been discovered.

1. Obtain the Uniform Bank Performance Report and, through a general review of it, note any conditions of interest particularly significant changes in trends and levels of income and expense categories that would indicate present problems or shifts in business emphasis including new directions or activities undertaken.
2. Determine early in the examination if any significant changes have occurred in:
   - Operations.
   - Accounting practices or records.
   - Financial reporting.
   - General business conditions.
3. If selected for implementation complete or update the Income and Expense section of the Internal Control Questionnaire.
4. Based on the evaluation of internal controls, the work performed by internal/external auditors and the results of performing the above procedures, determine the scope of the examination.
5. Test for compliance with policies, practices, procedures and internal controls in conjunction with performing the remaining examination procedures.
6. Obtain the bank's current financial statements, internal operating reports, interim financial statements, reports filed with the Federal Reserve and daily statements of condition or other available financial information, then review balances and amounts relative to information in the UBPR staying alert for the development or continuation of adverse trends and other significant or unusual trends or fluctuations. Primary considerations should include whether:
   - Significant structural changes are occurring in the bank that may impact the earnings stream.
   - The bank is making use of tax carrybacks or carryforwards.
   - Earnings are static or declining as a percentage of total resources.
   - Income before securities gains and losses is decreasing as a percentage of total revenues.
   - The ratio of operating expense to operating revenue is increasing.
   - Earnings trends are inconsistent.
   - The spread between interest earned and interest paid is decreasing.
   - Loan losses are increasing.
   - Provisions for loan losses are sufficient to cover loan losses and maintain reserves at an adequate level.
   - There is evidence that sources of interest and other revenues have changed since the last examination.
   - Earnings are deemed inadequate to provide increased capitalization commensurate with the bank's growth.
7. Obtain and review the bank's formalized planning procedures, profit plans, budgets, mid- and long-range financial plans, economic advisory reports, and any progress reports related to any of those and:
   a. Compare actual results to budgeted amounts.
   b. Determine the impact of any broad and important specific goals which have been set.
   c. Determine the frequency of planning revisions.
   d. Determine what triggers a specific plan revision.
   e. Determine who initiates plan revisions.
   f. Determine whether explanations are required for significant variations and whether causes are ascertained in implementating corrective action.
   g. Determine the sources of input for forecasts, plans and budgets.
   h. Extract any information considered relevant to the completion of ''Management Assessment'' and ''Overall Conclusions Regarding Condition of the Bank.''
8. Scan ledger accounts for unusual entries, as considered necessary. Examples of such items include:
   - Significant deviations from the normal amounts of recurring entries.
   - Unusual debit entries in income accounts or unusual credit entries in expense accounts.
   - Significant entries from an unusual source, such as a journal entry.
   - Significant entries in ''other income'' or ''other expense'' which may indicate fees or service losses on an off balance sheet activity (i.e., financial advisory or underwriting services).

9. Investigate, as appropriate, conditions of interest disclosed by the procedures in steps 1 and 2 and 6 through 8 by:
   a. Discussing exceptions or questionable findings with the examiner responsible for conducting those aspects of the examination which are most closely related to the item of interest, to determine if a satisfactory explanation already has been obtained.
   b. Reviewing copies of work papers prepared by internal auditors or management that explain account fluctuations from prior periods or from budgeted amounts.
   c. Discussing unresolved items with management.
   d. Reviewing underlying supporting data and records, as necessary, to substantiate explanations advanced by management.
   e. Performing any other procedures considered necessary to substantiate the authenticity of the explanations given.
   f. Reaching a conclusion as to the reasonableness of any explanations offered by other examiners or management and deciding whether extensions of examination or verification procedures are necessary.
10. Determine compliance with appropriate laws and regulations.
11. Review with officers of the bank and prepare, in appropriate report format, listings of:
   a. Deficiencies in and deviations from, policies, practices, procedures, and internal controls.
   b. Violations of law.
   c. Adverse trends.
   d. Any UBPR peer group or local constructed peer group data which should be brought to the attention of management.
   e. Comments on earnings.
12. Update workpapers with any information that will facilitate future examinations.

Review the bank's internal controls, policies, practices and procedures over income and expenses. The bank's system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used and other pertinent information. Items marked with an asterisk require substantiation by observation or testing.

GENERAL

1. Does the bank have a budget? If so:
   a. Is it reviewed and approved by managerial personnel and/or the board of directors?
   b. Is it periodically reviewed and updated for changed conditions?
   c. Are periodic statements compared to budget and are explanations of variances reviewed by managment?
   d. Is a separate budget prepared by the manager of each department or division?
2. Does the bank's accounting system provide sufficiently detailed breakdowns of accounts to enable it to analyze fluctuations?

*3. Are the general books of the bank maintained by someone who does not have access to cash?

4. Are all general ledger entries processed through the proof department?
5. Are all entries to the general ledger supported by a general ledger ticket?
6. Do general ledger tickets, both debit and credit, bear complete approvals, descriptions and an indication of the offset?

*7. Are all general ledger entries approved by a responsible person other than the general ledger bookkeeper or person associated with its preparation?

8. Is the general ledger posted daily?
9. Is a daily statement of condition prepared?

*10. Are corrections to ledgers made by posting a correcting entry and not by erasing (manual system) or deleting (computerized system) the incorrect entry?

11. Are supporting worksheets or other records maintained on accrued expenses and taxes?
12. Are those supporting records periodically reconciled with the appropriate general ledger controls?

PURCHASES

*13. If the bank has a separate purchasing department, is it independent of the accounting and receiving departments?

*14. Are purchases made only on the basis of requisitions signed by authorized individuals?

*15. Are all purchases routed through a purchasing department or personnel functioning in that capacity?

16. Are all purchases made by means of prenumbered purchase orders sent to vendors?
17. Are all invoices received checked against purchase orders and receiving reports?
18. Are all invoices tested for clerical accuracy?
19. Are invoice amounts credited to their respective accounts and tested periodically for accuracy?

DISBURSEMENTS

*20. Is the payment for all purchases, except minor items, made by official checks?

*21. Does the official signing the check review all supporting documents?

*22. Are supporting vouchers and invoices cancelled to prevent re-use?

*23. Are duties and responsibilities in the following areas segregated?
   a. Authorization to issue expense checks?
   b. Preparation of expense checks?
   c. Signing of expense checks?
   d. Sending of expense checks?
   e. Use and storage of facsimile signatures?
   f. General ledger posting?
   g. Subsidiary ledger posting?

PAYROLL

24. Is the payroll department separate from the personnel department?
25. Are signed authorizations on file for all payroll deductions including W-4s for withholding?
26. Are salaries authorized by the board of directors or its designated committee?

27. Are individual wage rates authorized in writing by an authorized officer?
28. Are vacation and sick leave payments fixed or authorized?
29. Are payrolls paid from a special bank account or directly credited to the employee's demand deposit account?
30. Are time records reviewed and signed by the employee's supervisor?
31. Are double checks made of hours, rates, deductions, extension, and footings?
32. Are payroll signers independent of the persons approving hours worked and preparation of the payroll?
33. If a check signing machine is used, are controls over its use adequate (such as a dual control)?
34. Are payrolls subject to final officer approval?
35. Are the names of persons leaving employment of the bank reported promptly, in writing, to the payroll department?
36. Are payroll expense distributions reconciled with the general payroll payment records?

CONCLUSION

37. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
38. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate, inadequate).

Funds management is at the core of sound bank planning and financial management. Although funding practices, techniques, and norms have been revised substantially in recent years, funds management is not a new concept. It is the process of managing the spread between interest earned and interest paid while ensuring adequate liquidity. Therefore, funds management has two components—liquidity and interest-rate risk management.

To evaluate a bank's funds management, an understanding of the bank, its customer mix, the nature of its assets and liabilities, and its economic and competitive environment is required. No single theory can be applied universally to all banks.

LIQUIDITY

Liquidity is the ability to accommodate decreases in liabilities and to fund increases in assets. A bank has adequate liquidity when it can obtain sufficient funds, either by increasing liabilities or converting assets, promptly and at a reasonable cost. Liquidity is essential in all banks to compensate for expected and unexpected balance-sheet fluctuations and to provide funds for growth. The price of liquidity is a function of market conditions and the market's perception of risks, both interest-rate and credit, as reflected in the bank's on-balance-sheet and off-balance-sheet activities. Additionally, market perceptions of a bank's management and strategic direction can be critical to the price of liquidity. To the extent that liquidity needs are met through holdings of high-quality short-term assets, the price of liquidity is the income sacrificed by not holding longer-term or lower-quality assets. If liquidity needs are not met through liquid asset holdings, a bank may be forced to restructure or acquire additional liabilities under adverse market conditions.

Liquidity exposure can stem from both internally (institution-specific) and externally generated factors. Sound liquidity-risk management should address both types of exposure. External liquidity risks can be geographic (such as the premiums required on deposits within a certain state), systemic (such as the adverse effects on several large banks of the near failure of a large regional bank), or instrument-specific (such as the collapse of a floating-rate note market). Internal liquidity risk relates largely to how an institution is perceived in its various markets: local, regional, national, or international.

An analysis of the following factors will help to determine the adequacy of a bank's liquidity position:

- historical funding requirements
- current liquidity position
- anticipated future funding needs
- sources of funds
- options for reducing funding needs or attracting additional funds
- current and anticipated asset quality
- current and future earnings capacity
- current and planned capital position

To satisfy its funding needs, a bank must perform one or a combination of the following:

- dispose of liquid assets
- increase short-term borrowings (or issue additional short-term deposit liabilities)
- decrease holdings of less-liquid assets
- increase liabilities of a term nature
- increase capital funds

All banks are affected by changes in the economic climate, so the monitoring of economic and money market trends is key to liquidity planning. Sound financial management can minimize the negative effects of these trends while accentuating the positive ones. Factors that management should consider in liquidity planning include—

- internal costs of funds,
- maturity and repricing mismatches in the balance sheet,
- anticipated funding needs,
- economic and market forecasts, and
- the need to maintain a plan that ensures adequate access to a diversified array of readily accessible, confirmed funding sources, including liquid assets such as high-grade investment securities and a diversified mix of wholesale and retail borrowings.

Management must have an effective contingency plan that identifies minimum and maximum liquidity needs and weighs alternative courses of action designed to meet those needs.

Some factors that may affect a bank's liquidity include—

- a decline in earnings,
- an increase in nonperforming assets,
- deposit concentrations,
- a downgrading by a rating agency,
- expanded business opportunities,
- acquisitions, and
- new tax initiatives.

Once liquidity needs have been determined, management must decide how to meet them through asset management, liability management, or a combination of both.

Sound Liquidity-Risk Management

Sound liquidity-risk management requires the following four elements.[1]

- Well-established strategies, policies, and procedures for managing both the sources and uses of an institution's funds across various tenors or time frames. (This includes assessing and planning for short-term, intermediate-term, and long-term liquidity needs.)
- Liquidity-risk measurement systems that are appropriate for the size and complexity of the institution. (Depending upon the institution, such measurement systems can range from simple gap-derived cash-flow measures to very sophisticated cash-flow simulation models.)
- Adequate internal controls and internal audit processes. (Internal controls and internal audit reviews are needed to ensure compliance with internal liquidity management policies and procedures.)
- Comprehensive liquidity contingency planning. (Contingency plans need to be well designed and should span a broad range of potential liquidity events that are tailored to an institution's specific business lines and liquidity-risk profile.)

1. See the July 23, 2003, Interagency Advisory on the Use of the Federal Reserve's Primary Credit Program in Effective Liquidity Management, issued by the federal financial institution regulatory agencies. The interagency advisory supplements and does not replace existing agency guidance or policy. See also section 4010.0 of the *Bank Holding Company Supervision Manual*.

Adequate liquidity contingency planning is critical to the ongoing maintenance of the safety and soundness of any depository institution. Contingency planning starts with an assessment of the possible liquidity events that an institution might encounter. The types of potential liquidity events considered should range from high-probability/low-impact events that can occur in day-to-day operations to low-probability/high-impact events that can arise through institution-specific or systemic market or operational circumstances. Responses to these events should be assessed in the context of their implications for an institution's short-term, intermediate-term, and long-term liquidity profile. A fundamental principle in designing contingency plans for each of these liquidity tenors is to ensure adequate diversification in the potential sources of funds that could be used to provide liquidity. Such diversification should not only focus on the number of potential funds providers but on the underlying stability, availability, and flexibility of funds sources in the context of the type of liquidity event they are expected to address.

Liquidity-Risk Management Using the Federal Reserve's Primary Credit Program

The Federal Reserve's primary credit program (discount window) offers depository institutions an additional source of available funds (at a rate above the target federal funds rate) for managing short-term liquidity risks.[2] Management should fully assess the potential role that the Federal Reserve's primary credit program might play in managing their institution's liquidity. The primary credit program can be a viable source of very short-term backup funds. Management may find it appropriate to incorporate the availability of the primary credit program into their institution's diversified liquidity-management policies, procedures, and contingency plans. The primary credit program has the following attributes that make the discount window a viable source of backup or contingency funding for short-term purposes:

- Primary credit provides a simpler, less-burdensome administrative process and a more

2. See section 3010.1 for further discussion of the Federal Reserve's credit programs that are available to qualifying institutions.

accessible source of backup, short-term funding.

- Primary credit can enhance diversification in short-term funding contingency plans.
- Borrowings can be secured with an array of collateral, including consumer and commercial loans.
- Requests for primary credit advances can be made anytime during the day.[3]
- There are no restrictions on the use of short-term primary credit.

If an institution incorporates primary credit into its contingency plans, the institution should ensure that it has in place with the appropriate Reserve Bank the necessary collateral arrangements and documentation. This is particularly important when the intended collateral consists of loans or other assets that may involve significant processing or lead time for pledging to the Reserve Bank.

It is a long-established sound practice for institutions to periodically test all sources of contingency funding. Accordingly, if an institution incorporates primary credit in its contingency plans, management should occasionally test the institution's ability to borrow at the discount window. The goal of such testing is to ensure that there are no unexpected impediments or complications in the case that such contingency lines need to be used.

Institutions should ensure that any planned use of primary credit is consistent with the stated purposes and objectives of the program. Under the primary credit program, the Federal Reserve generally expects to extend funds on a very short-term basis, usually overnight. Therefore, as with any other type of short-term contingency funding, institutions should ensure that any use of primary credit facilities for short-term liquidity contingencies is accompanied by viable take-out or exit strategies to replace this funding expeditiously with other sources of funding. Institutions should factor into their contingency plans an analysis of their eligibility for primary credit under various scenarios, recognizing that if their financial condition were to deteriorate, primary credit may not be available. Under those scenarios, secondary credit may be available.

Another critical element of liquidity management is an appropriate assessment of the costs and benefits of various sources of potential liquidity. This assessment is particularly important in managing short-term and day-to-day sources and uses of funds. Given the above-market rates charged on primary credit, institutions should ensure that they adequately assess the higher costs of this form of credit relative to other available sources. Extended use of any type of relatively expensive source of funds can give rise to significant earnings implications which, in turn, may lead to supervisory concerns.

It is also important to note that the Federal Reserve's primary credit facility is only one of many tools institutions may use in managing their liquidity-risk profiles. An institution's management should ensure that the institution maintains adequate access to a diversified array of readily available and confirmed funding sources, including liquid assets such as high-grade investment securities and a diversified mix of wholesale and retail borrowings. (See SR-03-15.)

Supervisory and Examiner Considerations

Because primary credit can serve as a viable source of backup, short-term funds, supervisors and examiners should view the occasional use of primary credit as appropriate and unexceptional. At the same time, however, supervisors and examiners should be cognizant of the implications that too-frequent use of this source of relatively expensive funds may have for the earnings, financial condition, and overall safety and soundness of the institution. Overreliance on primary credit borrowings, or any one source of short-term contingency funds, regardless of the relative costs, may be symptomatic of deeper operational or financial difficulties. Importantly, the use of primary credit, as with the use of any potential sources of contingency funding, is a management decision that must be made in the context of safe and sound banking practices.

ASSET MANAGEMENT

Liquidity needs may be met by manipulating the bank's asset structure through the sale or planned runoff of a reserve of readily marketable assets. Because many banks (primarily the smaller ones) tend to have little influence over the size of their total liabilities, liquid assets enable a bank to provide funds to satisfy increased loan demand.

3. Advances generally are booked at the end of the business day.

Banks that rely solely on asset management concentrate on adjusting the price and availability of credit and the level of liquid assets held in response to a change in customer asset and liability preferences. However, assets that are often assumed to be liquid are sometimes difficult to liquidate. For example, investment securities may be pledged against public deposits or repurchase agreements or may be heavily depreciated because of interest-rate changes. Trading accounts cannot be reduced materially if banks must maintain adequate inventories for their customers. Furthermore, the holding of liquid assets for liquidity purposes is less attractive because of their thin profit spreads.

Management must also consider the cost of maintaining liquidity. An institution that maintains a strong liquidity position may do so at the opportunity cost of generating higher earnings.

The amount of liquid assets a bank should hold depends on the stability of its deposit structure and the potential for rapid expansion of its loan portfolio. If deposit accounts are composed primarily of small stable accounts, a relatively low allowance for liquidity is necessary. Additionally, management must consider the current and expected ratings by regulatory and rating agencies when planning liquidity needs. A higher allowance for liquidity is required when—

- high interest rates increase the potential for deposit disintermediation,
- recent trends show a substantial increase or reduction in large deposits or borrowings,
- a significant portion of deposits are short-term municipal special assessment–type accounts,
- a substantial portion of the loan portfolio consists of large static loans with little likelihood of reduction,
- large unused lines of credit or commitments to lend are expected to be used in the near term,
- a strong relationship exists between individual deposit accounts and principal employers in the trade area who have financial problems, or
- a concentration of credit has been extended to industries with current or anticipated financial problems.

Asset liquidity, or how ‘‘salable’’ the bank's assets are in terms of both time and cost, is of primary importance in asset management. To maximize profitability, management must carefully weigh the full return on liquid assets (yield plus liquidity value) against the higher return associated with less-liquid assets. Income derived from higher-yielding assets may be offset if a forced sale, at less than book value, is necessary because of adverse balance-sheet fluctuations.

Seasonal, cyclical, or other factors may cause aggregate outstanding loans and deposits to move in opposite directions and result in loan demand that exceeds available deposit funds. A bank relying strictly on asset management would restrict loan growth to a level that could be supported by available deposits. As an alternative, liquidity needs may be met through liability sources, such as federal funds purchased and the sale of securities under agreements to repurchase, which would allow the bank to meet the loan demand of its trade area. If short-term funding is not readily available in the marketplace, the bank may qualify for borrowings from the local Federal Reserve Bank. The decision whether to use liability sources should be based on a complete analysis of seasonal, cyclical, and other factors and on the costs involved. In addition to supplementing asset liquidity, liability sources of liquidity may be an alternative even when asset sources are available. The number of banks relying solely on manipulation of the asset structure to meet liquidity needs is declining rapidly.

LIABILITY MANAGEMENT

Liquidity needs can be met through the discretionary acquisition of funds on the basis of interest rate competition. This does not preclude the option of selling assets to meet funding needs, and conceptually, the availability of asset and liability options should result in a lower liquidity maintenance cost. The alternative costs of available discretionary liabilities can be compared to the opportunity cost of selling various assets. The major difference between liquidity in larger banks and in smaller banks is that larger banks are better able to control the level and composition of their liabilities and assets. When funds are required, larger banks have a wider variety of options from which to select the least costly method of generating funds. In addition, discretionary access to the money markets should reduce the size of the liquid asset ‘‘buffer’’ that would be needed if the bank were solely dependent upon asset management to obtain funds.

The ability to obtain additional liabilities represents liquidity potential. The marginal cost of liquidity, the cost of incremental funds acquired, is of paramount importance in evaluating liability sources of liquidity. Consideration must be given to such factors as the frequency with which the banks must regularly refinance maturing purchased liabilities, as well as an evaluation of the bank’s ongoing ability to obtain funds under normal market conditions. The obvious difficulty in estimating the latter is that, until the bank goes to the market to borrow, it cannot determine with complete certainty that funds will be available and/or at a price which will maintain a positive yield spread. Changes in money market conditions may cause a rapid deterioration in a bank’s capacity to borrow at a favorable rate. In this context, liquidity represents the ability to attract funds in the market when needed, at a reasonable cost vis-à-vis asset yield.

As previously noted the access of a large bank to discretionary funding sources is a function of its position and reputation in the money markets. Although smaller institutions do not have a ‘‘name’’ in those markets, they are not precluded from liability management. The scope and volume of smaller institution’s operations is somewhat limited, however, particularly as they attempt to access the brokered or purchased CD market.

Although the acquisition of funds at a competitive cost has enabled many banks to meet expanding customer loan demand, misuse or improper implementation of liability management can have severe consequences. Further, liability management is not riskless. For example,

- Purchased funds may not always be available at a reasonable cost when needed. If the market loses confidence in a bank, the availability of purchased funds may be threatened.
- Concentrations in funding sources increase liquidity risk. For example, a bank relying heavily on foreign interbank deposits will experience funding problems if overseas markets perceive instability in U.S. banks or the economy. Replacing foreign source funds might be difficult and costly because the domestic market may view the bank’s sudden need for funds negatively.
- Over-reliance on liability management may cause a tendency to minimize holdings of short-term securities, relax asset liquidity standards, and result in a large concentration of short-term liabilities supporting assets of longer maturity. During times of tight money, this could cause an earnings squeeze and an illiquid condition.
- If rate competition develops in the money market, a bank may incur a high cost of funds and may elect to lower credit standards to book higher yielding loans and securities. If a bank is purchasing liabilities to support assets which are already on its books, the higher cost of purchased funds may result in a negative yield spread.
- When national monetary tightness occurs, heightened interest rate discrimination, or tiering, may develop, and may make the cost of purchased funds prohibitive to all but a small number of money center banks. Therefore, banks with limited funding sources should avoid heavy reliance on purchased funds.
- Preoccupation with obtaining funds at the lowest possible cost, without considering maturity distribution, greatly intensifies a bank’s exposure to the risk of interest rate fluctuations.

In all banks, and particularly those relying on wholesale funding sources, management must constantly be aware of the composition, characteristics, and diversification of its funding sources.

Real or perceived deterioration in the financial condition of a bank because of weak asset quality, fraud, or external economic developments will adversely affect wholesale and retail funding. The extent of market reaction depends on the composition and risk tolerance of the bank's funding base. (Risk tolerance is the willingness and ability of an individual or institution to borrow/lend money for a given risk and reward).

Many factors affect the risk tolerance of funds providers, including these:

- Obligations to fiduciary investors, such as money market funds, trust funds and pensions.
- Reliance on rating firms—bylaws or internal guidelines may prohibit placing funds in banks that have low ratings.
- Obligations to disclose information on investment holdings.
- Self-interest in maintaining an orderly marketplace—for this reason major banks are slow in eliminating funding to other banks.
- Having a personal contact at the bank to provide timely and accurate information about its financial condition.

The following common fund providers are ranked generally (while subject to change) from the least to the most risk tolerant:

- Money market funds.
- Trust funds.
- Pension funds.
- Money market brokers-dealers
  - — small denomination certificates of deposit (under $100,000) sold through broker-dealers; and
  - — large denomination certificates of deposit ($100,000 and over) sold through brokers-dealers
- Regional banks.
- Government agencies.
- Community banks.
- Insurance companies.
- Corporations.
- Multinational banks.
- Individuals.

POLICY/MANAGEMENT REPORTING SYSTEMS

Regardless of the method or combination of methods chosen to manage a bank's liquidity position, it is of key importance that the bank formulate a policy and develop a measurement system to ensure that liquidity requirements are monitored and met on an ongoing basis. This should be done in anticipation of future occurrences, both expected and unexpected. It should also reflect the bank's strategy for managing its investment portfolio and the potential for those investments to provide liquidity to the bank. Such a policy should recognize the unique characteristics of the bank and should reflect its goals. The scope of the policy will vary with the sophistication of the institution.

The policy should provide for coordination between concerned bank departments and should establish clear responsibility for decisions affecting liquidity. Senior management should be apprised regularly of liquidity conditions. Furthermore, the policy should set forth guidelines delineating appropriate levels of liquidity. Examples of some typical guidelines are listed below:

- A limit on the loan to deposit ratio.
- A limit on the loan to capital ratio.
- A general limit on the relationship between anticipated funding needs and available sources for meeting those needs (for example: the ratio of anticipated needs/primary sources shall not exceed _____ percent).
- Primary sources for meeting funding needs should be quantified.
- Flexible limits on the percentage reliance on a particular liability category (for example: negotiable certificates of deposit should not account for more than _____ percent of total liabilities).
- Limits on the dependence on individual customers or market segments for funds in liquidity position calculations.
- Flexible limits on the minimum/maximum average maturity for different categories of liabilities (for example: the average maturity of negotiable certificates of deposit shall not be less than _____ months).
- Minimum liquidity provision to be maintained to sustain operations while necessary longer-term adjustments are made.

A workable management information system is integral to making sound funds management decisions. Reports containing certain basic information should be prepared and reviewed regularly. Report content and format will vary from bank to bank depending on the characteristics of the bank and the funds management methods and practices used. Normally, a good management information system will contain reports detailing liquidity needs and the sources of funds available to meet those needs. (The maturity distribution of assets and liabilities and expected funding of commitments would prove useful in preparing this report.) Additionally, policies should establish, and the management information system should be able to track, contingency liquidity plans for use in a variety of emergency funding situations.

1. To evaluate the management of the bank's assets, liabilities, and off-balance-sheet position to determine if management is planning adequately for liquidity needs, and if the bank can effectively meet anticipated and potential liquidity needs.
2. To determine if reasonable parameters have been established for the bank's liquidity position and if the bank is operating within those established parameters.
3. To determine if internal management reports provide the necessary information for informed liquidity decisions and for monitoring the results of those decisions.
4. To urge corrective action when liquidity policies, practices, or procedures are deficient.
5. To determine if guidelines and procedures have been developed to assess the adequacy of the following: a formal contingency plan; the level of liquid assets; the ability of the bank to liquidate the loan and investment portfolios; the level of term deposits and funding lines; and whether committed funds lines are needed.

1. If internal controls or the internal audit function is determined to be inadequate, complete or update the internal control questionnaire, and prepare a brief description of the bank's liquidity policies and practices.
2. Review the UBPR interim financial statements and internal management reports to assess the asset/liability mix and trends, paying particular attention to—
   a. deposit composition and stability,
   b. the ratios of loan commitments to total loans and of standby letters of credit to total loans,
   c. the loan-to-deposit ratio (at community banks),
   d. the ratio of temporary investments to volatile liabilities, and
   e. the ratio of pledged securities to total securities.

   When performing steps 3 through 9, evaluate the effectiveness of internal management reporting systems in providing for adequate liquidity management.
3. Determine if management has properly planned for liquidity needs.
   a. Are well-established strategies, policies, and procedures for managing both the sources and uses of an institution's funds across various tenors or time frames in place, and do these strategies include assessing and planning for short-term, intermediate-term, and long-term liquidity needs?
   b. Are there liquidity-risk measurement systems appropriate for the size and complexity of the institution?
   c. Are the short-term sources of funds to meet anticipated or potential needs adequate?
   d. Has management—
      - reviewed the internal management report detailing liquidity requirements and sources of liquidity, and
      - evaluated the bank's ability to meet anticipated or potential needs?
4. To determine if management is adequately planning for intermediate-term and longer-term liquidity or funding needs—
   a. discuss with management or review the bank's budget projections for the appropriate planning period;
   b. ascertain if management has planned the future direction of the bank, noting the projected growth, source of funding for the growth, and any projected changes in asset or liability mix;
   c. evaluate future plans regarding liquidity needs, ascertaining whether the bank can reasonably achieve the amounts and types of funding projected and can achieve the amounts and types of asset growth projected; and
   d. ascertain whether the appropriate interest-rate sensitivity concerns have been addressed in planning long-term funding strategies.
5. Assess the reasonableness of bank-established parameters for the use of volatile liabilities.
   a. Does the liquidity policy incorporate limits on both the volume and intended use of such liabilities?
   b. Does the policy establish permissible ranges for maturity mismatches between volatile liabilities and assets being supported by these liabilities?
6. Review the adequacy of the bank's contingency liquidity plan.
   a. Does management's plan ensure adequate access to a diversified array of readily accessible confirmed funding sources, including liquid assets such as high-grade investment securities and a diversified mix of wholesale and retail borrowings?
   b. Has management determined what potential funding losses could occur if unexpected financial or operational problems arise?
   c. Have alternative funding sources or assets that could be sold to cover such losses been identified?
   d. Is the contingency plan well designed, and does it span a broad range of potential liquidity events that are tailored to an institution's specific business lines and liquidity-risk profile?
7. Does the liquidity policy restrict borrowings from affiliated banks to reasonable levels?
8. Does the liquidity policy provide appropri-

ate control and supervision of the volume of loan commitments and other off-balance-sheet activities?

9. Are adequate internal controls and internal audit processes in place? Do the internal controls and internal audit reviews ensure compliance with internal liquidity-management policies and procedures?
10. Discuss the following issues with management, and summarize your findings in the report:
    a. the quality of the bank's planning to meet liquidity needs and the current ability of the bank to meet anticipated and potential liquidity needs
    b. the quality of administrative control and internal management reporting systems
    c. where appropriate, the effect of liquidity management decisions on earnings
11. Update the workpapers with any information that will facilitate future examinations. Discuss with senior management the findings of the examination of their liquidity policies and practices.

1. Has the board of directors, consistent with its duties and responsibilities, reviewed and ratified funds-management policies, practices and procedures that include—
   a. lines of authority and responsibility for liquidity management decisions?
   b. a formal mechanism to coordinate asset and liability management decisions?
   c. a method to identify liquidity needs and the means to meet those needs?
   d. guidelines for the level of liquid assets and other sources of funds in relationship to anticipated and potential needs?
2. Does the planning and budgeting function consider liquidity requirements?
3. Have provisions been made for the preparation of internal management reports that are an adequate basis for ongoing liquidity management decisions and for monitoring the results of the decisions?
4. Are internal management reports concerning liquidity needs and sources of funds to meet those needs prepared regularly and reviewed as appropriate by senior management and the board of directors?
5. Is the information obtained in questions 1–4 an adequate basis for evaluating internal controls over asset/liability management in that there are no significant additional deficiencies that impair any control? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
6. On the basis of a composite evaluation, as evidenced by answers to the foregoing questions, are the internal controls and internal audit procedures considered adequate? Do the internal controls and internal audit reviews ensure compliance with internal liquidity management policies and procedures?

OVERVIEW

Many banking organizations (BOs) have substantially increased their securitization activities. Asset securitization typically involves the transfer of potentially illiquid on-balance-sheet assets (for example, loans, leases, and other assets) to a third party or trust. In turn, the third party or trust issues certificates or notes to investors. The cash flow from the transferred assets supports repayment of the certificates or notes. BOs use asset securitization to access alternative funding sources, manage concentrations, improve financial-performance ratios, and more efficiently meet customer needs. Assets typically securitized include credit card receivables, automobile receivable paper, commercial and residential first mortgages, commercial loans, home equity loans, and student loans.

Managing the risks of securitization activities poses increasing challenges, which may be less obvious and more complex than the risks of traditional lending activities. Securitization can involve credit, liquidity, operational, legal, and reputational risks in concentrations and forms that may not be fully recognized by bank management or adequately incorporated into an institution's risk-management systems. In reviewing these activities, examiners should assess whether banking organizations fully understand and adequately manage the full range of risks involved in securitization activities.

BOs have been involved with asset-backed securities (ABS), both as investors in them and as major participants in the securitization process. The federal government encourages the securitization of residential mortgages. In 1970, the Government National Mortgage Association (GNMA or Ginnie Mae) created the first publicly traded mortgage-backed security. Shortly thereafter, the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), both government-sponsored agencies, also developed mortgage-backed securities. The guarantees on the securities that these government or government-sponsored entities provide ensure investors of the payment of principal and interest. These guarantees have greatly facilitated the securitization of mortgage assets. Banks also securitize other types of assets, such as credit card receivables, automobile loans, boat loans, commercial real estate loans, student loans, nonperforming loans, and lease receivables.

While the objectives of securitization may vary from institution to institution, there are essentially five benefits that can be derived from securitized transactions. First, the sale of assets may reduce regulatory costs. The removal of an asset from an institution's books reduces capital requirements and reserve requirements on the deposits funding the asset. Second, securitization provides originators with an additional source of funding or liquidity. The process of securitization basically converts an illiquid asset into a security with greater marketability. Securitized issues often require a credit enhancement, which results in a higher credit rating than what would normally be obtainable by the institution itself. Consequently, these issues may provide the institution with a cheaper form of funding. Third, securitization may be used to reduce interest-rate risk by improving the institution's asset-liability mix. This is especially true if the institution has a large investment in fixed-rate, low-yield assets. Fourth, by removing assets, the institution enhances its return on equity and assets. Finally, the ability to sell these securities worldwide diversifies the institution's funding base, which reduces the bank's dependence on local economies.

While securitization activities can enhance both credit availability and bank profitability, the risks of these activities must be known and managed. Accordingly, banking institutions should ensure that their overall risk-management process explicitly incorporates the full range of risks involved in their securitization activities, and examiners should assess whether institutions fully understand and adequately manage these risks. Specifically, examiners should determine whether institutions are recognizing the risks of securitization activities by (1) adequately identifying, quantifying, and monitoring these risks; (2) clearly communicating the extent and depth of these risks in reports to senior management and the board of directors and in regulatory reports; (3) conducting ongoing stress testing to identify potential losses and liquidity needs under adverse circumstances; and (4) setting adequate minimum internal standards for allowances or liabilities for losses, capital, and contingency funding. Incorporating asset-securitization activities into banking organizations' risk-management systems and internal capital-adequacy allocations is particularly important since the current regulatory capital rules may not fully capture the economic substance of the risk exposures arising from many of these activities.

Senior management and directors must have the requisite knowledge of the effect of securitization on the BO's risk profile, and they must be fully aware of the accounting, legal, and risk-based capital nuances of this activity. BOs must fully and accurately distinguish and measure the risks that are transferred versus those that are retained, and must adequately manage the retained portion. It is essential that BOs engaging in securitization activities have appropriate front- and back-office staffing; internal and external accounting and legal support; audit or independent-review coverage; information systems capacity; and oversight mechanisms to execute, record, and administer these transactions correctly.

Appropriate valuation and modeling methodologies must be used. They must be able to determine the initial and ongoing fair value of retained interests. Accounting rules (generally accepted accounting principles or GAAP) provide a method to recognize an immediate gain (or loss) on the sale through booking a "retained interest." The carrying value, however, of that interest must be fully documented, based on reasonable assumptions, and regularly analyzed for any subsequent impairment in value. The best evidence of fair value is a quoted market price in an active market. When quoted market prices are not available, accounting rules allow fair value to be estimated. This estimate must be based on the "best information available in the circumstances."[1] An estimate of fair value must be supported by reasonable and current assumptions. If a best estimate of fair value is not practicable, the asset is to be recorded at zero in financial and regulatory reports.

Unforeseen market events that affect the discount rate or performance of receivables supporting a retained interest can swiftly and dramatically alter its value. Without appropriate internal controls and independent oversight, an institution that securitizes assets may inappropriately generate "paper profits" or mask actual losses through flawed loss assumptions, inaccurate prepayment rates, and inappropriate discount rates. Liberal and unsubstantiated assumptions can result in material inaccuracies in financial statements; substantial write-downs of retained interests; and, if retained interests represent an excessive concentration of the sponsoring institution's capital, the institution's demise.

An institution's failure to adequately understand the risks inherent in its securitization activities and to incorporate risks into its risk-management systems and internal capital allocations may constitute an unsafe and unsound banking practice. Furthermore, retained interests that lack objectively verifiable support or that fail to meet these supervisory standards will be classified as loss and disallowed for inclusion as assets of the institution for regulatory capital purposes. (See SR-99-37.) Accordingly, for those institutions involved in asset securitization or providing credit enhancements in connection with loan sales and securitization, examiners should assess whether the institutions' systems and processes adequately identify, measure, monitor, and control *all* the risks involved in its securitization activities. Examiners also will review an institution's valuation of retained interests and the concentration of these assets relative to capital. Consistent with existing supervisory authority, BOs may be required, on a case-by-case basis, to hold additional capital commensurate with their risk exposures.[2] An excessive dependence on securitizations for day-to-day core funding can present significant liquidity problems during times of market turbulence or if there are difficulties specific to the BO.

Traditional lending activities are generally funded by deposits or other liabilities, with both the assets and related liabilities reflected on the balance sheet. Liabilities must generally increase in order to fund additional loans. In contrast, the securitization process generally does not increase on-balance-sheet liabilities in proportion to the volume of loans or other assets securitized. As discussed more fully below, when banking organizations securitize their assets and these transactions are treated as sales, both the assets and the related asset-backed securities (liabilities) are removed from the balance sheet. The cash proceeds from the securitization transac-

1. See Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 140 (FAS 140), "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities."

2. For instance, an institution that has high concentrations of retained interests relative to its capital or is otherwise at risk from impairment of these assets may be subject to this requirement.

tions are generally used to originate or acquire additional loans or other assets for securitization, and the process is repeated. Thus, for the same volume of loan originations, securitization results in lower assets and liabilities compared with traditional lending activities.

THE SECURITIZATION PROCESS

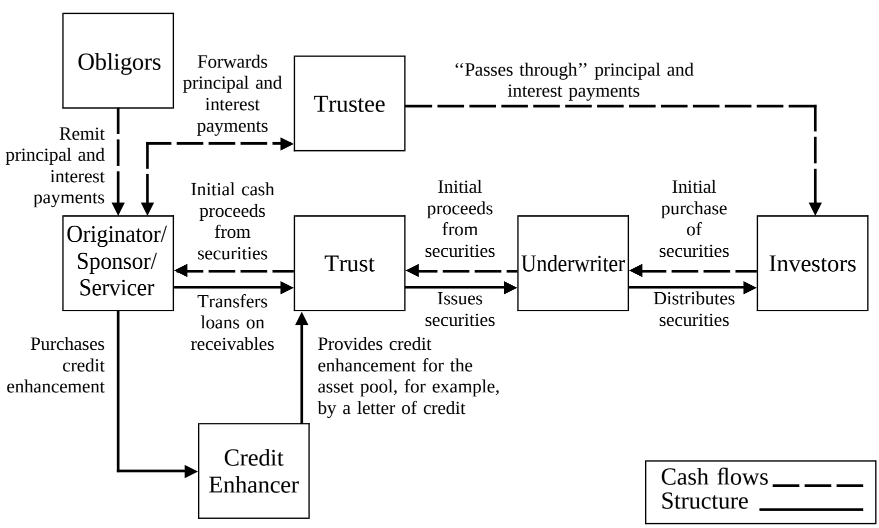
As depicted in figure 1, the asset-securitization process begins with the segregation of loans or leases into pools that are relatively homogeneous with respect to credit, maturity, and interest-rate risks. These pools of assets are then transferred to a trust or other entity known as an issuer because it issues the securities or ownership interests that are acquired by investors. These ABS may take the form of debt, certificates of beneficial ownership, or other instruments. The issuer is typically protected from bankruptcy by various structural and legal arrangements. A sponsor that provides the assets to be securitized owns or otherwise establishes the issuer.

Each issue of ABS has a servicer that is responsible for collecting interest and principal payments on the loans or leases in the underlying pool of assets and for transmitting these funds to investors (or a trustee representing them). A trustee is responsible for monitoring the activities of the servicer to ensure that it properly fulfills its role.

A guarantor may also be involved to ensure that principal and interest payments on the securities will be received by investors on a timely basis, even if the servicer does not collect these payments from the obligors of the underlying assets. Many issues of mortgage-backed securities are either guaranteed directly by GNMA, which is backed by the full faith and credit of the U.S. government, or by Fannie Mae or Freddie Mac, which are government-sponsored agencies that are perceived by the credit markets to have the implicit support of the federal government. Privately issued, mortgage-backed securities and other types of ABS generally depend on some form of credit enhancement provided by the originator or third party to insulate the investor from a portion of or all credit losses. Usually, the amount of the credit enhancement is based on several multiples of the historical losses experienced on the particular asset backing the security.

The structure of an asset-backed security and the terms of the investors' interest in the collateral can vary widely depending on the type of collateral, the desires of investors, and the use of credit enhancements. Securitizations typically carve up the risk of credit losses from the

Figure 1—Pass-through, asset-backed securities: structure and cash flows



underlying assets and distribute it to different parties. The ''first-dollar,'' or most subordinate, loss position is first to absorb credit losses, and the most ''senior'' investor position is last to absorb losses; there may also be one or more loss positions in between (''second-dollar'' loss positions). Each loss position functions as a credit enhancement for the more senior positions in the structure. In other words, when ABS reallocate the risks in the underlying collateral (particularly credit risk), the risks are moved into security tranches that match the desires of investors. For example, senior-subordinated security structures give holders of senior tranches greater credit-risk protection—albeit at lower yields—than holders of subordinated tranches. Under this structure, at least two classes of asset-backed securities, a senior and a junior or subordinated class, are issued in connection with the same pool of collateral. The senior class is structured so that it has a priority claim on the cash flows from the underlying pool of assets. The subordinated class must absorb credit losses on the collateral before losses can be charged to the senior portion. Because the senior class has this priority claim, cash flows from the underlying pool of assets must first satisfy the requirements of the senior class. Only after these requirements have been met will the cash flows be directed to service the subordinated class.

Credit Enhancement

ABS can use various forms of credit enhancements to transform the risk-return profile of underlying collateral. These include third-party credit enhancements, recourse provisions, overcollateralization, and various covenants and indentures. The sponsor of the asset securitization may provide a portion of the total credit enhancement internally, as part of the securitization structure, through the use of excess spread accounts, overcollateralization, retained subordinated interests, or other similar on-balance-sheet assets. When these or other on-balance-sheet internal enhancements are provided, the enhancements are ''residual interests'' and are a form of recourse.[3]

A seller may also arrange for a third party to provide credit enhancement in an asset securitization. If the third-party enhancement is provided by another bank, the other bank assumes some portion of the assets' credit risk. All forms of third-party enhancements, that is, all arrangements in which a bank assumes credit risk from third-party assets or other claims that it has not transferred, are referred to as ''direct-credit substitutes.'' The economic substance of a bank's credit risk from providing a direct-credit substitute can be identical to its credit risk from retaining recourse on assets it has transferred. Third-party credit enhancements include standby letters of credit, collateral or pool insurance, or surety bonds from third parties. Many asset securitizations use a combination of recourse and third-party enhancements to protect investors from credit risk. When third-party enhancements are not provided, the selling bank ordinarily retains virtually all of the credit risk on the assets transferred.

Some ABS, such as those backed by credit card receivables, typically use a ''spread account.'' This account is actually an escrow account. The funds in this account are derived from a portion of the spread between the interest earned on the assets in the underlying pool and the lower interest paid on securities issued by the trust. The amounts that accumulate in the account are used to cover credit losses in the underlying asset pool up to several multiples of historical losses on the particular asset collateralizing the securities. Overcollateralization, a form of credit enhancement covering a predetermined amount of potential credit losses, occurs when the value of the underlying assets exceeds the face value of the securities.

A similar form of credit enhancement is the cash-collateral account, which is established when a third party deposits cash into a pledged account. The use of cash-collateral accounts, which are considered by enhancers to be loans, grew as the number of highly rated banks and other credit enhancers declined in the early 1990s. Cash-collateral accounts eliminate ''event risk,'' or the risk that the credit enhancer will have its credit rating downgraded or that it will not be able to fulfill its financial obligation to absorb losses and thus provide credit protection to investors in a securitization.

An investment banking firm or other organization generally serves as an underwriter for ABS. In addition, for asset-backed issues that are publicly offered, a credit-rating agency will analyze the policies and operations of the originator and servicer, as well as the structure,

3. Purchased credit-enhancing interest-only strips are also considered ''residual interests.''

underlying pool of assets, expected cash flows, and other attributes of the securities. Before assigning a rating to the issue, the rating agency will also assess the extent of loss protection provided to investors by the credit enhancements associated with the issue.

TYPES OF ASSET-BACKED SECURITIES

Asset securitization involves different types of capital-market instruments. (For more information, see the *Trading and Capital-Markets Activities Manual,* section 4105.1, ''Asset-Backed Securities and Asset-Backed Commercial Paper,'' and section 4110.1, ''Residential Mortgage–Backed Securities.'') These instruments may be structured as ''pass-throughs'' or ''pay-throughs.'' Under a pass-through structure, the cash flows from the underlying pool of assets are passed through to investors on a pro rata basis. This type of security may be a single-class instrument, such as a GNMA pass-through, or a multiclass instrument, such as a real estate mortgage investment conduit (REMIC).[4]

The pay-through structure, with multiple classes, combines the cash flows from the underlying pool of assets and reallocates them to two or more issues of securities that have different cash-flow characteristics and maturities. An example is the collateralized mortgage obligation (CMO), which has a series of bond classes, each with its own specified coupon and stated maturity. In most cases, the assets that make up the CMO collateral pools are pass-through securities. Scheduled principal payments and any prepayments from the underlying collateral go first to the earliest maturing class of bonds. This first class of bonds must be retired before the principal cash flows are used to retire the later bond classes. The development of the pay-through structure resulted from the desire to broaden the marketability of these securities to investors who were interested in maturities other than those generally associated with pass-through securities.

Multiple-class ABS may also be issued as derivative instruments, such as ''stripped'' securities. Investors in each class of a stripped security will receive a different portion of the principal and interest cash flows from the underlying pool of assets. In their purest form, stripped securities may be issued as interest-only (IO) strips, for which the investor receives 100 percent of the interest from the underlying pool of assets, and as principal-only (PO) strips, for which the investor receives all of the principal.

In addition to these securities, other types of financial instruments may arise as a result of asset securitization, as follows:

- *Servicing assets.* These assets become a distinct asset recorded on the balance sheet when contractually separated from the underlying assets that have been sold or securitized and when the servicing of those assets is retained. (See FAS 140 for more information.) In addition, servicing assets are created when organizations purchase the right to act as servicers for loan pools. The value of the servicing assets is based on the contractually specified servicing fees, net of servicing costs.
- *Interest-only strips receivables.* These cash flows are accounted for separately from servicing assets and reflect the right to future interest income from the serviced assets in excess of the contractually specified servicing fees.
- *ABS residuals.* These residuals (sometimes referred to as ''residuals,'' ''residual interests,'' or ''retained interests'' represent claims on any cash flows that remain after all obligations to investors and any related expenses have been met. The excess cash flows may arise as a result of overcollateralization or from reinvestment income. Residuals can be retained by sponsors or purchased by investors in the form of securities.

RISKS ASSOCIATED WITH ASSET SECURITIZATION

While clear benefits accrue to banking organizations that engage in securitization activities

4. In the early 1980s, collateralized mortgage obligations (CMOs), or multiple-class securities, were introduced to help minimize the reinvestment and interest-rate risks inherent in the traditional fixed-rate mortgage-backed security. As a result of the Tax Reform Act of 1986, the REMIC was created. The REMIC is a more flexible mortgage security that expanded the appeal of the CMO structure to a wider investor base and offered preferred tax status to both investors and issuers. Today, almost all CMOs are issued in REMIC form. (''The ABCs of CMOs, REMICs and IO/POs: Rocket Science Comes to Mortgage Finance,'' *Journal of Accountancy,* April 1991, p. 41.)

and invest in ABS, these activities have the potential to increase the overall risk profile of the banking organization if they are not carried out prudently. For the most part, the types of risks that financial institutions encounter in the securitization process are identical to those that they face in traditional lending transactions, including credit risk, concentration risk, interest-rate risk (including prepayment risk), operational risk, liquidity risk, moral-recourse risk, and funding risk. However, since the securitization process separates the traditional lending function into several limited roles, such as originator, servicer, credit enhancer, trustee, and investor, the types of risks that a bank will encounter will differ depending on the role it assumes.

Investor-Specific Risks

Investors in ABS will be exposed to varying degrees of credit risk, that is, the risk that obligors will default on principal and interest payments. Like the investors in the direct investments of the underlying assets, ABS investors are also subject to the risk that the various parties in the securitization structure, for example, the servicer or trustee, will be unable to fulfill their contractual obligations. Moreover, investors may be susceptible to concentrations of risks across various asset-backed security issues (1) through overexposure to an organization that performs various roles in the securitization process or (2) as a result of geographic concentrations within the pool of assets providing the cash flows for an individual issue. Also, since the secondary markets for certain ABS are limited, investors may encounter greater than anticipated difficulties (liquidity risk) when seeking to sell their securities. Furthermore, certain derivative instruments, such as stripped asset-backed securities and residuals, may be extremely sensitive to interest rates and exhibit a high degree of price volatility. Therefore, they may dramatically affect the risk exposure of investors unless used in a properly structured hedging strategy. Examiner guidance in the *Trading and Capital-Markets Activities Manual,* section 3000.1, ‘‘Investment Securities and End-User Activities,’’ is directly applicable to ABS held as investments.

Issuer-Specific Risks

Banking organizations that issue ABS may be subject to pressures to sell only their best assets, thus reducing the quality of their own loan portfolios. On the other hand, some banking organizations may feel pressures to relax their credit standards because they can sell assets with higher risk than they would normally want to retain for their own portfolios.

To protect their name in the market, issuers may face pressures to provide ‘‘moral recourse’’ by repurchasing securities backed by loans or leases they have originated that have deteriorated and become nonperforming. Funding risk may also be a problem for issuers when market aberrations do not permit the issuance of asset-backed securities that are in the securitization pipeline.

Servicer-Specific Risks

Banking organizations that service securitization issues must ensure that their policies, operations, and systems will not permit breakdowns that may lead to defaults. Substantial fee income can be realized by acting as a servicer. An institution already has a fixed investment in its servicing systems, and achieving economies of scale relating to that investment is in its best interest. The danger, though, lies in overloading the system's capacity, thereby creating enormous out-of-balance positions and cost overruns. Servicing problems may precipitate a technical default, which in turn could lead to the premature redemption of the security. In addition, expected collection costs could exceed fee income. (For further guidance, examiners should see section 2040.3, ‘‘Loan Portfolio Management,’’ examination procedure 14.b.)

ACCOUNTING ISSUES

Sale or Borrowing Treatment

Asset-securitization transactions are frequently structured to obtain certain accounting treatments, which in turn affect reported measures of profitability and capital adequacy. In transferring assets into a pool to serve as collateral for ABS, a key question is whether the transfer should be treated as a sale of the assets or as a collateralized borrowing, that is, a financing transaction secured by assets. Treating these transactions as a sale of assets results in their being removed from the banking organization's balance sheet, thus reducing total assets relative to earnings and capital, and thereby producing higher performance and capital ratios.[5] Treating these transactions as financings, however, means that the assets in the pool remain on the balance sheet and are subject to capital requirements and the related liabilities-to-reserve requirements.[6]

Valuation and Modeling Processes for Retained Interests

The methods and models BOs use to value retained interests and the difficulties in managing exposure to these volatile assets can raise supervisory concerns. Under GAAP, a BO recognizes an immediate gain (or loss) on the sale of assets by recording its retained interest at fair value. The valuation of the retained interest is based on the present value of future cash flows in excess of the amounts needed to service the bonds and cover credit losses and other fees of the securitization vehicle.[7]

Determinations of fair value should be based on reasonable, conservative assumptions about factors such as discount rates, projected credit losses, and prepayment rates. Bank supervisors expect retained interests to be supported by verifiable documentation of fair value in accordance with GAAP. In the absence of such support, the retained interests should not be carried as assets on an institution's books, but should be charged off. Other supervisory concerns include failure to recognize and hold sufficient capital against recourse obligations generated by securitizations, and the absence of an adequate and independent audit function.

The method and key assumptions used to value the retained interests and servicing assets or liabilities must be reasonable and fully documented. The key assumptions in all valuation analyses include prepayment or payment rates, default rates, loss-severity factors, and discount rates. Institutions are expected to take a logical and conservative approach when developing securitization assumptions and capitalizing future income flows. It is important that management quantifies the assumptions at least quarterly on a pool-by-pool basis and maintains supporting documentation for all changes to the assumptions as part of the valuation. Policies should define the acceptable reasons for changing assumptions and require appropriate management approval.

An exception to this pool-by-pool valuation analysis may be applied to revolving-asset trusts if the master-trust structure allows excess cash flows to be shared between series. In a master trust, each certificate of each series represents an undivided interest in all of the receivables in the trust. Therefore, valuations are appropriate at the master-trust level.

To determine the value of the retained interest at inception, and to make appropriate adjustments going forward, the institution must implement a reasonable modeling process to comply with FAS 140. Management is expected to employ reasonable and conservative valuation assumptions and projections, and to maintain verifiable objective documentation of the fair value of the retained interest. Senior management is responsible for ensuring that the valuation model accurately reflects the cash flows according to the terms of the securitization's structure. For example, the model should account for any cash collateral or overcollateralization triggers, trust fees, and insurance payments if appropriate. The board and management are accountable for the model builders' possessing the necessary expertise and technical proficiency to perform the modeling process. Senior management should ensure that internal controls are in place to provide for the ongoing integrity of management information systems (MIS) associated with securitization activities.

As part of the modeling process, the risk-management function should ensure that periodic validations are performed to reduce vulnerability to model risk. Validation of the model includes testing the internal logic, ensuring empirical support for the model assumptions, and back-testing the models using actual cash flows on a pool-by-pool basis. The validation process should be documented to support conclusions. Senior management should ensure the validation process is independent from line man-

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5. See FAS 140 for criteria that must be met for the securitization of assets to be accounted for as a sale.

6. Note, however, that the Federal Reserve's Regulation D (12 CFR 204) defines what constitutes a reservable liability of a depository institution. Thus, although a given transaction may qualify as an asset sale for call report purposes, it nevertheless could result in a reservable liability under Regulation D. See the call report instructions for further guidance. Also, see section 3020.1, "Assessment of Capital Adequacy."

7. See FAS 140.

agement and from the modeling process. The audit scope should include procedures to ensure that the modeling process and validation mechanisms are both appropriate for the institution's circumstances and executed consistently with its asset-securitization policy.

Use of Outside Parties

Third parties are often engaged to provide professional guidance and support regarding an institution's securitization activities, transactions, and valuing of retained interests. The use of outside resources does not relieve directors of their oversight responsibility, nor does it relieve senior management of its responsibilities to provide supervision, monitoring, and oversight of securitization activities, particularly the management of the risks associated with retained interests. Management is expected to have the experience, knowledge, and abilities to discharge its duties; understand the nature and extent of the risks that retained interests present; and have the policies and procedures necessary to implement an effective risk-management system to control such risks. Management must have a full understanding of the valuation techniques employed, including the basis and reasonableness of underlying assumptions and projections.

Market Discipline and Disclosures

Transparency through public disclosure is crucial to effective market discipline and can reinforce supervisory efforts to promote high standards in risk management. Timely and adequate information on the institution's asset-securitization activities should be disclosed. The information in the disclosures should be comprehensive; however, the amount of disclosure that is appropriate will depend on the volume of securitizations and complexity of the BO. Well-informed investors, depositors, creditors, and other counterparties can provide a BO with strong incentives for maintaining sound risk-management systems and internal controls. Adequate disclosure allows market participants to better understand the BO's financial condition and apply market discipline, thus creating incentives to reduce inappropriate risk-taking or inadequate risk-management practices. Examples of sound disclosures include—

- accounting policies for measuring retained interests, including a discussion of the impact of key assumptions on the recorded value;
- the process and methodology used to adjust the value of retained interests for changes in key assumptions;
- risk characteristics, both quantitative and qualitative, of the underlying securitized assets;
- the role of retained interests as credit enhancements to special-purpose entities and other securitization vehicles, including a discussion of techniques used for measuring credit risk; and
- sensitivity analyses or stress testing conducted by the BO, showing the effect of changes in key assumptions on the fair value of retained interests.

CAPITAL ADEQUACY

As with all risk-bearing activities, institutions should fully support the risk exposures of their securitization activities with adequate capital. Banking organizations should ensure that their capital positions are sufficiently strong to support *all* the risks associated with these activities on a fully consolidated basis and should maintain adequate capital in all affiliated entities engaged in these activities. The Federal Reserve's risk-based capital guidelines establish *minimum* capital ratios, and those banking organizations exposed to high or above-average degrees of risk are expected to operate significantly *above* the minimum capital standards.

The current regulatory capital rules may not fully incorporate the economic substance of the risk exposures involved in many securitization activities. Therefore, when evaluating capital adequacy, examiners should ensure that banking organizations that (1) sell assets with recourse, (2) assume or mitigate credit risk through the use of credit derivatives, or (3) provide direct-credit substitutes and liquidity facilities to securitization programs are accurately identifying and measuring these exposures and maintaining capital at aggregate levels sufficient to support the associated credit, market, liquidity, reputational, operational, and legal risks.

Examiners should review the substance of securitizations when assessing underlying risk exposures. For example, partial, first-loss direct-credit substitutes providing credit protection to a securitization transaction can, in substance, involve the same credit risk as would be involved in holding the entire asset pool on the institution's balance sheet. Examiners should ensure that banks have implemented reasonable methods for allocating capital against the economic substance of credit exposures arising from early-amortization events and liquidity facilities associated with securitized transactions. These liquidity facilities are usually structured as short-term commitments in order to avoid a risk-based capital requirement, even though the inherent credit risk may be similar to that of a guarantee.[8]

If, in the examiner's judgment, an institution's capital level is not sufficient to provide protection against potential losses from the above credit exposures, this deficiency should be reflected in the banking organization's CAMELS rating. Furthermore, examiners should discuss the capital deficiency with the institution's management and, if necessary, its board of directors. Such an institution will be expected to develop and implement a plan for strengthening the organization's overall capital adequacy to levels deemed appropriate given all the risks to which it is exposed.

RISK-BASED CAPITAL PROVISIONS AFFECTING ASSET SECURITIZATION

The risk-based capital framework assigns risk weights to loans, ABS, off-balance-sheet credit enhancements, and other assets related to securitization.[9] Second, banks that transfer assets with recourse to the seller as part of the securitization process are explicitly required to hold capital against their off-balance-sheet credit exposures. However, the specific capital requirement will depend on the amount of recourse retained by the transferring institution and the type of asset sold with recourse. Third, banking organizations that provide credit enhancement to asset-securitization issues through standby letters of credit or by other means must hold capital against the related off-balance-sheet credit exposure.

Assigning Risk Weights

The risk weights assigned to an asset-backed security generally depend on the issuer and on whether the assets that compose the collateral pool are mortgage-related assets or assets guaranteed by a U.S. government agency. ABS issued by a trust or single-purpose corporation and backed by nonmortgage assets generally are to be assigned a risk weight of 100 percent.

Securities guaranteed by U.S. government agencies and those issued by U.S. government–sponsored agencies are assigned risk weights of 0 percent and 20 percent, respectively, because of the low degree of credit risk. Accordingly, mortgage pass-through securities guaranteed by GNMA are placed in the risk category of 0 percent. In addition, securities such as participation certificates and CMOs issued by Fannie Mae or Freddie Mac are assigned a 20 percent risk weight.

However, several types of securities issued by Fannie Mae and Freddie Mac are excluded from the lower risk weight and slotted in the 100 percent risk category. Residual interests (for example, CMO residuals) and subordinated classes of pass-through securities or CMOs that absorb more than their pro rata share of loss are assigned to the 100 percent risk-weight category. Furthermore, high-risk mortgage-derivative securities and all stripped, mortgage-backed securities, including IOs, POs, and similar instruments, are assigned to the 100 percent risk-weight category because of their high price volatility and market risk.

A privately issued mortgage-backed security that meets the criteria listed below is considered a direct or indirect holding of the underlying mortgage-related assets and is generally assigned to the same risk category as those assets (for example, U.S. government agency securities, U.S. government–sponsored agency securities, FHA- and VA-guaranteed mortgages, and con-

8. For further guidance on distinguishing, for risk-based capital purposes, whether a facility is a short-term commitment or a direct-credit substitute, see SR-92-11, "Asset-Backed Commercial Paper Programs." Essentially, facilities that provide liquidity, but which also provide credit protection to secondary-market investors, are to be treated as direct-credit substitutes for purposes of risk-based capital.

9. In addition to being subject to risk-based capital requirements, servicing assets are also subject to capital limitations. The total amount of servicing assets (including both mortgage-servicing assets and nonmortgage-servicing assets) and purchased credit-card relationships that may be included in a bank's capital may not, in the aggregate, exceed 100 percent of tier 1 capital. The total amount of nonmortgage-servicing assets and purchased credit-card relationships is subject to a separate aggregate sublimit of 25 percent of tier 1 capital.

ventional mortgages). However, under no circumstances will a privately issued mortgage-backed security be assigned to the 0 percent risk category. Therefore, private issues that are backed by GNMA securities will be assigned to the 20 percent risk category as opposed to the 0 percent category appropriate to the underlying GNMA securities. The criteria that a privately issued mortgage-backed security must meet to be assigned the same risk weight as the underlying assets are as follows:

- The underlying assets are held by an independent trustee, and the trustee has a first-priority, perfected security interest in the underlying assets on behalf of the holders of the security.
- The holder of the security has an undivided pro rata ownership interest in the underlying mortgage assets, or the trust or single-purpose entity (or conduit) that issues the security has no liabilities unrelated to the issued securities.
- The cash flow from the underlying assets of the security in all cases fully meets the cash-flow requirements of the security without undue reliance on any reinvestment income.
- No material reinvestment risk is associated with any funds awaiting distribution to the holders of the security.

Those privately issued mortgage-backed securities that do not meet the above criteria are to be assigned to the 100 percent risk category.

If the underlying pool of mortgage-related assets is composed of more than one type of asset, then the entire class of mortgage-backed securities is assigned to the category appropriate to the highest risk-weighted asset in the asset pool. For example, if the security is backed by a pool consisting of U.S. government–sponsored agency securities (for example, Freddie Mac participation certificates) that qualify for a 20 percent risk weight and conventional mortgage loans that qualify for the 50 percent risk category, then the security would receive the 50 percent risk weight.

While not set forth specifically in the risk-based capital guidelines, securities backed by student loans that meet the above-mentioned criteria may also be considered an indirect holding of the underlying assets and assigned to the same risk category as those assets. For instance, the U.S. Department of Education conditionally guarantees banks originating student loans for 98 percent of each loan under the Federal Family Education Loan Program. The guaranteed portion of the student loans is eligible for the 20 percent risk category. Therefore, senior ABS that are supported solely by student loans that are conditionally guaranteed by the Department of Education and that meet the four criteria listed above may be assigned to the 20 percent risk category to the extent they are guaranteed. As with mortgage-backed securities, subordinated student loan–backed securities and securities backed by pools of conditionally guaranteed and nonguaranteed student loans would be assigned to the 100 percent risk category.

Banks report their activities in accordance with GAAP, which permits asset-securitization transactions to be treated as sales when certain criteria are met even when there is recourse to the seller. In accordance with the RBC guideline, banks are required to hold capital against the off-balance-sheet credit exposure arising from the contingent liability associated with the recourse provisions. This exposure, generally the outstanding principal amount of the assets sold with recourse, is considered a direct-credit substitute that is converted at 100 percent to an on-balance-sheet credit-equivalent amount for appropriate risk weighting.

Recourse Obligations

For regulatory purposes, recourse is generally defined as an arrangement in which an institution retains the risk of credit loss in connection with an asset transfer, if the risk of credit loss exceeds a pro rata share of its claim on the assets.[10] In addition to broad contractual language that may require the seller to support a securitization, recourse can arise from retained interests, retained subordinated security interests, the funding of cash-collateral accounts, or other forms of credit enhancements that place a BO's earnings and capital at risk. These enhancements should generally be aggregated to determine the extent of a BO's support of securitized assets. Although an asset securitization qualifies for sales treatment under GAAP, the underlying assets may still be subject to regulatory risk-

10. See the risk-based capital treatment for sales with recourse at 12 CFR 3, appendix A, section (3)(b)(1)(iii) (for the OCC), and 12 CFR 567.6(a)(2)(i)(c) (for the OTS). For a further explanation of recourse, see the glossary of the call report instructions at ''sales of assets for risk-based capital purposes.''

based capital requirements. Assets sold with recourse should generally be risk-weighted as if they had not been sold.

Credit-Equivalent Amounts and Risk Weights of Recourse Obligations and Direct-Credit Substitutes

The credit-equivalent amount for a recourse obligation or direct-credit substitute is the full amount of the credit-enhanced assets for which the bank directly or indirectly retains or assumes credit risk, multiplied by a 100 percent conversion factor. A bank that extends a partial direct-credit substitute, for example, a financial standby letter of credit that absorbs the first 10 percent of loss on a transaction, must maintain capital against the full amount of the assets being supported.

To determine the bank's risk-weighted assets for an off-balance-sheet recourse obligation, a third-party direct-credit substitute, or a letter of credit, the credit-equivalent amount is assigned to the risk category appropriate to the obligor in the underlying transaction, after considering any associated guarantees or collateral. For a direct-credit substitute that is an on-balance-sheet asset, for example, a purchased subordinated security, a bank must calculate risk-weighted assets using the amount of the direct-credit substitute and the full amount of the assets it supports, that is, all the more senior positions in the structure. This treatment is subject to the low-level-exposure rule discussed below. (The risk-based capital treatment for asset securitizations is discussed in more detail in section 3020.1.)

If a bank has no claim on a transferred asset, then the retention of any risk of credit loss is recourse. A recourse obligation typically arises when a bank transfers assets and retains an explicit obligation to repurchase the assets or absorb losses due to a default on the payment of principal or interest, or due to any other deficiency in the performance of the underlying obligor or some other party. Recourse may also exist implicitly if a bank provides credit enhancement beyond any contractual obligation to support assets it has sold. The following are examples of recourse arrangements:

- credit-enhancing representations and warranties made on the transferred assets
- loan-servicing assets retained under an agreement that requires the bank to be responsible for credit losses associated with the loans being serviced (mortgage-servicer cash advances that meet the conditions of section III.B.3.a.viii. of the capital adequacy guidelines (12 CFR 208, appendix A) are not recourse arrangements)
- retained subordinated interests that absorb more than their pro rata share of losses from the underlying assets
- assets sold under an agreement to repurchase, if the assets are not already included on the balance sheet
- loan strips sold without contractual recourse when the maturity of the transferred loan is shorter than the maturity of the commitment under which the loan is drawn
- credit derivatives issued that absorb more than the bank's pro rata share of losses from the transferred assets
- clean-up calls at inception that are greater than 10 percent of the balance of the original pool of transferred loans (clean-up calls that are 10 percent or less of the original pool balance and that are exercisable at the option of the bank are not recourse arrangements)

The risk-based capital treatment for asset securitizations is discussed in detail in section 3020.1. In general, a multilevel, ratings-based approach is used to assess the capital requirements on recourse obligations, residual interests (except credit-enhancing interest-only (I/O) strips), direct-credit substitutes, and senior and subordinated securities in asset securitizations, based on their relative exposure to credit risk. Credit ratings from rating agencies are used to measure relative exposure to credit risk and to determine the associated risk-based capital requirement. The Federal Reserve is relying on these credit ratings to make determinations of credit quality for the regulatory capital treatment for loss positions that represent different gradations of credit risk, the same as investors and other market participants. As discussed later in this section, residual interests are subject to (1) a dollar-for-dollar capital charge and (2) a 25 percent of tier 1 capital concentration limit on a subset of residual interests, credit-enhancing I/O strips.

Implicit Recourse Provided to Asset Securitizations

Implicit recourse arises when a bank provides credit support to one of more of its securitizations beyond its contractual obligation. Implicit recourse, like contractual recourse, exposes an institution to the risk of loss arising from deterioration in the credit quality of the underlying assets of the securitization. Implicit recourse is of supervisory concern because it demonstrates that the securitizing institution is reassuming risk associated with the securitized assets—risk that the institution initially transferred to the marketplace. For risk-based capital purposes, banks deemed to be providing implicit recourse are generally required to hold capital against the entire outstanding amount of assets sold, as though the assets remained on the bank's books.

Banks have typically provided implicit recourse in situations where the originating bank perceived that the failure to provide this support, even though not contractually required, would damage its future access to the asset-backed securities market. An originating bank can provide implicit recourse in a variety of ways. The ultimate determination as to whether implicit recourse exists depends on the facts. The following actions point to a finding of implicit recourse:

- selling assets to a securitization trust or other special-purpose entity (SPE) at a discount from the price specified in the securitization documents, which is typically par value
- purchasing assets from a trust or other SPE at an amount greater than fair value
- exchanging performing assets for nonperforming assets in a trust or other SPE
- funding credit enhancements[10a] beyond contractual requirements

By providing implicit recourse, a bank signals to the market that it still holds the risks inherent in the securitized assets, and, in effect, the risks have not been transferred. Accordingly, examiners must be attentive to banks that provide implicit support, given the risk these actions pose to a bank's financial condition. Increased attention should be given to situations where a bank is more likely to provide implicit support.

Particular attention should be paid to revolving securitizations, such as those used for credit card lines and home equity lines of credit, in which receivables generated by the lines are sold into the securitizations. These securitizations typically provide that, when certain performance criteria hit specified thresholds, no new receivables can be sold into the securitization, and the principal on the bonds issued will begin to pay out. These early-amortization events are intended to protect investors from further deterioration in the underlying asset pool. Once an early-amortization event has occurred, the bank could have difficulties using securitization as a continuing source of funding and, at the same time, have to fund the new receivables generated by the lines of credit on its balance sheet. Thus, banks have an incentive to avoid early amortization by providing implicit support to the securitization.

Examiners should be alert for securitizations that are approaching early-amortization triggers, such as a decrease in the excess spread[10b] below a certain threshold or an increase in delinquencies beyond a certain rate. Providing implicit recourse can pose a degree of risk to a bank's financial condition and to the integrity of its regulatory and public financial statements and reports. Examiners should review securitization documents (for example, pooling and servicing agreements) to ensure that the selling institution limits any post-sale support to that specified in the terms and conditions in the securitization documents. Examiners should also review a sample of receivables transferred between the seller and the trust to ensure that these transfers were conducted in accordance with the contractual terms of the securitization, particularly in cases where the overall credit quality of the securitized loans or receivables has deteriorated. While banks are not prohibited from providing implicit recourse, such support will generally result in higher capital requirements.

Examiners should recommend that prompt supervisory action be taken when implicit recourse is identified. To determine the appropriate action, examiners need to understand the bank's reasons for providing support and the extent of the impact of this support on the bank's earnings and capital. As with contractual recourse, actions involving noncontractual post-sale credit enhancement generally result in the requirement that the bank hold risk-based capital against the entire outstanding amount of the

10a. Credit enhancements include retained subordinated interests, asset-purchase obligations, overcollateralization, cash-collateral accounts, spread accounts, and interest-only strips.

10b. Excess spread generally is defined as finance-charge collections minus certificate interest, servicing fees, and charge-offs allocated to the series.

securitized assets. Supervisors may require the bank to bring all assets in existing securitizations back on the balance sheet for risk-based capital purposes, as well as require the bank to increase its minimum capital ratios. Supervisors may also prevent a bank from removing assets from its risk-weighted asset base on future transactions until the bank demonstrates its intent and ability to transfer risk to the marketplace. In addition, supervisors may consider other actions to ensure that the risks associated with implicit recourse are adequately reflected in the capital ratios. For example, supervisors may require the bank to deduct residual interests from tier 1 capital as well as hold risk-based capital on the underlying assets.

The following examples illustrate post-sale actions that banks have taken on assets they have securitized. These examples are intended to provide guidance on whether these actions would be considered implicit recourse for risk-based capital and other supervisory purposes. A key factor in each scenario and analysis is the potential risk of loss the bank's earnings and capital may be exposed to as a result of its actions.

Account removal: Example 1a

Facts. A bank originates and services credit card receivables throughout the country. The bank decides to divest those credit card accounts of customers who reside in specific geographic areas where the bank lacks a significant market presence. To achieve the maximum sales price, the sale must include both the credit card relationships and the receivables. Because many of the credit card receivables are securitized through a master-trust structure, the bank needs to remove the receivables from the trust. The affected receivables are not experiencing any unusual performance problems. In that respect, the charge-off and delinquency ratios for the receivables to be removed from the trust are substantially similar to those for the trust as a whole.

The bank enters into a contract to sell the specified credit card accounts before the receivables are removed from the trust. The terms of the transaction are arm's length, wherein the bank will sell the receivables at market value. The bank separately agrees to purchase the receivables from the trust at this same price. Therefore, no loss is incurred as a result of removing the receivables from the trust. The bank will only remove receivables from the trust that are due from customers located in the geographic areas where the bank lacks a significant market presence, and it will remove all such receivables from the trust.

Analysis. The removal of the above-described receivables from the trust does not constitute implicit recourse for regulatory capital purposes. Supporting factors for this conclusion include the following:

- The bank's earnings and capital are not exposed to actual or potential risk of loss as a result of removing the receivables from the trust.
- There is no indication that the receivables are removed from the trust because of performance concerns.
- The bank is removing the receivables from the trust for a legitimate business purpose other than to systematically improve the quality of the trust's assets. The legitimate business purpose is evidenced by the bank's prearranged, arm's-length sale agreement that facilitates exiting the business in identified geographic locations.

Examiners should review the terms and conditions of the transaction to ensure that the market value of the receivables is documented and well supported before concluding that this transaction does not represent implicit recourse. Examiners should also ensure that the selling bank has not provided the purchaser with any guarantees or credit enhancements on the sold receivables.

Account removal: Example 1b

Facts. After the establishment of a master trust for a pool of credit card receivables, the receivables in the trust begin to experience adverse performance. A combination of lower-than-expected yields and higher-than-anticipated charge-offs on the pool causes spreads to compress significantly (although not to zero). The bank's internally generated forecasts indicate that spreads will likely become negative in the near future.

Management takes action to support the trust by purchasing the low-quality (delinquent) receivables from the trust at par, although their market value is less than par. The receivables purchased from the trust represent approximately one-third of the trust's total receivables.

This action improves the overall performance of the trust and avoids a potential early-amortization event.

Analysis. The purchase of low-quality receivables from a trust at par constitutes implicit recourse for regulatory capital purposes. The purchase of low-quality receivables at an above-market price exposes the bank's earnings and capital to potential future losses from assets that had previously been sold. Accordingly, the bank is required to hold risk-based capital for the remaining assets in the trust as if they were retained on the balance sheet, as well as hold capital for the assets that were repurchased.

Additions of future assets or receivables: Example 2a

Facts. Months after the issuance of credit card asset-backed securities, charge-offs and delinquencies on the underlying pool of receivables rise dramatically. A rating agency places the securities on watch for a potential rating downgrade, causing the bank to negotiate additional credit support for the securitized assets. The securitization documents require the bank to transfer new receivables to the securitization trust at par value. However, to maintain the rating on the securities, the bank begins to sell replacement receivables into the trust at a discount from par value.

Analysis. The sale of receivables to the trust at a discount constitutes implicit recourse for regulatory capital purposes. The sale of assets at a discount from the price specified in the securitization documents, par value in this example, exposes earnings and capital to future losses. The bank must hold regulatory capital against the outstanding assets in the trust.

Additions of future assets or receivables: Example 2b

Facts. A bank established a credit card master trust. The receivables from the accounts placed in the trust were, on average, of lesser quality than the receivables from accounts retained on the bank's balance sheet. Under the criteria for selecting the receivables to be transferred to the master trust, the bank was prevented from including the better-performing affinity accounts in the initial pool of accounts because the affinity-relationship contract was expiring. The bank and the affinity client subsequently revised the terms of their contract, enabling the affinity accounts to meet the selection criteria and be included in future securitization transactions. Later, rising charge-offs within the pool of receivables held by the trust caused spread compression in the trust. To improve the performance of the assets in the trust, the bank begins to include the better-performing and now-eligible receivables from the affinity accounts among the receivables sold to the trust. This action improves the trust's performance, including its spread levels and charge-off ratios. However, the replacement assets were sold at par in accordance with the terms of the trust agreement, so no current or future charge to the bank's earnings or capital will result from these asset sales. As another result of this action, the performance of the trust's assets closely tracks the credit card receivables that remain on the bank's balance sheet.

Analysis. The actions described above do not constitute implicit recourse for regulatory capital purposes. The bank did not incur any additional risk to earnings or capital after the affinity accounts met the selection criteria for replacement assets and after the associated receivables were among the receivables sold to the trust. The replacement assets were sold at par in accordance with the terms of the trust agreement, so no future charge to earnings or capital will result from these asset sales. The sale of replacement assets into a master-trust structure is part of normal trust management.

In this example, the credit card receivables that remain on the bank's balance sheet closely track the performance of the trust's assets. Nevertheless, examiners should ascertain whether a securitizing bank sells disproportionately higher-quality assets into securitizations while retaining comparatively lower-quality assets on its books; if so, examiners should consider the effect of this practice on the bank's capital adequacy.

Additions of future assets or receivables: Example 2c

Facts. A bank establishes a credit card master trust composed of receivables from accounts that were generally of lower quality than the receivables retained on the bank's balance sheet. The difference in the two portfolios is primarily due to logistical and operational problems that prevent the bank from including certain better-quality affinity accounts in the initial pool from which accounts were selected for securitization. Rising charge-offs and other factors later result in margin compression on the assets in the master trust, which causes some concern in the market regarding the stability of the outstanding asset-backed securities. A rating agency places several securities on its watch list for a potential rating downgrade. In response to the margin compression, as part of the bank's contractual obligations, spread accounts are increased for all classes by trapping excess spread in conformance with the terms and conditions of the securitization documents. To stabilize the quality of the receivables in the master trust as well as to preclude a downgrade, the bank takes several actions beyond its contractual obligations:

- Affinity accounts are added to the pool of receivables eligible for inclusion in the trust. This change results in improved overall trust performance. However, these receivables are sold to the trust at par value, consistent with the terms of the securitization documents, so no current or future charge to the bank's earnings or capital will result from these asset sales.
- The charge-off policy for cardholders that have filed for bankruptcy is changed from criteria that were more conservative than industry standards and the FFIEC Uniform Retail Credit Classification and Account Management Policy to criteria that conform to industry standards and the FFIEC's policy.
- Charged-off receivables held by the trust are sold to a third party. The funds generated by this sale, effectively accelerating the recovery on these receivables, improve the trust's spread performance.

Analysis. The actions described above do not constitute implicit recourse for regulatory capital purposes. None of the noncontractual actions results in a loss or exposes the bank's earnings or capital to the risk of loss. Because of the margin compression, the bank is obligated to increase the spread accounts in conformance with the terms and conditions of the securitization documents. To the extent this results in an increase in the value of the subordinated spread accounts (residual interests) on the bank's balance sheet, the bank will need to hold additional capital on a dollar-for-dollar basis for the additional credit risk it retains. In contrast, if the bank increased the spread accounts beyond its contractual obligation under the securitization documents in order to provide additional protection to investors, this action would be considered a form of implicit recourse. None of the other actions the bank took would affect the bank's earnings or capital:

- Like other additions to credit card trusts, the additions of receivables from the new affinity accounts were made at par value, in accordance with the securitization documents. Therefore, the addition of receivables to the new affinity accounts would not affect the bank's earnings or capital.
- The trust's policy on the timing of charge-offs on accounts of cardholders who have filed for bankruptcy was changed to meet the less-stringent standards of the industry and those required under the Federal Reserve's policy to improve trust performance, at least temporarily. Nonetheless, this would not affect the bank's earnings or capital.
- In accordance with the securitization documents, proceeds from recoveries on charged-off accounts are the property of the trust. These and other proceeds would continue to be paid out in accordance with the pooling and servicing agreement. No impact on the bank's earnings or capital would result.

Modification of loan-repayment terms: Example 3

Facts. In performing the role of servicer for its securitization, a bank is authorized under its pooling and servicing agreement to modify loan-repayment terms when it appears that this action will improve the likelihood of repayment on the loan. These actions are part of the bank's process of working with customers who are delinquent or otherwise experiencing temporary financial difficulties. All of the modifications are consistent with the bank's internal loan policy. However, in modifying the loan terms, the contractual maturity of some loans may be extended beyond the final maturity date of the most junior class of securities sold to investors. When this occurs, the bank repurchases these loans from the securitization trust at par.

Analysis. The modification of terms and repurchase of loans held by the trust constitutes implicit recourse for regulatory capital purposes. The combination of the loan-term modification for securitized assets and the subsequent repurchase constitutes implicit recourse. While the modification of loan terms is permitted under the pooling and servicing agreement, the repurchase of loans with extended maturities at par exposes the bank's earnings and capital to potential risk of loss.

Servicer's payment of deficiency balances: Example 4

Facts. A wholly owned subsidiary of a bank originates and services a portfolio of home equity loans. After liquidation of the collateral for a defaulted loan, the subsidiary makes the trust whole in terms of principal and interest if the proceeds from the collateral are not sufficient. However, there is no contractual commitment that requires the subsidiary to support the pool in this manner. The payments made to the trust to cover deficient balances on the defaulted loans are not recoverable under the terms of the pooling and servicing agreement.

Analysis. The subsidiary's action constitutes implicit recourse to the bank for regulatory capital purposes. This action is considered implicit recourse because it adversely affects the bank's earnings and capital since the bank absorbs losses on the loans resulting from the actions taken by its subsidiary. Further, no mechanism exists to provide for, and ensure that, the subsidiary will be reimbursed for the payments made to the trust. In addition, examiners will consider any servicer advance a credit enhancement if the servicer is not entitled to full reimbursement[10c] or if the reimbursement is subordinate to other claims.

Reimbursement of credit enhancer's actual losses: Example 5

Facts. A bank sponsoring a securitization arranges for an unrelated third party to provide a first-loss credit enhancement, such as a financial standby letter of credit that will cover losses up to the first 10 percent of the securitized assets. The bank agrees to pay a fixed amount as an annual premium for this credit enhancement. The third party initially covers actual losses that occur in the underlying asset pool in accordance with its contractual commitment under the letter of credit. Later, the selling bank agrees not only to pay the credit enhancer the annual premium on the credit enhancement, but also to reimburse the credit enhancer for the losses it absorbed during the preceding year. This reimbursement for actual losses was not originally provided for in the contractual arrangement between the bank and the credit-enhancement provider.

Analysis. The selling bank's subsequent reimbursement of the credit-enhancement provider's losses constitutes implicit recourse because the bank's reimbursement of losses went beyond its contractual obligations. Furthermore, the Federal Reserve would consider any requirement contained in the original credit-enhancement contract that obligates the bank to reimburse the credit-enhancement provider for its losses to be a recourse arrangement.

Low-Level Exposure

Securitization transactions involving recourse may be eligible for ''low-level-recourse'' treatment.[11] A bank that contractually limits its maximum off-balance-sheet recourse obligation or direct-credit substitute (except credit-enhancing I/O strips) to an amount less than the effective risk-based capital requirement for the enhanced assets is required to hold risk-based capital equal to the maximum contractual exposure, [12] less any recourse liability established in accordance with GAAP. The low-level-recourse capital treatment thus applies to transactions accounted for as sales under GAAP. The low-level-exposure rule provides that the dollar amount of risk-based capital required for assets transferred with recourse should not exceed the maximum dollar amount for which a bank is contractually liable, less any recourse liability account established in accordance with GAAP. The limitation does not apply when the bank provides credit enhancement beyond any con-

10c. A servicer advance will also be considered a form of credit enhancement if, for any one loan, nonreimbursable advances are not contractually limited to an insignificant amount of that loan's outstanding principal.

11. See the Federal Reserve's Regulation H, appendix A. See also 60 *Fed. Reg.* 17986, April 10, 1995 (OCC); 60 *Fed. Reg.* 8177, February 13, 1995 (FRB); and 60 *Fed. Reg.* 15858, March 28,1995 (FDIC). The OTS low-level-recourse rule is found at 12 CFR 567.6(a)(2)(i)(c).

12. For example, the effective risk-based capital requirement generally would be 4 percent for residential mortgages and 8 percent for commercial loans.

tractual obligation to support assets it has sold. The low-level capital treatment applies to low-level-recourse transactions involving all types of assets, including commercial loans and residential mortgages.

Low-level-recourse transactions can arise when a bank sells or securitizes assets and uses contractual cash flows, such as spread accounts and I/O strips receivables, as a credit enhancement for the sold or securitized assets. A spread account is an escrow account that a bank typically establishes to absorb losses on receivables it has sold in a securitization, thereby providing credit enhancement to investors in the securities backed by the receivables, for example, credit card receivables. As defined in paragraph 14 of FAS 140, an I/O strip receivable is the contractual right to receive some or all of the interest due on a bond, a mortgage loan, or other interest-bearing financial assets. I/O strips are to be measured at fair value with gains or losses recognized either in earnings (if classified as trading) or a separate component of shareholders' equity (if classified as available-for-sale). Paragraph 14 of FAS 140 states that I/O strips, retained interests in securitizations, loans, other receivables, or other financial assets that can contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment (except for instruments that are within the scope of Statement of Financial Accounting Standards No. 133 (FAS 133), ''Accounting for Derivative Instruments and Hedging Activities,'' shall be subsequently measured like investments in debt securities classified as available-for-sale or trading under Statement of Financial Accounting Standards No. 115 (FAS 115), ''Accounting for Certain Investments in Debt and Equity Securities.'' Retained interests that lack objectively verifiable support or that fail to meet the supervisory standards (discussed previously in this section) will be classified as loss and disallowed as assets of the BO for regulatory capital purposes.

Another divergence from the general risk-based capital treatment for assets sold with recourse concerns small-business obligations. Qualifying institutions that transfer small-business obligations with recourse are required, for risk-based capital purposes, to maintain capital against only the amount of recourse retained, provided two conditions are met. First, the transactions must be treated as a sale under GAAP. Second, the transferring institutions must establish, pursuant to GAAP, a noncapital reserve sufficient to meet the reasonably estimated liability under their recourse arrangements.

Banking organizations will be considered qualifying institutions for the purpose of treatment of recourse for small-business organizations if, pursuant to the Board's prompt-corrective-action regulation (12 CFR 208.40), they are well capitalized or, by order of the Board, adequately capitalized.[13] To qualify, an institution must be determined to be well capitalized or adequately capitalized without taking into account the preferential capital treatment for any previous transfers of small-business obligations with recourse. The total outstanding amount of recourse retained by a qualifying BO on transfers of small-business obligations receiving the preferential capital treatment cannot exceed 15 percent of the institution's total risk-based capital.

Standby Letters of Credit

Banking organizations that issue standby letters of credit as credit enhancements for ABS issues must hold capital against these contingent liabilities under the risk-based capital guidelines. According to the guidelines, financial standby letters of credit are direct-credit substitutes. A direct-credit substitute is an arrangement in which a bank assumes, in form or substance, credit risk associated with an on- or off-balance-sheet credit exposure that it did not previously own (a third-party asset), and the risk assumed by the bank exceeds the pro rata share of its interest in the third-party asset. If the bank has no claim on the third-party asset, then its

13. Under 12 CFR 208.43, a state member bank is deemed to be well capitalized if it (1) has a total risk-based capital ratio of 10.0 percent or greater; (2) has a tier 1 risk-based capital ratio of 6.0 percent or greater; (3) has a leverage ratio of 5.0 percent or greater; and (4) is not subject to any written agreement, order, capital directive, or prompt-corrective-action directive issued by the Board pursuant to section 8 of the FDI Act, the International Lending Supervision Act of 1983, or section 38 of the FDI Act or any regulation thereunder to meet and maintain a specific capital level for any capital measure.

A state member bank is deemed to be adequately capitalized if it (1) has a total risk-based capital ratio of 8.0 or greater, (2) has a tier 1 risk-based capital ratio of 4.0 percent or greater, (3) has a leverage ratio of 4.0 percent or greater or a leverage ratio of 3.0 percent or greater if the bank is rated composite 1 under the CAMELS rating system in its most recent examination and is not experiencing or anticipating significant growth, and (4) does not meet the definition of a well-capitalized bank.

assumption of *any* credit risk with respect to the third-party asset is a direct-credit substitute. Direct-credit substitutes are converted in their entirety to credit-equivalent amounts. The credit-equivalent amounts are then risk-weighted according to their credit rating, like other direct-credit substitutes, and the risk weight for the corresponding credit rating.

Concentration Limits Imposed on Residual Interests

The creation of a residual interest (the debit) typically results in an offsetting gain on sale (the credit), and thus the generation of an asset. Banking organizations that securitize high-yielding assets with long durations may create a residual-interest asset value that exceeds the risk-based capital charge that would be in place if it had not sold the assets. Serious problems can arise for those banking organizations that distribute earnings too generously, only to be faced later with a downward valuation and charge-off of part or all of the residual interests.

Under the Federal Reserve's capital adequacy guidelines, there is a dollar-for-dollar capital charge on residual interests and a concentration limit on a subset of residual interests, credit-enhancing I/O strips. These strips include any on-balance-sheet assets that represent a contractual right to receive some or all of the interest due on transferred assets, after taking into account trustee and other administrative expenses, interest payments to investors, servicing fees, reimbursements to investors for losses attributable to beneficial interests they hold, and reinvestment income and ancillary revenues (for example, late fees) on the transferred assets. Credit-enhancing I/O strips expose the bank to more than its pro rata share of credit risk and are limited to 25 percent of tier 1 capital, whether they are retained or purchased. Any amount of credit-enhancing I/O strips that exceeds the 25 percent limit will be deducted from tier 1 capital and assets. An example of the concentration calculation required for banks that hold credit-enhancing I/O strips is described below.

A bank has purchased and retained on its balance sheet credit-enhancing I/O strips with a face amount of $100, and it has tier 1 capital of $320 (before any disallowed servicing assets, disallowed purchased credit-card relationships, disallowed credit-enhancing I/O strips, disallowed deferred tax assets, and amounts of nonfinancial equity investments required to be deducted). To determine the amount of credit-enhancing I/O strips that fall within the concentration limit, the bank would multiply the tier 1 capital of $320 by 25 percent, which is $80. The amount of credit-enhancing I/O strips that exceeds the concentration limit, in this case $20, is deducted from tier 1 capital for risk-based and leverage capital calculations and from assets.

Credit-enhancing I/O strips that are not deducted from tier 1 capital (that is, the remaining $80 in the above example), along with all other residual interests not subject to the concentration limit, are subject to a dollar-for-dollar capital requirement. Banks are not required to hold capital for more than 100 percent of the amount of the residual interest. Credit-enhancing I/O strips are not aggregated with any servicing assets or purchased credit-card relationships for purposes of calculating the 25 percent concentration limit.

Continuing the above illustration, once a bank deducts the $20 in disallowed credit-enhancing I/O strips, it must hold $80 in total capital for the $80 that represents the credit-enhancing I/O strips not deducted from tier 1 capital. The $20 deducted from tier 1 capital, plus the $80 in total risk-based capital required under the dollar-for-dollar treatment, equals $100, the face amount of the credit-enhancing I/O strips. Banks may apply a net-of-tax approach to any credit-enhancing I/O strips that have been deducted from tier 1 capital, as well as to the remaining residual interests subject to the dollar-for-dollar treatment. A bank is permitted, but not required, to net the deferred tax liabilities recorded on its balance sheet, if any, that are associated with the residual interests. This netting of the deferred tax liabilities may result in a bank's holding less than 100 percent capital against residual interests.

Normally, a sponsor will eventually receive any excess cash flow remaining from securitizations after investor interests have been met. As previously stated, residual interests are vulnerable to sudden and sizeable write-downs that can hinder a bank's access to the capital markets; damage its reputation in the marketplace; and, in some cases, threaten its solvency. An institution's board of directors and management are expected to develop and implement policies that limit the amount of residual interests that may be carried as a percentage of total equity capital, based on the results of their valuation and modeling processes. Well-constructed internal limits also lessen the incentives for an institution's personnel to engage in activities designed to generate near-term "paper profits" that may be at the expense of the institution's long-term financial position and reputation.

SOUND RISK-MANAGEMENT PRACTICES

An institution must incorporate the risks involved in its securitization activities into its overall risk-management system. The system should entail (1) inclusion of risk exposures in reports to the institution's senior management and board to ensure proper management oversight; (2) adoption of appropriate policies, procedures, and guidelines to manage the risks involved; (3) appropriate measurement and monitoring of risks; and (4) assurance of appropriate internal controls to verify the integrity of the management process with respect to these activities.

Board and Senior Management Oversight

Both the board of directors and senior management are responsible for ensuring that they fully understand the degree to which the organization is exposed to the credit, market, liquidity, operational, legal, and reputational risks involved in the institution's securitization activities. They are also responsible for ensuring that the formality and sophistication of the techniques used to manage these risks are commensurate with the nature and volume of the organization's activities. Institutions with significant securitization activities are expected to have more elaborate and formal approaches to manage the risk of these activities. The board should approve all significant policies relating to the management of risk arising from securitization activities and should ensure that risk exposures are fully incorporated in board reports and risk-management reviews.

Policies and Procedures

Senior management is responsible for ensuring that the risks arising from securitization activities are adequately managed on both a short-term and long-run basis. Management should ensure that adequate policies and procedures are in place for incorporating the risk of these activities into the overall risk-management process of the institution. Such policies should ensure that the economic substance of the risk exposures generated by these activities is fully recognized and appropriately managed. In addition, BOs involved in securitization activities should have appropriate policies, procedures, and controls for underwriting asset-backed securities; funding the possible return of revolving receivables (for example, credit card receivables and home equity lines); and establishing limits on exposures to individual institutions, types of collateral, and geographic and industrial concentrations. The institution's directors and managers need to ensure that—

- independent risk-management processes are in place to monitor securitization-pool performance on an individual and aggregate transaction level (an effective risk-management function includes appropriate information systems to monitor securitization activities);
- conservative valuation assumptions and modeling methodologies are used to establish, evaluate, and adjust the carrying value of retained interests on a regular and timely basis;
- audit or internal-review staffs periodically review data integrity, model algorithms, key underlying assumptions, and the appropriateness of the valuation and modeling process for the securitized assets the institution retains (the findings of such reviews should be reported directly to the board or an appropriate board committee);
- accurate and timely risk-based capital calculations are maintained, including recognition and reporting of any recourse obligation resulting from securitization activity;
- internal limits are in place to govern the maximum amount of retained interests as a percentage of total equity capital; and
- the institution has a realistic liquidity plan in place in case of market disruptions.

Independent Risk-Management Function

Institutions engaged in securitizations need to have an independent risk-management function commensurate with the complexity and volume of their securitizations and their overall risk exposures. The risk-management function should ensure that securitization policies and operating procedures, including clearly articulated risk limits, are in place and appropriate for the institution's circumstances. A sound asset-securitization policy should include or address, at a minimum—

- a written and consistently applied accounting methodology;
- regulatory reporting requirements;
- valuation methods, including FAS 140 residual-value assumptions, and procedures to formally approve changes to those assumptions;
- a management reporting process; and
- exposure limits and requirements for both individual- and aggregate-transaction monitoring.

It is essential that the risk-management function monitor origination, collection, and default-management practices. This includes regular evaluations of the quality of underwriting, soundness of the appraisal process, effectiveness of collections activities, ability of the default-management staff to resolve severely delinquent loans in a timely and efficient manner, and appropriateness of loss-recognition practices. Because the securitization of assets can result in the current recognition of anticipated income, the risk-management function should pay particular attention to the types, volumes, and risks of assets being originated, transferred, and serviced. Senior management and the risk-management staff must be alert to any pressures on line managers to originate abnormally large volumes or higher-risk assets to sustain ongoing income needs. Such pressures can lead to a compromise of credit-underwriting standards. This may accelerate credit losses in future periods, impair the value of retained interests, and potentially lead to funding problems.

Risk Measurement and Monitoring

An institution's risk-management function should include information and risk-measurement and -monitoring systems that fully incorporate the risks involved in its securitization activities. BOs must be able to identify credit exposures from all securitization activities, as well as measure, quantify, and control those exposures on a fully consolidated basis. The economic substance of the credit exposures of securitization activities should be fully incorporated into the institution's efforts to quantify its credit risk, including efforts to establish more formal grading of credits to allow for statistical estimation of loss-probability distributions. Securitization activities should also be included in any aggregations of credit risk by borrower, industry, or economic sector.

An institution's information systems should identify and segregate those credit exposures arising from the institution's loan-sale and securitization activities. Such exposures include the sold portions of participations and syndications, exposures arising from the extension of credit-enhancement and liquidity facilities, the effects of an early-amortization event, and the investment in ABS. The management reports should provide the board and senior management with timely and sufficient information to monitor the institution's exposure limits and overall risk profile.

Stress Testing

The use of stress testing, including combinations of market events that could affect a BO's credit exposures and securitization activities, is another important element of risk management. Stress testing involves identifying possible events or changes in market behavior that could have unfavorable effects on the institution, and assessing the organization's ability to withstand them. Stress testing should consider not only the probability of adverse events but also likely worst-case scenarios. Stress testing should be done on a consolidated basis and should consider, for instance, the effect of higher than expected levels of delinquencies and defaults, as well as the consequences of early-amortization events with respect to credit card securities, that could raise concerns regarding the institution's capital adequacy and its liquidity and funding capabilities. Stress-test analyses should also include contingency plans for possible management actions in certain situations.

Internal Controls

One of management's most important responsibilities is establishing and maintaining an effective system of internal controls. Among other things, internal controls should enforce the official lines of authority and the appropriate separation of duties in managing the risks of the institution. These internal controls must be suitable for the type and level of risks at the institution, given the nature and scope of its activities. Moreover, these internal controls should ensure that financial reporting is reliable (in published financial reports and regulatory reports), including adequate allowances or liabilities for expected losses.

Effective internal controls are essential to an institution's management of the risks associated with securitization. When properly designed and consistently enforced, a sound system of internal controls will help management safeguard the institution's resources; ensure that financial information and reports are reliable; and comply with contractual obligations, including securitization covenants. Internal controls will also reduce the possibility of significant errors and irregularities, and assist in their timely detection. Internal controls typically (1) limit authorities; (2) safeguard access to and use of records; (3) separate and rotate duties; and (4) ensure both regular and unscheduled reviews, including testing.

Operational and managerial standards have been established for internal-control and information systems.[14] A system of internal controls should be maintained that is appropriate to the institution's size and the nature, its scope, and the risk of its activities.[15]

Audit Function or Internal Review

The institution's board of directors is responsible for ensuring that its audit staff or independent-review function is competent to review its securitization activities. The audit function should perform periodic reviews of securitization activities, including transaction testing and verification, and report all findings to the board or appropriate board committee. The audit function also may be useful to senior management in identifying and measuring risk related to securitization activities. Principal audit targets should include compliance with securitization policies, operating and accounting procedures (FAS 140), deal covenants, and the accuracy of MIS and regulatory reports. The audit function also should confirm that the institution's regulatory reporting process is designed and managed to facilitate timely and accurate report filing. Furthermore, when a third party services loans, the auditors should perform an independent verification of the existence of the loans to ensure that balances reconcile to internal records.

Management Information Systems

An institution's reporting and documentation methods must support the initial valuation of any retained interests and provide ongoing impairment analyses of these assets. Pool-performance information will help well-managed institutions ensure, on a qualitative basis, that a sufficient amount of economic capital is being held to cover the various risks inherent in securitization transactions. The absence of an adequate management information system (MIS) will hinder management's ability to monitor specific pool performance and securitization activities. MIS reports, at a minimum, should address the following:

- *Securitization summaries for each transaction.* The summary should include relevant transaction terms such as collateral type, facility amount, maturity, credit-enhancement and subordination features, financial covenants (termination events and spread-account capture "triggers"), right of repurchase, and counterparty exposures. Management should ensure that the summaries for each transaction are distributed to all personnel associated with securitization activities.
- *Performance reports by portfolio and specific product type.* Performance factors include gross portfolio yield, default rates and loss severity, delinquencies, prepayments or payments, and excess spread amounts. The reports should reflect the performance of assets, both on an individual-pool basis and total managed assets. These reports should segregate specific products and different marketing campaigns.

14. See the safety-and-soundness standards for national banks at 12 CFR 30 (OCC) and for savings associations at 12 CFR 570 (OTS).

15. Institutions that are subject to the requirements of FDIC regulation 12 CFR 363 should include an assessment of the effectiveness of internal controls over their asset-securitization activities as part of management's report on the overall effectiveness of the system of internal controls over financial reporting. This assessment implicitly includes the internal controls over financial information that is included in regulatory reports.

- *Vintage analysis for each pool using monthly data.* Vintage analysis will help management understand historical performance trends and their implications for future default rates, prepayments, and delinquencies, and therefore retained interest values. Management can use these reports to compare historical performance trends with underwriting standards, including the use of a validated credit scoring model, to ensure loan pricing is consistent with risk levels. Vintage analysis also helps in the comparison of deal performance at periodic intervals and validates retained-interest valuation assumptions.
- *Static-pool cash-collection analysis.* A static-pool cash-collection analysis involves reviewing monthly cash receipts relative to the principal balance of the pool to determine the cash yield on the portfolio, comparing the cash yield to the accrual yield, and tracking monthly changes. Management should compare monthly the timing and amount of cash flows received from the trust with those projected as part of the FAS 140 retained-interest valuation analysis. Some master-trust structures allow excess cash flow to be shared between series or pools. For revolving-asset trusts with this master-trust structure, management should perform a cash-collection analysis for each master-trust structure. These analyses are essential in assessing the actual performance of the portfolio in terms of default and prepayment rates. If cash receipts are less than those assumed in the original valuation of the retained interest, this analysis will provide management and the board with an early warning of possible problems with collections or extension practices and impairment of the retained interest.
- *Sensitivity analysis.* A sensitivity analysis measures the effect of changes in default rates, prepayment or payment rates, and discount rates to assist management in establishing and validating the carrying value of the retained interest. Stress tests should be performed at least quarterly. Analyses should consider potential adverse trends and determine ''best,'' ''probable,'' and ''worst case'' scenarios for each event. Other factors that need to be considered are the impact of increased defaults on collections staffing, the timing of cash flows, spread-account capture triggers, overcollateralization triggers, and early-amortization triggers. An increase in defaults can result in higher than expected costs and a delay in cash flows, thus decreasing the value of the retained interests. Management should periodically quantify and document the potential impact to both earnings and capital, and report the results to the board of directors. Management should incorporate this analysis into their overall interest-rate risk measurement system.[16] Examiners will review the institution's analysis and the volatility associated with retained interests when assessing the Sensitivity to Market Risk component rating (the ''S'' in the CAMELS rating system for banks or the ''M'' for the BHC rating system).[17]
- *Statement of covenant compliance.* Ongoing compliance with deal-performance triggers as defined by the pooling and servicing agreements should be affirmed at least monthly. Performance triggers include early amortization, spread capture, changes to overcollateralization requirements, and events that would result in servicer removal.

Securitization Convenants Linked to Supervisory Actions or Thresholds

A bank's board of directors and senior management are responsible for initiating policies and procedures and for monitoring processes and internal controls that will provide reasonable assurance that the bank's contracts and commitments do not include detrimental covenants that affect the safety and soundness of the bank. When examiners review a bank's securitization contracts and related documentation, they should be alert to any covenants that use adverse supervisory actions or the breach of supervisory thresholds as triggers for early-amortization events or the transfer of servicing. Examples of such supervisory actions include a downgrade in the organization's CAMELS rating, an enforcement action, or a downgrade in a bank's prompt-corrective-action capital category. The inclusion of supervisory-linked covenants in securitization documents is considered to be an "unsafe and unsound banking practice" that undermines the objective of supervisory actions and thresholds. An early amortization or transfer of ser-

16. The Joint Agency Policy Statement on Interest-Rate Risk (see SR-96-13 and section 4090.1) advises institutions with a high level of exposure to interest-rate risk relative to capital that they will be directed to take corrective action.

17. See the appendix to section 5020.1 (section A.5020.1).

vicing triggered by such events can create or exacerbate liquidity and earnings problems for a bank that may lead to further deterioration in its financial condition.

Convenants that contain triggers tied, directly or indirectly, to supervisory actions or thresholds can also result in the early amortization of a securitization at a time when the sponsoring organization's ability to access other funding sources is limited. If an early-amortization event occurs, investors may lose confidence in the stability of the sponsoring organization's asset-backed securities, thus limiting its ability to raise new funds through securitization. At the same time, the organization must fund new receivables on the balance sheet, potentially resulting in liquidity problems. Moreover, the existence of a supervisory-linked trigger potentially could inhibit supervisors from taking action intended to address problems at a troubled institution because the action could trigger an event that worsens the institution's condition or causes its failure.

The Federal Reserve and the other federal banking agencies (the OCC, FDIC, and OTS) also are concerned that covenants related to supervisory actions may obligate a bank's management to disclose confidential examination information, such as the CAMELS rating. Disclosure of such information by a bank's directors, officers, employees, attorneys, auditors, or independent auditors, without explicit authorization by the institution's primary regulator, violates the agencies' information-disclosure rules and may result in follow-up supervisory actions. (See SR-02-14.)

Because of the supervisory concerns about convenants linked to supervisory actions, a federal bank interagency advisory was issued on May 23, 2002. The advisory emphasizes that a bank's management and board of directors should ensure that covenants related to supervisory actions or thresholds are not included in securitization documents. Covenants that provide for the early termination of the transaction or compel the transfer of servicing due, directly or indirectly, to the occurrence of a supervisory action or event will be criticized, under appropriate circumstances, as an unsafe and unsound banking practice. The agencies also may take other supervisory actions, such as requiring additional capital or denying capital relief for risk-based capital calculations, regardless of the GAAP treatment.

Examiners should consider the potential impact of such covenants in existing transactions when evaluating both the overall condition of the bank and the specific component ratings of capital, liquidity, and management. Early-amortization triggers will specifically be considered in the context of the bank's overall liquidity position and contingency funding plan. For organizations with limited access to other funding sources or a significant reliance upon securitization, the existence of these triggers presents a greater degree of supervisory concern. Any bank that uses securitization as a funding source should have a viable contingency funding plan in the event it can no longer access the securitization market. Examiners should encourage bank management to amend, modify, or remove covenants linked to supervisory actions from existing transactions. Any impediments a bank may have to taking such actions should be documented and discussed with the appropriate supervisory staff of its responsible Reserve Bank.

SECURITIZATION OF COMMERCIAL PAPER

The involvement of banks in the securitization of commercial paper has increased significantly over time. It is important to note, however, that asset-backed commercial paper programs differ from other methods of securitization. One difference is that more than one type of asset may be included in the receivables pool.[18] Moreover, in certain cases, the cash flow from the receivables pool may not necessarily match the payments to investors because the maturity of the underlying asset pool does not always parallel the maturity of the structure of the commercial paper. Consequently, when the paper matures, it is usually rolled over or funded by another issue. In certain circumstances, a maturing issue of commercial paper cannot be rolled over. To address this problem, many banks have established back-up liquidity facilities. Certain banks have classified these back-up facilities as pure liquidity facilities, despite the credit-enhancement element present in them, and, as a result, have incorrectly assessed the risks associated with these facilities. In these cases, the back-

18. See the Federal Reserve System's Supervision and Regulation Task Force on Securitization, "An Introduction to Asset Securitization," issued as an attachment to SR-90-16, and "Asset-Backed Commercial Paper Programs," *Federal Reserve Bulletin*, February 1992.

up liquidity facilities have been more similar to direct-credit substitutes than to loan commitments.

APPRAISALS AND MORTGAGE-BACKED SECURITIES

Under 12 CFR 225.63(a)(8), an appraisal performed by a state-certified or -licensed appraiser is not required for any real estate–related financial transaction in which a regulated institution purchases a loan or interest in a loan; pooled loans; or an interest in real property, including mortgage-backed securities, provided that the appraisal prepared for each pooled loan or real property interest met the requirements of the regulation. Banks must establish procedures for determining and ensuring that applicable appraisals meet the requirements.

EXAMINATION GUIDELINES FOR ASSET SECURITIZATION

A banking organization may be involved in originating the assets to be pooled, packaging the assets for securitization, servicing the pooled assets, acting as trustee for the pool, providing credit enhancements, underwriting or placing the ABS, or investing in the securities. Individual securitization arrangements often possess unique features, and the risks addressed in this abbreviated version of the examiner guidelines[19] do not apply to all securitization arrangements. Conversely, arrangements may entail risks not summarized here. Examiners should judge a banking organization's exposure to securitization with reference to the specific structures in which the organization is involved and the degree to which the organization has identified exposures and implemented policies and controls to manage them. Examiners may tailor the scope of their examinations if the banking organization's involvement in securitization is immaterial relative to its size and financial strength.

A banking organization participating in securitization, in any capacity, should ensure that the activities are clearly and logically integrated into the overall strategic objectives of the organization. The management of the organization should understand the risks and should not rely excessively on outside expertise to make crucial decisions regarding securitization activities.

As mentioned earlier, the degree of securitization exposure faced by an individual banking organization depends on the role of the organization in the securitization process. An organization involved in the issuance of ABS as originator, packager, servicer, credit enhancer, underwriter, or trustee may face combinations and degrees of risk different than those faced by an organization that only invests in ABS. Examiners should assess a BO's level, identification, and management of risks within the context of its roles.

19. A complete version of the "Examination Guidelines for Asset Securitization" is attached to SR-90-16.

A BO should conduct an independent analysis of its exposures before participating in any aspect of securitization and should continue to monitor its exposures throughout its involvement. The analysis and subsequent monitoring should take into account the entire securitization arrangement, emphasizing different risks according to the role that the organization plays. Excessive reliance on opinions of third parties and reported collateral values should be avoided.

An organization involved in the issuance of ABS should scrutinize the underlying assets, giving consideration to their yield, their maturity, their credit risk, their prepayment risk, and the accessibility of collateral in cases of default, as well as the structure of the securitization arrangement and the ability of the other participants in the transaction to meet their obligations. On the other hand, a BO investing in ABS can be expected to place greater emphasis on the characteristics of the ABS as securities, paying attention primarily to credit risk, prepayment risk, liquidity risk, and concentration risk; the underlying assets and structure of the securitization arrangement would be evaluated only within this context.

Appropriate policies, procedures, and controls should be established by a BO before participating in asset securitization. Controls should include well-developed management information systems. In addition, significant policies and procedures should be approved and reviewed periodically by the organization's board of directors.

In addition to evaluating and monitoring exposure to particular securitization deals, a BO should manage its overall exposure on a consolidated holding company basis. Management of these exposures should include—

- reasonable limits on geographic and industrial concentrations, as well as on exposures to individual institutions;
- internal systems and controls to monitor these exposures and provide periodic and timely reports to senior management and the board of directors on performance and risks; and
- procedures for identifying potential or actual conflicts of interest and policies for resolving those conflicts.

The following general guidelines are intended to help examiners assess the exposures of banks and bank holding companies to asset securitization.

Banking Organizations Involved in Issuing or Managing ABS

A BO involved in the issuance of ABS as originator, packager, servicer, credit enhancer, underwriter, or trustee should analyze the assets underlying the asset-backed security and the structure of the arrangement, including—

- the characteristics and expected performance of the underlying assets,
- the BO's ability to meet its obligations under the securitization arrangement, and
- the ability of the other participants in the arrangement to meet their obligations.

Analysis of the underlying assets should be conducted independently by each participant in the process, giving consideration to yield, maturity, credit risk, prepayment risk, and the accessibility of collateral in cases of default. An originator should further consider the impact of securitization on the remaining asset portfolio and on the adequacy of loan-loss reserves and overall capital.

Financial position and operational capacity should be adequate to meet obligations to other parties in a securitization arrangement, even under adverse scenarios. Accordingly, a BO should ensure that the pricing of services is adequate to cover costs over the term of the obligation, as well as to compensate for associated risks. Further, the organization should have contingency plans to transfer responsibilities to another institution in the event that those responsibilities can no longer be fulfilled. Examiners should determine that the BO has policies and controls for managing contractual obligations, including management of collateral, if applicable. Staffing levels should be adequate to fulfill responsibilities.

If a BO's obligations, under a securitization agreement, are subcontracted to other parties, an assessment of the subcontractor's financial position and operational capacity should be conducted before delegating responsibility. Further, the subcontractor's financial position and compliance with contractual obligations should be monitored periodically.

A BO involved in issuing ABS should make certain that the agreement permits it to assess the ability of other participants in the securitization arrangement to meet their obligations (considering obligations that they may have under other securitization arrangements). The rights and obligations of each of the participants under possibly novel legal and institutional arrangements should be clearly documented.

Funding and liquidity management for originators and packagers of securitized assets should avoid excessive reliance on the device of securitization. Originators and packagers should monitor the securitization market closely, develop a broad customer base for their securitization activities, and maintain diversified funding sources.

BOs should not rely excessively on the expertise of a single individual or a small group of individuals, either inside or outside the organization, for the management of participation in securitization activities. Examiners should ensure that an organization acting as trustee for ABS follows the usual standards for trust services.

Policy and Portfolio Analysis

Credit risk. Institutions should be aware that the credit risk involved in many securitization activities may not always be obvious. For certain types of loan-sales and securitization transactions, a BO may actually be exposed to essentially the same credit risk as in traditional lending activities, even though a particular transaction may, superficially, appear to have isolated the institution from any risk exposure. In such cases, removal of an asset from the balance sheet may not result in a commensurate reduction in credit risk. Transactions that can give rise to such instances include loan sales with recourse; credit derivatives; direct-credit substitutes, such as letters of credit; and liquidity facilities extended to securitization programs, as well as certain asset-securitization structures, such as the structure typically used to securitize credit card receivables.

The partial, first-loss recourse obligations an institution retains when selling assets, and the extension of partial credit enhancements (for example, 10 percent letters of credit) in connection with asset securitization, can be sources of concentrated credit risk by exposing institutions to the full amount of expected losses on the protected assets. For instance, the credit risk associated with whole loans or pools of assets that are sold to secondary-market investors can often be concentrated within the partial, first-loss recourse obligations retained by the BOs that are selling and securitizing the assets. In these situations, even though institutions may have reduced their exposure to catastrophic loss on the assets sold, they generally retain the same credit-risk exposure that they would have had if they continued to hold the assets on their balance sheets.

In addition to recourse obligations, institutions assume concentrated credit risk through the extension of partial direct-credit substitutes, such as through the purchase (or retention) of subordinated interests in their own asset securitizations or through the extension of letters of credit. For example, BOs that sponsor certain asset-backed commercial paper programs, or so-called ‘‘remote-origination’’ conduits, can be exposed to high degrees of credit risk even though it may seem that their notional exposure is minimal. A remote-origination conduit lends directly to corporate customers referred to it by the sponsoring BO that used to lend directly to these same borrowers. The conduit funds this lending activity by issuing commercial paper that, in turn, is guaranteed by the sponsoring BO. The net result is that the sponsoring institution has much the same credit-risk exposure through this guarantee that it would have had if it had made the loans directly and held them on its books. This is an off-balance-sheet transaction, however, and its associated risks may not be fully reflected in the institution’s risk-management system.

Furthermore, BOs that extend liquidity facilities to securitized transactions, particularly to asset-backed commercial paper programs, may be exposed to high degrees of credit risk which may be subtly embedded within a facility’s provisions. Liquidity facilities are commitments to extend short-term credit to cover temporary shortfalls in cash flow. While all commitments embody some degree of credit risk, certain commitments extended to asset-backed commercial paper programs to provide liquidity may subject the extending institution to the credit risk of the underlying asset pool, often trade receivables, or of a specific company using the program for funding. Often, the stated purpose of these liquidity facilities is to provide funds to the program to retire maturing commercial paper when a mismatch occurs in the maturities of the underlying receivables and the commercial paper, or when a disruption occurs in the commercial paper market. However, depending on the provisions of the facility—such as whether the facility covers dilution of the underlying receivable pool—credit risk can be shifted from the program's explicit credit enhancements to the liquidity facility.[20] Such provisions may enable certain programs to fund riskier assets and yet maintain the credit rating on the program's commercial paper without increasing the program's credit-enhancement levels.

The structure of various securitization transactions can also result in an institution's retaining the underlying credit risk in a sold pool of assets. Examples of this contingent credit-risk retention include credit card securitizations in which the securitizing organization explicitly sells the credit card receivables to a master trust, but, in substance, retains the majority of the economic risk of loss associated with the assets because of the credit protection provided to investors by the excess yield, spread accounts, and structural provisions of the securitization. Excess yield provides the first level of credit protection that can be drawn upon to cover cash shortfalls between the principal and coupon owed to investors and the investors' pro rata share of the master trust's net cash flows. The excess yield is equal to the difference between the overall yield on the underlying credit card portfolio and the master trust's operating expenses.[21] The second level of credit protection is provided by the spread account, which is essentially a reserve funded initially from the excess yield.

In addition, the structural provisions of credit card securitizations generally provide credit protection to investors through the triggering of early-amortization events. Such an event usually is triggered when the underlying pool of credit card receivables deteriorates beyond a certain point and requires that the outstanding credit card securities begin amortizing early to pay off investors before the prior credit enhancements are exhausted. As the early amortization accelerates the redemption of principal (paydown) on the security, the credit card accounts that were assigned to the master credit-card trust return to the securitizing institution more quickly than had originally been anticipated. Thus, the institution is exposed to liquidity pressures and any further credit losses on the returned accounts.

Examiner procedures for reviewing credit risk are outlined below:

- Examiners should review a BO's policies and procedures to ensure that the organization follows prudent standards of credit assessment and approval for all securitization exposure. Procedures should include an initial thorough and independent credit assessment of each loan or pool for which it has assumed credit risk, followed by periodic credit reviews to monitor performance throughout the life of the exposure.
- Examiners should determine that rigorous credit standards are applied, regardless of the role an organization plays in the issuance of ABS. The servicer, credit enhancer, and underwriter must perform assessments and approvals independent of and distinct from reviews provided by the originator or packager.
- Major policies and procedures, including internal credit-review and -approval procedures and in-house exposure limits, should be reviewed periodically and approved by the institution's board of directors.
- Failure, fraud, or mismanagement on the part of one participant in an ABS issue could result in loss to any of the other institutions involved in the issue. A BO involved in securitization should have adequate procedures for evaluating the internal-control procedures and financial strength of other institutions with which it is involved.
- Securitization arrangements may remove a credit enhancer from direct access to the collateral. The remedies available to a BO involved in the provision of credit enhancement in the event of a default should be clearly documented.
- Examiners should ensure that, regardless of the role an institution plays in securitization, ABS documentation clearly specifies the limitations of the institution's legal responsibility to assume losses.
- Examiners should verify that a banking organization acting as originator, packager, or underwriter has written policies addressing the repurchase of assets and other reimbursement to investors in the event that a defaulted package results in losses exceeding any contractual credit enhancement. A BO that repurchases defaulted assets or pools in con-

20. Dilution essentially occurs when the receivables in the underlying asset pool—before collection—are no longer viable financial obligations of the customer. For example, dilution can arise from returns of consumer goods or unsold merchandise by retailers to manufacturers or distributors.

21. The monthly excess yield is the difference between the overall yield on the underlying credit card portfolio and the master trust's operating expenses. It is calculated by subtracting from the gross portfolio yield (1) the coupon paid to investors; (2) charge-offs for that month; and (3) a servicing fee, usually 200 basis points, paid to the banking organization sponsoring the securitization.

tradiction of the underlying agreement in effect sets a standard by which it could potentially be found legally liable for all ''sold'' assets. A BO that responds in this manner to the ''moral hazard'' or reputational risk arising from its securitization activities may face additional risk from other areas of its securitization activities. Examiners should review any situations in which the organization has repurchased or otherwise reimbursed investors for poor-quality assets.
- A BO's records should be reviewed to ensure that credit, pricing, and servicing standards for securitized assets are equivalent to standards for assets that remain on the books. The quality of securitized assets should be accurately characterized to investors and other parties to the securitization arrangement to avoid unforeseen pressures to repurchase defaulted issues.
- Pricing policies and practices should be reviewed to determine that they incorporate an analysis of the trade-off between risk and return.
- Examiners should consider securitization risks when analyzing the adequacy of an organization's capital or reserve levels. Adverse credit risk should be classified accordingly.

Concentration risk. A banking organization involved in originating, packaging, servicing, underwriting, or enhancing the creditworthiness of ABS must take special care to follow in-house diversification requirements for aggregate outstandings to a particular institution, industry, or geographic area. Examiner procedures for reviewing concentration risk are outlined below:

- When determining compliance with internal credit-exposure limits, securitization exposure should be aggregated with all loans, extensions of credit, debt and equity securities, legally binding financial guarantees, commitments, and any other investments involving the same obligor.
- Examiners should review all pools of sold assets for industrial or geographic concentrations. Excessive exposures to an industry or region among these assets should be noted in the review of the BO's loan portfolio.
- Inherent in securitization is the risk that, if another party involved in the securitization arrangement becomes unable to perform according to contract terms, the issue might default even while the underlying credits are performing. This credit exposure to the other managing parties in a securitization transaction should be included under a BO's general line to those institutions. Examiners should, therefore, ensure that, in addition to policies limiting direct credit exposure, an institution has developed exposure limits, with respect to particular originators, credit enhancers, and servicers.

Reputational risk. The securitization activities of many institutions may also expose them to significant reputational risks. Often, BOs that sponsor the issuance of asset-backed securities act as servicers, administrators, or liquidity providers in the securitization transactions. These institutions must be aware of the potential losses and risk exposure associated with reputational risk that arise from these securitization activities. The securitization of assets whose performance has deteriorated may result in a negative market reaction that could increase the spreads on an institution's subsequent issuances. To avoid a possible increase in their funding costs, institutions have supported their securitization transactions by improving the performance of the securitized asset pool (for example, by selling discounted receivables or adding higher-quality assets to the securitized asset pool). Thus, an institution's voluntary support of its securitization in order to protect its reputation can adversely affect the sponsoring or issuing organization's earnings and capital.

Liquidity and market risk. The existence of recourse provisions in asset sales, the extension of liquidity facilities to securitization programs, and early-amortization triggers of certain asset-securitization transactions can involve significant liquidity risk to institutions engaged in these securitization activities. Institutions should ensure that their liquidity contingency plans fully incorporate the potential risk posed by their securitization activities. When new ABS are issued, the issuing banking organization should determine their potential effect on its liquidity at the inception of each transaction and throughout the life of the securities to better ascertain its future funding needs.

An institution's contingency plans should consider the need to obtain replacement funding and specify the possible alternative funding sources, in the event of the amortization of outstanding ABS. Replacement funding is particularly important for securitizations of revolving receivables, such as credit cards, in which an early amortization of the ABS could unexpectedly return the outstanding balances of the securitized accounts to the issuing institution's balance sheet. Early amortization of a banking organization's ABS could impede an institution's ability to fund itself—either through reissuance or other borrowings—since the institution's reputation with investors and lenders may be adversely affected. Moreover, the liquidity risk and market risk to which ABS are subject may be exacerbated by thin secondary markets for them. Examiner procedures for reviewing liquidity and market risk are outlined below:

- Examiners should review the policies of a BO engaged in underwriting, looking for situations in which it cannot sell underwritten ABS. Credit review, funding capabilities, and approval limits should allow the institution to purchase and hold unsold securities. Absent this analysis, the institution should only handle ABS on a best-efforts basis. All potential credit exposure should be within legal lending limits.
- Examiners should ensure that a BO engaged in underwriting or market making has implemented adequate hedging or other risk-management policies to limit its exposure to adverse price movements.
- Examiners should determine whether an organization targets certain loans at origination to be packaged and securitized. If so, examiners should review the length of time these assets are held while being processed. Examiners should review management information systems reports to age targeted loans and to determine if there is any decline in value while the loans are in the pipeline. Loans held for resale in this pipeline should be segregated and carried at the lower of cost or market value.

Transfer risk and operational risk. Transfer risk is analogous to liquidity risk. It is the risk that an organization with obligations under securitization arrangements may wish to relinquish those obligations but may not be able to do so. Operational risk arises from uncertainty about an organization's ability to meet its obligations under securitization arrangements and may arise from insufficient computer resources or from a failure of fees to cover associated costs. An organization filling a role that potentially requires long-term resource commitments, such as servicer or credit enhancer, is most susceptible to transfer risk and operational risk. Examiner procedures for reviewing transfer and operational risk are outlined below:

- Examiners should determine that a BO has reviewed the relevant contracts to verify that they are free of any unusual features that increase the potential cost of transfer of obligations.
- Examiners should ascertain that a BO has evaluated the fee structure of the securitization to determine that fees are sufficient to cover the costs of associated services. Further, examiners should determine that a BO has reviewed the projected cash flow from the underlying assets to ensure that principal and interest payments will be timely and will be sufficient to cover costs, even under adverse scenarios.
- A servicer or credit enhancer subcontracting or participating responsibilities should initially assess the financial condition and reputation of any organization to which responsibility may be delegated. Subsequent periodic monitoring by the servicer or credit enhancer should assess the financial condition of organizations to which responsibility has been delegated, as well as their compliance with contractual obligations. Trustees should, likewise, monitor the financial condition and compliance of all participants in the securitization arrangement.

Conflicts of interest. With respect to the various functions performed by a BO, the potential for conflicts of interest exists when an organization plays multiple roles in securitization. Policies and procedures must address this potential conflict, especially the risk of legal ramifications or negative market perceptions if the organization appears to compromise its fiduciary responsibility to obligors or investors. Examiner procedures for reviewing conflicts of interest are outlined below:

- Examiners should review a BO's policies for disclosure of confidential but pertinent information about the underlying assets and obligors. An organization involved in the origination or processing of a securitization transaction should have written statements from obligors allowing the disclosure of pertinent confidential information to potential investors. In addition, the underwriting bank must follow proper procedures of due diligence.

- If the securitization business of an originator, underwriter, or credit enhancer is volume-driven, legal obligations or prudent banking practices may be breached. Examiners should review credit standards used in analyzing assets earmarked for securitization to determine that sound banking practices are not being compromised to increase volume or to realize substantial fees.
- Examiners should determine that the organization's policies addressing activities at various subsidiaries or affiliates are managed consistently and prudently in compliance with regulatory policies.

Legal Review and Liability

The complexity of asset-securitization transactions requires a BO that participates in them in any capacity to fully investigate all applicable laws and regulations, to establish policies and procedures to ensure legal review of all securitization activities, and to take steps to protect the organization from liability in the case of problems with particular asset-backed issues. Organizations and examiners should be aware of the continual evolution of criteria on the types of assets that may be securitized and the types of BOs that may engage in the various aspects of securitization. Examiner procedures for checking an institution's legal-review and liability-protection measures are outlined below:

- Different responsibilities in connection with securitizations may be split among various subsidiaries of an organization. Examiners should, therefore, review the overall risk exposure to an organization. Specifically, examiners should be alert to situations in which the structure of a securitization obscures the concentration risk in individual ABS or in a portfolio of ABS. Examiners should also be mindful of structures that may effectively conceal low-quality assets or contingent liabilities from examination scrutiny and possible classification.
- Examiners should review a BO's insurance coverage to determine if it is sufficient to cover its fiduciary responsibilities under securitization arrangements. At least one rating agency requests that servicers carry errors and omissions insurance that will cover a minimum of 5 percent of the outstanding obligation.
- Private placements of ABS are not subject to the same legal-disclosure requirements as public placements. An organization involved in private placements of ABS should, therefore, exercise special caution with regard to disclosure of the risks and attributes of the securitized assets.

Banking Organizations Investing in ABS

ABS may appear similar to corporate notes; however, ABS possess many unique characteristics that affect their riskiness as investments. A BO should independently analyze all potential risk exposures before investing in ABS and should continue to monitor exposures throughout the life of the ABS. Analyses should focus primarily on characteristics of ABS, such as credit risk, concentrations of exposures, interest-rate risk, liquidity risk, market risk, and prepayment risk. As an integral part of these analyses, a BO investing in ABS should evaluate the underlying assets, the participants in the securitization arrangement, and the structure of the securitization arrangement, although it should not be expected to analyze these factors in the same detail as BOs involved in the issuance of ABS.

Any purchase of ABS should be consistent with the overall objectives of the organization. The securities should constitute an integrated component of the investment or hedging plans of the organization and should not be purchased for speculative purposes. A banking organization should not rely on investment or trading strategies, which depend on the existence of liquid secondary ABS markets.

Policy and Portfolio Analysis

Credit risk. While ABS are often insulated, to some extent, from the credit risk of the underlying assets, credit risk is still affected by a number of factors, in addition to the performance of the underlying asset pool. These factors include the ability of the parties involved in the securitization arrangement to fulfill their obligations and the structure of the securitization itself.

In the event of default by obligors or other failure of the securitization structure, access to collateral may be difficult and recourse to the various providers of credit enhancement may be time-consuming and costly. Some forms of credit enhancement may be revocable. Banking organizations should not place undue reliance on collateral values and credit enhancement in evaluating ABS.

In many cases, ratings of the creditworthiness of ABS issues are available from external credit agencies. A banking organization may use credit ratings as a source of information, but should not depend solely on external agencies' evaluations of creditworthiness. Unrated ABS should be subject to particular scrutiny. Examiner procedures for reviewing credit risk are outlined below:

- Examiners should review a BO's policies and procedures to ensure that the organization follows prudent standards of credit assessment and has approval criteria for all ABS exposure. Procedures should include an initial thorough and independent credit assessment of ABS issues for which the organization has assumed any degree of credit risk, followed by periodic reviews to monitor performance of the ABS throughout the life of the exposure.
- Examiners should determine that a banking organization does not rely solely upon conclusions of external rating services in evaluating ABS.
- Examiners should determine that a banking organization investing in ABS has independently made use of available documents in evaluating the credit risk of ABS. These documents include indentures, trustee reports, rating-agency bulletins, and prospectuses.
- Examiners should determine that a banking organization investing in privately placed ABS is aware of the differences in disclosure requirements between publicly placed and privately placed securities, and has taken extra steps to obtain and analyze information relevant to the evaluation of holdings of any privately placed ABS.
- Major policies and procedures, including internal credit-review and -approval procedures and in-house exposure limits, should be reviewed periodically and approved by the institution's board of directors.
- Failure, fraud, or mismanagement on the part of another party could result in loss to investors. A banking organization should have adequate procedures for assessing the financial strength and operational capacity of institutions involved in enhancing the credit quality of or managing an ABS issue.
- A banking organization should have procedures for evaluating the structural soundness of securitization arrangements for ABS in which it invests. The degree of investor control over transfer of servicing rights should be clearly delineated.
- Securitization arrangements may remove the ultimate investor from direct access to the collateral; the remedies available to an investor, in the event of default, should be clearly documented.

Concentration risk. Banking organizations may face concentrations of risk within the pool of assets, underlying an individual ABS issue, across different ABS issues, or through combinations of ABS and other credit exposures. Banking organizations that invest in ABS must take special care to follow in-house diversification requirements for aggregate outstandings to a particular institution, industry, or geographic area. Examiner procedures for reviewing concentration risk are outlined below:

- When determining compliance with internal credit-exposure limits, securitization exposure should be aggregated with all loans, extensions of credit, debt and equity securities, legally binding financial guarantees and commitments, and any other investments involving the same obligor.
- Inherent in securitization is the risk that, if another party involved in the transaction becomes unable to perform, according to contract terms, the issue might default, even while the underlying credits are performing. Examiners should, therefore, ensure that, in addition to policies limiting direct credit exposure, an institution has developed exposure limits for particular credit enhancers, servicers, or trustees. Credit exposure to the other managing parties in a securitization should be included under a BO's general line to those institutions.
- Examiners should review the ABS portfolio for any industrial or geographic concentrations. Excessive exposures to a particular industry or region within the portfolio should be noted in the examiner's review.

Liquidity risk and market risk. Limited secondary markets may make ABS, especially unrated or innovative ABS, less liquid than many other debt instruments. Examiner procedures for reviewing liquidity and market risk are outlined below:

- If an investing bank is purchasing securitized assets for trading purposes, the examiner should ensure that the trading assets are carried at market value or at the lower of market or book value, and that market values are determined regularly. The risks involved are similar in character to the risks involved in trading other marketable securities. As with any trading activity, the BO must take proper steps to analyze market character and depth.
- A banking organization investing in ABS should not depend on secondary-market liquidity for the securities, especially in the case of ABS involving novel structures or innovative types of assets.
- Management information systems should provide management with timely and periodic information on the historical costs, market values, and unrealized gains and losses on ABS held in investment, trading, or resale portfolios.

Prepayment risk. The prepayment of assets underlying ABS may create prepayment risk for an investor in ABS. Prepayment risk may not be adequately reflected in agency ratings of ABS. Examiner procedures for reviewing prepayment risk are outlined below:

- Examiners should determine that a BO investing in ABS has analyzed the prepayment risk of ABS issues in its portfolio. Special care should be taken in the analysis of issues involving multiple tranches.
- Prepayment risk for ABS should be incorporated into an organization's net income-at-risk model, if such a model is used.

Legal Review

Examiners should review policies and procedures for compliance with applicable state lending limits and federal law, such as section 5136 of the Revised Codes. These requirements must be analyzed to determine whether a particular ABS issue is considered a single investment or a loan to each of the creditors underlying the pool. Collateralized mortgage obligations may be exempt from this limitation, if they are issued or guaranteed by an agency or instrumentality of the U.S. government.

Internal Audit and Management Information Systems

A BO's management of securitization risk depends on the providing of timely and accurate information about the organization's exposure to those responsible for monitoring risks. Examiners must be aware that a BO's involvement in asset securitization can be very extensive and place significant demands on systems without being readily evident, either as an on-balance-sheet exposure or a contingent liability. System overload or other technical default in the organization's systems could render the organization unable to provide proper monitoring or servicing. While the risk is not clearly associated with the servicer (whose responsibility is long term and requires ongoing resource commitments), systems breakdowns may have risk implications for the credit enhancer and trustee. Examiners should ensure that internal auditors examine all facets of securitization regularly, as outlined below:

- Examiners should ensure that internal systems and controls adequately track the performance and condition of internal exposures and should monitor the organization's compliance with internal procedures and limits. In addition, adequate audit trails and internal-audit coverage should be provided.
- Cost-accounting systems should be adequate to permit a reliable determination of the profitability and volatility of asset-securitization activities.
- Management information systems and reporting procedures should be reviewed to determine that they—
  - — provide a listing of all securitizations for which the banking organization is either originator, servicer, credit enhancer, underwriter, trustee, or investor;
  - — provide concentration listings by industry and geographic area;
  - — generate information on total exposure to specific originators, servicers, credit enhancers, trustees, or underwriters;
  - — generate information on portfolio aging and performance relative to expectations; and
  - — provide periodic and timely information to senior management and directors on the organization's involvement in, and credit exposure arising from, securitization.

ADDITIONAL REFERENCES

The following is a list of accounting literature issued by the FASB and AICPA that relates to asset securitization or asset transfers.

FASB Statements

FASB Statement No. 5	Accounting for Contingencies
FASB Statement No. 48	Revenue Recognition When Right of Return Exists
FASB Statement No. 65	Accounting for Certain Mortgage Banking Enterprises, as amended
FASB Statement No. 66	Accounting for Sales of Real Estate
FASB Statement No. 77	Reporting by Transferors for Transfers of Receivables with Recourse
FASB Statement No. 91	Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases
FASB Statement No. 115	Accounting for Certain Investments in Debt and Equity Securities
FASB Statement No. 122	Accounting for Mortgage-Servicing Rights
FASB Statement No. 125	Accounting for Trustees and Servicing of Financial Assets and Extinguishments of Liabilities
FASB Statement No. 133	Accounting for Derivative Instruments and Hedging Activities
FASB Statement No. 134	Accounting for Mortgage-Backed Securities Retained After the Securitization of Mortgage Loans Held for Sale by a Mortgage Banking Enterprise
FASB Statement No. 137	Accounting for Derivative Instruments and Hedging Activities—Deferral of the Effective Date of FASB Statement No. 133 (an amendment of FASB Statement No. 133)
FASB Statement No. 138	Accounting for Certain Derivative Instruments and Hedging Activities (an amendment of FASB Statement No. 133)
FASB Statement No. 140	Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (a replacement of FASB Statement No. 125)

Technical Bulletins

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1. To determine if the bank is in compliance with laws, regulations, and policy statements.
2. To determine if the bank has originated, serviced, credit enhanced, served as a trustee for, or invested in securitized assets.
3. To determine that securitization activities are integrated into the overall strategic objectives of the organization.
4. To determine that management has an appropriate level of experience in securitization activities.
5. To ensure that the bank does not hold any asset-backed securities that are inappropriate, for example IOs and POs, given the size of the bank and the sophistication of its operations.
6. To ensure that all asset-backed securities owned, any assets sold with recourse, and retained interests are properly accounted for on the bank's books and on regulatory reports.
7. To determine that sources of credit risk are understood, properly analyzed, and managed, without excessive reliance on credit ratings by outside agencies.
8. To determine that credit, operational, and other risks are recognized and are addressed through appropriate policies, procedures, management reports, and other controls.
9. To determine if officers are operating in conformance with established bank policies and procedures.
10. To determine whether liquidity and market risks are recognized and whether the organization is excessively dependent on securitization as a substitute for day-to-day core funding or as a source of income.
11. To determine that steps have been taken to minimize the potential for conflicts of interest due to securitization.
12. To determine that possible sources of structural failure in securitization transactions are recognized and that the organization has adopted measures to minimize the impact of these failures if they occur.
13. To determine that the organization is aware of the legal risks and uncertainty of various aspects of securitization.
14. To determine that concentrations of exposure in the underlying asset pools, asset-backed securities portfolio, or structural elements of securitization transactions are avoided.
15. To determine that all sources of risk are evaluated at the inception of each securitization activity and are monitored on an ongoing basis.
16. To determine whether the institution's retained interests from asset securitization are properly documented, valued, and accounted for.
17. To verify that the amount of retained interests not supported by adequate documentation has been charged off and that the assets involved in those retained interests are not used for risk-based calculation purposes.
18. To ascertain the existence of sound risk modeling, management information systems (MIS), and disclosure practices for asset securitization.
19. To obtain assurances that the board of directors and management oversee sound policies and internal controls concerning the recording of asset-securitization transactions and any valuation of retained interests derived therefrom.
20. To determine that capital is commensurate with the risk exposures arising from recourse obligations generated by asset securitizations.
21. To determine whether there is an independent audit function that is capable of evaluating asset-securitization activities and any associated retained interests.
22. To initiate corrective action if policies, practices, procedures, or internal controls are deficient or when violations of laws, regulations, or policy statements are disclosed.

1. a. Request a schedule of all asset-backed securities owned by the bank. Reconcile to subsidiary ledgers of the balance sheet and review credit ratings assigned to these securities by independent rating agencies. Determine that the accounting methods and procedures used for these assets, at inception and throughout the carrying life, are appropriate.
   b. Request and review information on the types and amount of assets that have been securitized by the bank. In addition, request information concerning potential contractual or contingent liability from guarantees, underwriting, and servicing of securitized assets.
2. Review the parent company's policies and procedures to ensure that its banking and nonbanking subsidiaries follow prudent standards of credit assessment and approval for all securitization exposure. Procedures should include thorough and independent credit assessment of each loan or pool for which it has assumed credit risk, followed by periodic credit reviews to monitor performance throughout the life of the exposure. If a banking organization (BO) invests in asset-backed securities (ABS), determine whether it relies soley on conclusions of external rating services when evaluating the securities.
3. Determine that rigorous credit standards are applied regardless of the role the organization plays in the securitization process, for example, servicer, credit enhancer, or investor.
4. Determine that major policies and procedures, including internal credit review and approval procedures and ''in-house'' exposure limits, are reviewed periodically and approved by the bank's board of directors.
5. Determine whether adequate procedures for evaluating the organization's internal-control procedures and the financial strength of the other institutions involved in the securitization process are in place.
6. Obtain the documentation outlining the remedies available to provide credit enhancement in the event of a default. Both originators and purchasers of securitized assets should have prospectuses on the issue. Obtaining a copy of the prospectus can be an invaluable source of information. Prospectuses generally contain information on credit enhancement, default provisions, subordination agreements, etc. In addition to the prospectus, obtain the documentation confirming the purchase or sale of a security.
7. Ensure that, regardless of the role an institution plays in securitization, the documentation for an asset-backed security clearly specifies the limitations of the institution's legal responsibility to assume losses.
8. Determine the existence of independent risk-management processes and MIS, and whether they are being used to monitor securitization-pool performance on an aggregate and individual transaction level.
9. Verify whether the BO, acting as originator, packager, or underwriter, has written policies addressing the repurchase of assets and other measures to reimburse investors in the event that a defaulted package results in losses exceeding any contractual credit enhancement. The repurchase of defaulted assets or pools in contradiction or outside the terms of the underlying agreement in effect sets a standard by which a banking organization could potentially be found legally liable for all ''sold'' assets. Review and report any situations in which the organization has repurchased or otherwise reimbursed investors for poor-quality assets.
10. Classify adverse credit risk associated with securitization of assets when analyzing the adequacy of an organization's capital or reserve levels. Evaluate credit risk of ABS and classify any adverse credit risk. List classified assets. Also, evaluate the impact of the classification on capital adequacy and overall soundness of the institution.
11. Aggregate securitization exposures with all loans, extensions of credit, debt and equity securities, legally binding financial guarantees and commitments, and any other investments involving the same obligor when determining compliance with internal credit-exposure limits.
12. Review the bank's valuation assumptions and modeling methodology used for ABS to determine if they are conservative and

appropriate and are being used to establish, evaluate, and adjust the carrying value of retained interests on a regular and timely basis.

13. Determine if audit or internal-review staffs periodically review data integrity, model algorithms, key underlying assumptions, and the appropriateness of the valuation and modeling process for the securitized assets that the institution retains.
14. Review the risk-based capital calculations, and determine if they include recognition and reporting of any recourse obligation resulting from securitization activities.
15. Ascertain that internal limits govern the amount of retained interests held as a percentage of total equity capital.
16. Establish that an adequate liquidity contingency plan is in place and will be used in the event of market disruptions. Determine further whether liquidity problems may arise as the result of an overdependence on asset-securitization activities for day-to-day core funding.
17. Determine whether consistent, conservative accounting practices are in place that satisfy the reporting requirements of regulatory supervisors, GAAP reporting requirements, and valuation assumptions and methods. Ascertain that adequate disclosures of asset-securitization activities are made commensurate with the volume of securitizations and the complexities of the institution.
18. Establish that risk-exposure limits and requirements exist and are adhered to on an aggregate and individual transaction basis.
19. Review securitized assets for industrial or geographic concentrations. Excessive exposures to an industry or region among the underlying assets should be noted in the review of the loan portfolio.
20. Ensure that, in addition to policies limiting direct credit exposure, an institution has developed exposure limits with respect to particular originators, credit enhancers, trustees, and servicers.
21. Review the policies of the banking organization engaged in underwriting, watching for situations in which it cannot sell underwritten asset-backed securities. Credit review, funding capabilities, and approval limits should allow the institution to purchase and hold unsold securities. All potential credit exposure should be within legal lending limits.
22. Ensure that internal systems and controls adequately track the performance and condition of internal exposures and monitor the organization's compliance with internal procedures and limits. In addition, adequate audit trails and internal-audit coverage should be provided. Ensure that the reports have adequate scope and frequency of detail.
23. Determine that management information systems provide—
    a. a listing of each securitization transaction in which the organization is involved;
    b. a listing of industry and geographic concentration;
    c. information on total exposure to specific originators, servicers, credit enhancers, trustees, or underwriters;
    d. information regarding portfolio monthly vintage or aging and performance by specific product type relative to expectations;
    e. periodic and timely information to senior management and directors on the organization's involvement in, and credit exposure arising from, securitization;
    f. static-pool cash-collection analysis;
    g. sensitivity analysis; and
    h. a statement of covenant compliance.
24. Ensure that internal auditors examine all facets of securitization regularly.
25. Review policies and procedures for compliance with applicable state lending limits and federal law such as section 5136 of the Revised Codes. These requirements must be analyzed to determine whether a particular asset-backed security issue is considered a single investment or a loan to each of the creditors underlying the pool. Collateralized mortgage obligations may be exempt from this limitation, if they are issued or guaranteed by an agency or instrumentality of the U.S. government.
26. Determine whether the underwriting of ABS of affiliates are—
    a. rated by an unaffiliated, nationally recognized statistical rating organization; or
    b. issued or guaranteed by Fannie Mae, FHLMC, or GNMA, or represent interests in such obligations.
27. Determine if purchases of high-risk mortgage-backed securities were made to reduce the overall interest-rate risk of the bank. Determine if the bank evaluates and documents at least quarterly whether these securities have reduced the interest-rate risk.

28. Review and discuss any documentation exceptions, violations, internal-control exceptions, and classifications with management, and obtain management's response.
29. Review the bank's liquidity agreements with any asset-backed commercial paper programs and determine whether the agreements have any credit-related components. Is the bank required to purchase the assets? Are these assets repurchased from the bank? If the facility is determined to be a commitment, determine whether its maturity is short term or long term. Do any of the liquidity agreements contain a material adverse clause or any other credit-contingency provision?

Review the bank's internal controls, policies, practices and procedures for all aspects of asset securitization. The bank's system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used and other pertinent information.

POLICIES

1. Does the bank employ the services of a securities dealer? If so, does the bank rely solely on the advice of such dealer when purchasing asset-backed securities for the bank's investment portfolio? Does the bank have persons responsible for reviewing/approving the investment manager's acquisitions? Are there minimum established criteria for selecting a securities dealer?
2. Has the board of directors, consistent with its duties and responsibilities, reviewed and ratified asset securitization policies, practices, and procedures which:
   a. Require an initial thorough and independent credit assessment of each pool for which the bank has assumed credit risk as either a participant in the securitization process or as an investor?
   b. Address the repurchase of assets and other forms of reimbursement to investors by the bank, when acting as the originator, packager, or underwriter, in the event that a default results in losses exceeding any contractual credit enhancement?
   c. Assure that the credit, pricing, and servicing standards for securitized assets are equivalent to standards for assets that remain on the bank's books?
   d. Assure that the credit, pricing, and servicing standards and compliance with any provisions relating to government guarantees are reviewed periodically by the board of directors?
   e. Establish ''in-house'' diversification requirements with respect to aggregate outstanding exposures to a particular institution, industry, or geographic area?
   f. Hedge the institution's exposure to adverse price movements when engaged in underwriting or market-making activities?
3. Are securitization policies reviewed and reaffirmed at least annually to determine if they are compatible with changing market conditions?

INTERNAL CONTROL/ MANAGEMENT INFORMATION SYSTEMS

4. Do the internal systems and controls adequately track the performance and condition of internal exposures, and do the systems monitor the bank's compliance with internal procedures and limits? Are adequate audit trails and internal audit coverage provided?
5. Do the cost accounting systems provide a reliable determination of the profitability and volatility of asset securitization activities?
6. Are management information systems and reporting procedures adequate, in that they:
   a. Provide a listing of all securitizations for which the bank is either originator, servicer, credit enhancer, underwriter, or trustee?
   b. Provide a listing of industry and geographic concentrations?
   c. Provide information on total exposure to specific originators, servicers, credit enhancers, trustees, or underwriters?
   d. Provide information regarding portfolio aging and performance relative to expectations?
   e. Provide periodic and timely information to senior management and directors on the organization's involvement in, and credit exposure arising from, securitization?
   f. Provide credit ratings assigned by independent rating agencies to all asset-backed securities held by the bank?

Bank management is responsible for controlling risk at a level deemed acceptable for the organization. An effective risk-management program begins with the identification of exposures that could disrupt the timely and accurate delivery of business services or result in unexpected financial claims on bank resources. Risk management also involves the implementation of cost-effective controls and the shifting, transfer, or assignment of risk to third parties through insurance coverage or other risk-transfer techniques. Although the design and sophistication of risk-management procedures varies from bank to bank, each institution's decision-making process should effectively identify; control; and, when or where appropriate, result in some transfer of risk. The risk-assessment program should be conducted annually to establish whether potential service disruptions and estimated risk-related financial costs and losses can be contained at levels deemed acceptable to bank management and the board of directors. Note that insurance can provide a bank with the resources to restore business operations and financial stability only *after* an unanticipated event has occurred, but a bank's own risk-management controls can prevent and minimize losses before they occur.

RISK-MANAGEMENT PROGRAM

A sound operational risk-management program requires the annual review of all existing business operations and a risk assessment of all proposed services. Identified risks should be analyzed to estimate their potential and probable levels of loss exposure. While the historical loss experience of the bank and other service providers may be helpful in quantifying loss exposure, technological and societal changes may result in exposure levels that differ from historical experience. Nevertheless, current exposure estimates should be derived from the bank's historical loss experience and augmented with industry experience. Industry loss experience is summarized in publications of the Security and Risk Management Division of the American Bankers Association and The Surety Association of America. In addition, the bank's insurance broker or agent should be a source of advice.

Management must decide the most appropriate method for addressing a particular risk. Although many factors influence this decision, the purpose of risk management is to minimize the probability of losses and the net costs associated with them. In that context, cost is broadly defined to include—

- the direct and consequential cost of loss-prevention measures (controls), plus
- insurance premiums, plus
- losses sustained, including the consequential effects and expenses to reduce such losses, minus
- recoveries from third parties and indemnities from insurers on account of such losses, plus
- pertinent administrative costs.

Bank risks with potentially high or even catastrophic financial consequences should be eliminated or substantially mitigated whenever possible, even when the risk's frequency of occurrence is low. These risks can be eliminated by discontinuing operations where appropriate or by assigning the risk exposure to other parties using third-party service providers. When the exposure cannot be shifted to other parties or otherwise mitigated, the bank must protect itself with appropriate levels of insurance. Certain loss exposures may be deemed reasonable because their probability of frequency and severity of loss are low, the level of expected financial loss or service disruption is minimal, or the costs associated with the recovery of assets and restoration of services are low.

Bank management may decide to reduce insurance premiums and claims-processing costs by self-insuring for various types of losses, setting higher deductible levels, lowering the coverage limits for insurance purchased, and narrowing coverage terms and conditions. A financial organization's primary defenses against loss are adequate internal controls and procedures, which insurance is intended to complement, not replace. Thus, an overall appraisal of the organization's control environment is a significant consideration in determining the adequacy of the insurance program. To the extent that controls are lacking, the need for additional insurance coverage increases. These determinations should be based on the results of the risk assessment and be consistent with the limits established by the board of directors. Insurance decisions may also be influenced by the insurance broker's advice regarding current insurance market and premium trends.

Following September 2001, insurance companies reevaluated their position on providing coverage for acts of terrorism. As a result, terrorism coverage has become expensive or unavailable. The bank's "schedule of insurance" should note which policies contain exclusions, sublimits, or large deductibles for losses incurred as a result of terrorism.

When selecting insurance carriers, banks should consider the financial strength and claims-paying capacity of the insurance underwriter, as well as the robustness or strength of the supervisory regime to which the insurer is subject. This procedure is important for all significant policy-coverage lines. Rating agencies typically consider a number of insurers vulnerable, and some underwriters may have large environmental exposures but capped equity resources. Many large commercial enterprises acquire insurance coverage from foreign companies or from subsidiaries of U.S. insurers domiciled in the Caribbean or other countries. The quality of insurance supervision in many foreign countries may not meet the standards expected in the United States.

TYPES OF RISKS

Business risks generally fall into three categories: (1) physical property damage, (2) liability resulting from product failure or unintended employee performance, and (3) loss of key personnel. Common property risks are fires or natural disasters such as storms and earthquakes, but acts of violence or terrorism can also be included in this category. Risk-management programs for property damage should consider not only the protection and replacement of the physical plant, but also the effects of business interruptions, loss of business assets, and reconstruction of records.

Insurance programs increasingly cover the consequences of the second category, product failure or unintended employee performance. These risks include the injury or death of employees, customers, and others; official misconduct; and individual and class-action lawsuits alleging mistreatment or the violation of laws or regulations. All aspects of a bank's operation are susceptible to liability risks. While property-loss levels can be estimated with relative confidence, jury awards for personal injury or product liability, and the related litigation costs, often exceed expectations. In addition, it can be difficult to identify potential sources of liability exposure.

The third category, personnel risk, concerns those exposures associated with the loss of key personnel through death, disability, retirement, or resignation, as well as threats to all employees and third parties arising out of crimes such as armed robbery and extortion. The consequences of personnel loss are often more pronounced in small and medium-sized banks that do not have the financial resources to support a broad level of management.

INSURANCE PROGRAM

Program Objectives

A bank's insurance program should match the objectives of its management, the director-approved risk guidelines, and its individual risk profile. Insurance is primarily the transfer of the financial effect of losses and should be considered as only a part of the broader risk-management process. In that sense, it is imperative that management understands the costs and benefits of the bank's insurance program.

Due to the fluid nature of the insurance market and insurance products, there is no standard program or contract structure. Rather, many different insurance policies, coverages, endorsements, limits, deductibles, and payment plans fit together to form an insurance program. Based on the size and scope of a bank's operations, broader or narrower coverage, higher or lower limits, and separate policies may be purchased. Insurance programs should be customized to the risks that each bank faces. If a bank is particularly susceptible to a specific risk, purchasing additional insurance for that risk may be prudent.

A policy's deductible size and coverages, and the limits purchased, determine how much risk the bank has retained. Likewise, the payment plan of an insurance policy greatly influences the amount of risk transferred. An insurance policy alone does not represent significant risk transfer if the payment plan includes reimbursement to the insurance company for all losses, usually subject to a maximum. These reimbursement, loss-sensitive, or retrospectively rated plans can be viewed more as a risk-financing tool than as risk transfer. Management should understand and quantify the total ''all-in'' cost of these plans, as well as how these costs correspond with the risk guidelines approved by the directors.

Common Insurance-Policy Components and Concepts

There is a difference between ''policy'' and ''coverage,'' but the two terms are often used interchangeably. The term ''policy'' usually refers to the actual insurance contract, while the term ''coverage'' refers to the types of risks to which the policy is designed to respond. For example, a directors' and officers' policy may include employment-practices liability (EPL) coverage. However, the bank may also purchase a separate EPL policy

An ''endorsement'' is a modification to a policy. Endorsements can be either a simple change in wording from the original contract or a more complex addition or deletion of a coverage section. To expand on the example above, EPL coverage is often endorsed onto a directors' and officers' policy. When an endorsement adds a coverage to a policy, it is often called a ''rider.''

The ''limit of insurance'' is the dollar amount of insurance protection purchased. Each policy has a different limit, and some may have separate limits for separate coverages provided under the same policy. Policies usually include a ''per-occurrence'' and an ''aggregate'' limit. The per-occurrence limit is the most the insurer will pay under the policy for any one insured event, while the policy aggregate is the most the insurer will pay in total, regardless of the number and size of insurable events.

''Deductibles'' and ''self-insured retentions (SIRs)'' are the dollar amounts the bank must contribute to the loss before insurance applies.[1] They are effectively the same concept, with the difference being a deductible reduces the limits of insurance while a SIR does not. A deductible is included within or as part of the limits. A SIR is outside or in addition to the provided limits. For example, a $5 million policy limit with a $1 million deductible consists of $4 million of protection and the $1 million deductible. A $5 million policy limit with a $1 million SIR provides $5 million in protection after the $1 million dollar SIR is paid by the bank. As in any clause of an insurance contract, the terms can be negotiated so a deductible does not reduce the limits.

''Occurrence'' and ''claims made'' are two separate types of coverage bases of policies that differ as to the period protected, when claims are recognized, and when the policies are ''triggered'' or respond. Under an occurrence, or ''loss-sustained,'' form the amount and type of coverage (if any) for the loss event is based on the policy that was in force when the event took place or occurred, regardless of when a claim is submitted. Under a claims-made, or ''discovery,'' policy, the insurance policy in force when the loss event was discovered and reported to the insurance company would apply, regardless of when the event causing the claim occurred. Both types of policies have provisions regarding prompt claims-reporting to insurers. However, claims-made policies are usually stricter and their coverage may be compromised by failing to report claims in a timely manner.

Self-Insurance or Alternative Risk Transfer

There are numerous nontraditional insurance programs that larger, more complex banking organizations employ. These programs include, but are not limited to, captive insurance companies, individual or group self-insurance, risk-retention groups, and purchasing groups. These alternative risk-transfer (ART) programs are complex, and they should include common bank policies and procedures. For example, the bank should have access to individuals with insurance expertise. Outside consultants, qualified insurance brokers, and bank directors or management with insurance expertise are an integral part of a successful ART program. The ART program should also incorporate stop-loss provisions and reinsurance coverage to cap the organization's exposure to severe claims or unexpected loss experience.

COMMON POLICIES AND COVERAGES

The following is not intended to be a compre-

1. An organization can maintain an unfunded reserve for loss-retention purposes.

hensive list of policies and coverages available, but rather a listing and description of those that banks most frequently purchase. The list is divided into three general types of insurance: liability, property, and life insurance. A fourth category is included for aircraft and aviation insurance, which consists of various types of property and liability coverage. While this last coverage category may be unnecessary for most banking organizations, for those institutions that do have exposure to risks associated with aircraft ownership, the risks may be exceptionally large.

Fidelity Insurance Bond

Liability insurance is sometimes called ‘‘third-party insurance’’ because three parties are involved in a liability loss: the insured, the insurance company, and the party (the claimant) who is injured or whose property is damaged by the insured. The insurance company pays the claimant on behalf of the insured if the insured is legally liable for the injury or damage. An insured's legal liability for injury is often the result of a negligent act, but there are other sources of liability. Several examples of liability insurance are discussed below.

Fidelity bond coverage provides reimbursement for loss from employee dishonesty; robbery; burglary; theft; forgery; mysterious disappearance; and, in specified instances, damage to offices or fixtures of the insured. Coverage applies to all banking locations except automated teller machines, for which coverage must be specifically added. All banks should obtain fidelity bond coverage that is appropriate for their business needs.

The most widely used form of fidelity bond is the Financial Institution Bond (FIB), Standard Form No. 24 (formerly named the bankers' blanket bond). Standard Form No. 24 is a claims-made, or discovery, form. The ‘‘basic’’ FIB has four insuring agreements or parts. Employee Dishonesty/Fidelity (Clause A) covers dishonest or fraudulent acts committed by employees. On-Premises (Clause B) covers losses from burglary, misplacement, or an unexplained disappearance that occurs on premises. In-Transit (Clause C) covers losses from burglary, misplacement, or an unexplained disappearance that occurs while the property is in transit. Counterfeit Currency (Clause F) covers losses from accepting counterfeit currency.

In addition to the basic four FIB insuring agreements, Forgery or Alteration (Clause D) and Securities (Clause E) may also appear on the standard form. (These coverages may not be a component of the most basic insurance program for a small bank.) Significant enhancements and additional coverages are often endorsed onto the FIB. Any misrepresentation, omission, concealment, or incorrect statement of material fact in the insurance application is grounds for recission of the fidelity bond by the underwriting insurance company.

When the bank under examination is a subsidiary of a bank holding company, and the holding company has purchased one fidelity bond to cover all affiliated banks, the examiner should determine that the policy is sufficient to cover the exposures of the subsidiary bank being examined. Examiners also should determine that any policy premiums the subsidiary bank pays to the parent holding company are not disproportionate to the bank's benefits from the group policy and that such premiums are consistent with the fair-market requirements of section 23B of the Federal Reserve Act. Split-limit coverage may reduce protection if a loss involves the collusion of subsidiary bank employees or other affiliates of a bank holding company.

Clause A: Fidelity (Employee Dishonesty)

Clause A covers losses resulting directly from dishonest or fraudulent acts an officer or employee commits, either acting alone or in collusion with others. The employee must have had a manifest intent to cause a loss to the financial institution, and the employee or another person or entity must obtain financial benefit from the dishonest or fraudulent act. Officers, attorneys retained by the bank, persons provided by an employment contractor, and nonemployee data processors who are performing services for the insured are typically all considered ‘‘employees.’’ If any of the loss results from loans, that part of the loss is covered only if the employee was in collusion with other parties to the transaction and the employee received a minimum financial-benefit amount, as specified in the policy. (‘‘Financial benefit’’ does not include any employee benefits earned in the normal course of employment, including salaries, commissions, fees, bonuses, promotions, awards, profit-sharing plans, or pensions.) Clause A should not prevent the recovery of losses from employee dishonesty that are concealed by fictitious loans.

Clause B: On-Premises

Clause B covers losses of property (as defined in the bond) that occur on premises as a result of robbery, burglary, larceny, misplacement, theft, or a mysterious and unexplained disappearance. Under specified conditions, damage to offices and equipment may be covered under this clause, However, premises coverage should not be confused with standard fire or other types of property insurance.

Clause C: In-Transit

Clause C covers loss of property that is in transit. The property typically must be in the custody of (1) a natural person acting as a messenger for the insured, (2) a transportation company transporting the property in an armored motor vehicle, or (3) a transportation company transporting the property by means other than an armored motor vehicle. When an armored vehicle is not used by a transportation company, "property" is generally limited to records, certified securities, and negotiable instruments that are not payable to the bearer, are not endorsed, and have no restrictive endorsements. Some insuring agreements insure certain financial institution employees that carry cash.

Clause D: Forgery or Alteration

Clause D covers forgery, which is the signing of the name of another person or organization with the intent to deceive. Clause D also covers losses resulting from the alteration of any negotiable instrument. Evidences of debt, which the bank receives either over-the-counter or through clearings, are not usually covered. Fraudulent items received through an electronic funds transfer system are generally excluded.

Clause E: Securities

Clause E covers losses that result from a bank's extending credit or assuming liability on the faith of original securities, documents, or written instruments that are forged, altered, lost, or stolen. These include but are not limited to a certificated security, a title, a deed or mortgage, a certificate of origin or title, an evidence of debt, a security agreement, an instruction to a Federal Reserve Bank, and a statement of uncertificated security of a Federal Reserve Bank. Coverage is included for certain counterfeit securities and instruments. The bank must have acted in good faith and had actual physical possession of the original instrument.

Clause F: Counterfeit Currency

Clause F provides coverage for losses resulting from the receipt of counterfeit money. The coverage is counterfeit money of the United States, Canada, or any other country where the insured maintains a branch office.

Common FIB Extensions, Riders, or Endorsements

Fidelity bond protection can be extended by purchasing additional coverage through extensions, riders, and endorsements. If a bank has significant risk exposures in certain areas, these additional protections should be considered. The most common of these protections are listed below.

Extortion/Threats to Persons or Property

The extortion/threats to persons or property rider insures against loss of property that is surrendered away from a banking office as the result of a threat to do bodily harm to a director, trustee, employee, or relative, or of threats to damage banking premises or property. While a bank may add this coverage with a rider to its FIB, many banks purchase a separate, more comprehensive policy or endorse this coverage onto the directors' and officers' policy.

Trading Losses

The trading-loss rider amends the FIB exclusion by providing coverage for trading losses resulting directly from employee dishonesty.

Automated Teller Machines

The automated teller machine (ATM) rider covers losses of money from, or damage to, an unattended ATM that results from robbery, burglary, or theft.

Electronic or Computer Systems

The electronic or computer-systems rider covers direct losses caused by fraudulent funds transfers originated through the bank's computer systems. The fraud may be caused by a dishonest employee, customer, or third party.

Unauthorized Signatures

The unauthorized-signature rider covers losses resulting from a bank's acceptance, cashing, or payment of any negotiable instrument or withdrawal order that bears an unauthorized signature. An ''unauthorized signature'' is not forged, but is the signature of an individual who is not an authorized signatory on the account.

Fraudulent Mortgages

The fraudulent-mortgages rider insures against loan losses that result from a bank's accepting or acting on mortgages or deeds of trust that have defective signatures. ''Defective signatures'' are those obtained through fraud or trickery or under false pretenses.

Counterfeit Checks

The counterfeit-check rider insures against loss from counterfeit checks and other negotiable instruments. The coverage applies whether or not the counterfeit instruments are forged.

Service Contractors

The service-contractor rider covers loss resulting from fraudulent or dishonest acts committed by a servicing contractor. A ''servicing contractor'' services real estate and home-improvement mortgages, as well as tax and insurance escrow accounts; manages real property; or provides other related services. The coverage extends to losses resulting from the contractor's failure to forward collected funds to the bank when the servicing contractor has committed to do so.

Money-Order Issuer's

With a money-order-issuer's rider, coverage is expanded to authorized third parties that issue registered checks or personal money orders on behalf of the insured.

Liability Insurance

Electronic and Computer Crimes

To broaden the electronic and computer-systems rider that is normally attached to the FIB, an additional electronic and computer-crime rider may be purchased. This rider is a ''companion policy'' that covers losses the bank may incur from having (1) transferred, paid, or delivered any funds or property; (2) established any credit; or (3) debited any account or given value as a direct result of fraudulent input of electronic data or computer instructions into the insured's computer. These losses may result from someone's unauthorized access to a terminal or the bank's communications lines, or from the fraudulent preparation of tapes or computer programs. Under this rider, coverage may include electronic funds transfer systems, the bank's proprietary systems, and voice instructions given over the telephone. Losses caused by software programmers and consultants, ATM systems, computer viruses, software piracy, computer extortion, and facsimiles may also be covered.

Excess Bank Employee Dishonesty Bond

The excess bank employee dishonesty bond adds limits over and above the FIB. Often an FIB cannot be purchased with limits that are large enough to satisfy the risk-transfer needs of larger banks. When this occurs, the bank may purchase an excess bond that would respond if a claim is larger than the per-occurrence limits on the FIB or if the aggregate limit of the FIB has been exhausted. The most common form of this coverage is the excess bank employee dishonesty blanket bond, Standard Form No. 28.

Combination Safe Depository

Combination safe depository insurance consists of two coverage sections that can be purchased together or separately. Coverage (A) applies to losses when the bank is legally obligated to pay for loss of a customer's property held in safe deposit boxes (including loss from damage or destruction). Coverage (B) generally covers loss, damage, or destruction of property in customers' safe deposit boxes, whether or not the bank is legally liable, when the loss results from an activity other than employee dishonesty, such as robbery or burglary.

Directors' and Officers' Liability

Directors' and officers' (D&O) liability insurance usually has three coverage parts: Side A, Side B, and Entity Securities Coverage (C). Side A covers the directors and officers individually for alleged wrongful acts. Side B reimburses the bank for money it has paid to or on behalf of its directors and officers to indemnify them for damages they may be liable for as a result of alleged wrongful acts. Entity Securities Coverage protects the corporation against securities claims. Subject to many exclusions and definitions, a ''wrongful act'' means any actual or alleged act, error, omission, misstatement, misleading statement, neglect, or breach of duty. D&O policies are primarily written on a claims-made basis. Larger banks will purchase excess D&O coverage. Like the FIB, there are numerous coverages or enhancements that can be endorsed onto a D&O policy.

Entity errors and omissions. The entity errors and omissions (E&O) insurance rider extends coverage to the financial institution as an entity for wrongful acts. A separate, more robust E&O policy may also be purchased. The separate policy is commonly referred to as bankers' professional liability.

Fiduciary liability and ERISA errors and omissions. Fiduciary liability (or fiduciary errors and omissions) extends insurance coverage for management of the bank's own employee pension or profit-sharing plans. A separate, more robust fiduciary policy may be purchased to expand further the coverage of the bank's management of its own plans. Without this additional special endorsement, neither the fiduciary errors and omissions nor the bank's directors' and officers' liability insurance will cover liability arising under the Employee Retirement Income Security Act of 1974 (ERISA). For protection against exposure arising from a breach of fiduciary duty under ERISA, a special ERISA errors and omissions endorsement is required (also called fiduciary or employee benefit plan liability). In addition to bank trust departments, banks whose only fiduciary responsibilities relate to their employee benefit plan should consider this coverage. A related specialized coverage called IRA/Keogh errors and omissions is also available.

For properties held or managed by a bank's trust department, a master or comprehensive policy is often obtained instead of individual policies. A master policy protects the trust-account properties from fire or other loss and insures the accounts and the bank against third-party liability in connection with the properties. The master policy does not usually cover claims by trust customers against the bank for negligence, errors, or violations resulting in loss to fiduciary accounts. However, separate fiduciary (or trust department) errors and omissions policies incorporate these areas.

Trust Errors and Omissions

Trust errors and omissions insurance provides coverage for wrongful acts while the bank is acting as trustee, guardian, conservator, or administrator. This is a claims-made policy that can be endorsed onto the D&O policy.

Employment-Practices Liability

Employment-practices liability (EPL) insurance provides coverage for an entity against employee claims of wrongful termination, discrimination, sexual harassment or ''wrongful employment acts.'' This is usually a claims-made policy that can be endorsed onto the D&O policy.

Bankers' Professional Liability

Bankers' professional liability (BPL-E&O) provides coverage for claims resulting from any actual or alleged wrongful acts, errors, or omissions bank employees commit in the performance of professional duties. Coverage can be broadened to include securities E&O, insurance agent E&O, brokerage service E&O, and notary E&O.

Mortgage Impairment

Mortgage-impairment insurance coverage protects the bank's interest, as mortgagee, from loss when contractually required insurance on real property held as collateral has inadvertently not been obtained. Upon discovery of the lack of required coverage, the bank has a limited time to either induce the borrower to obtain the required insurance or to place the insurance on its own.

Mortgage Errors and Omissions

Mortgage errors and omissions insurance, a broader version of mortgage-impairment coverage, provides coverage for direct damage and E&O losses to either the bank or the borrower. Mortgage E&O coverage also applies to the bank's mishandling of real estate taxes, life and disability insurance, and escrowed insurance premiums. Claims must result in a loss to the mortgaged property.

Commercial General Liability

Commercial general liability (CGL) insurance protects against claims of bodily injury or property damage for which the business may be liable and which may arise from the bank's premises, operations, and products. In addition to bodily injury and property damage, CGL can include liability coverage for various other offenses that might give rise to claims, such as libel, slander, false arrest, and advertising injury. A CGL policy can be underwritten on either an occurrence or a claims-made basis.

Workers' Compensation and Employers' Liability

Workers' compensation insurance covers injuries or deaths of employees caused by accidents in the course of employment. Workers' compensation insurance consists of two basic coverage parts: statutory benefits and employers' liability (EL). The two are mutually exclusive remedies to an employee injured on the job. EL protects a company from a lawsuit filed by an employee, while statutory benefits coverage provides medical care and long-term disability, death, or other benefits. State laws govern these provisions, so the provisions differ from state to state. The statutory coverage of workers' compensation is a no-fault system intended to benefit both the injured employee and the employer.

Automobile Liability and Physical Damage

Automobile liability insurance provides third-party liability protection for bodily injury or property damage resulting from accidents that involve the bank's vehicles. First-party coverage for damage to the vehicles is also provided. This coverage should be extended to include—

- nonowned and hired coverage, if employees use personal autos or rent autos while on bank business;
- coverage for autos that have been repossessed; and
- garage-keeper's liability, if the bank rents its parking facilities to customers or the public.

Umbrella and Excess Liability

Umbrella and excess liability insurance offers additional liability limits in excess of the coverage limits of any policy over which it "attaches" or becomes effective. Basic umbrella coverage attaches to CGL and automobile insurance and to the employers' liability section of workers' compensation policies. An excess liability policy attaches over an umbrella policy. More complex insurance programs may include both umbrella and excess liability policies that attach over the D&O, E&O, EPL, or other insurance.

Property Insurance

Several types of insurance coverage are available to help banks recover from property damage. Some of the more common types of property coverages are briefly described below.

Broad Form Property Insurance

Property insurance insures against the loss of or damage to real and personal property. The loss or damage may be caused by perils such as fire, theft, windstorm, hail, explosion, riot, aircraft, motor vehicles, vandalism, malicious mischief, riot and civil commotion, and smoke.

Fire

Fire insurance covers all losses directly attributed to fire, including damage from smoke or water and chemicals used to extinguish the fire. Additional fire damage for the building contents may be included, but often is written in combination with the policy on the building and permanent fixtures. Most fire insurance policies contain ‘‘co-insurance’’ clauses, meaning that insurance coverage must be maintained at a fixed proportion of the replacement value of the building. If a bank fails to maintain the required relationship of protection, all losses will be reimbursed at the ratio of the amount of the insurance carried to the amount required, applied to the value of the building at the time of the loss. When determining insurable value for fire insurance purposes, the basis typically is the cost of replacing the property with a similar kind or quality at the time of loss. Different types of values, however, may be included in policies, and care should be taken to ensure that the bank is calculating the correct value for its needs.

Business Personal Property

Traditionally known as ‘‘contents’’ insurance, business personal property insurance affords insurance protection coverage for the furniture, fixtures, equipment, machinery, merchandise, materials, and all other personal property owned by the bank and used in its business.

Blanket Coverage

Blanket insurance covers, in a single contract, either multiple types of property at a single location or one or more types of property at multiple locations.

Builder’s Risk

Builder’s-risk insurance is commercial property coverage specifically for buildings that are in the course of construction.

Business Interruption

Business-interruption insurance indemnifies the insured against losses arising from its inability to continue normal operations and functions of the business. Coverage is triggered by the total or partial suspension of business operations due to the loss of, loss of use of, or damage to all or part of the bank’s buildings, plant machinery, equipment, or other personal property, when the loss is the result of a covered cause.

Contingent business-interruption insurance is also available to cover the bank’s loss of earnings caused by a loss to another business that is one of its major suppliers or customers. This insurance is also known as ‘‘business income from dependent properties.’’

Crimes

Crime insurance covers money, securities, merchandise, and other property from various criminal causes of loss, such as burglary, robbery, theft, and employee dishonesty.

Data Processing

Data processing insurance coverage provides loss protection if data processing systems break down. This insurance also covers the additional expense incurred in making the system operational again.

Difference in Conditions

A difference-in-conditions (DIC) insurance contract is a separate coverage that expands or supplements property insurance that was written on a named-perils basis. A DIC policy will cover the property on an all-risk basis, subject to certain exclusions.

Ocean and Inland Marine

Ocean marine insurance covers ships and their cargo against such causes as fire, lightning, and ‘‘perils of the seas.’’ These include high winds, rough waters, running aground, and collision with other ships or objects.

Inland marine insurance was originally developed to provide coverage for losses to cargo transported over land. It now covers limited types of property in addition to goods in transit.

Valuable Papers and Destruction of Records

Valuable-papers and destruction-of-records insurance coverage is for the physical loss or damage to valuable papers and records of the insured. The coverage includes practically all types of printed documents or records except money.

Accounts Receivable

Accounts-receivable insurance covers losses that occur when an insured is unable to collect outstanding accounts because of damage to or destruction of the accounts-receivable records that was caused from a peril covered in the policy.

Cash Letters

Cash-letter insurance covers the costs for reproducing cash-letter items and items that remain uncollectible after a specified period of time. Generally, these policies do not cover losses due to dishonest acts of employees.

First-Class, Certified, and Registered Mail

The insurance coverage for first-class, certified, and registered mail provides protection on the shipment of property sent through the mail, as well as during transit by messenger or carrier to and from the post office. The insurance is principally used to cover registered mail in excess of the maximum $25,000 insurance provided by the U.S. Postal Service.

Commercial Multiple Peril

Commercial multiple peril insurance encompasses a range of insurance coverages, including property and liability. Small institutions may purchase this package policy when stand-alone polices are excessive or inefficient.

Life Insurance

Common types of life insurance policies purchased by banks are described below.

Key Person

When the death of a bank officer, or key person, would be of such consequence to the bank as to give it an insurable interest, key-person life insurance would insure the bank on the life of this individual.

Split-Dollar

In split-dollar life insurance, the purchaser of the policy pays at least part of the insurance premiums and is entitled to only a portion of the cash surrender value, death benefit, or both. See SR-93-37 (“Split-Dollar Life Insurance,” June 18, 1993) and its attachments for further discussion of the Federal Reserve’s position on these arrangements between bank holding companies and their subsidiary banks.

Bank-Owned

Bank-owned life insurance consists of tax-advantaged insurance policies that are purchased to cover the lives of bank officers and other highly compensated employees. The policies may be used as a funding mechanism for employee pension and benefit plans. The bank is the owner and beneficiary of the policy, and the cash value of the policy is considered an asset of the bank.

Aircraft or Aviation Insurance

Although aviation-liability exposures are frequently overlooked in the myriad of other financial institution exposures, they have tremendous potential for large catastrophic losses and must be addressed by senior risk-management executives at all financial institutions. Often hidden or obscure, aviation liability ranges from the more typical owned and nonowned liability and physical-damage exposures to the more exotic exposures from hangar-keepers, aviation products, and airport or heliport premises. In view of the specialized nature of aviation exposures, it is important that the bank deal with knowledgeable and experienced agents or brokers and underwriters in developing its aviation insurance program. While exposure categories overlap significantly, the following summary highlights the key areas of concern to most financial institutions.

Aviation Liability

Aviation liability insurance can be written to include aviation-products liability, all owned or nonowned exposures, and passenger liability. A bank's umbrella liability insurance program should also apply over the aviation policy's limit.

Nonowned Exposures

While many banks do not feel the need for aviation insurance because they do not own an aircraft, they may overlook liability exposures from nonowned aircraft and may, in fact, need this coverage. For example, an employee may use a personal aircraft on bank business, or lease or rent an aircraft to ferry customers or employees to a distant meeting. Financing or leasing an aircraft could create a nonowned exposure, even though the aircraft is not under bank control.

Most aviation-underwriting markets have programs available to meet the above exposures. However, additional exposures may require special coverage. Banks should consider the following situations:

- If the bank repairs and maintains the aircraft, it may incur a products-liability exposure after control is relinquished to others, such as when the aircraft is sold.
- If the bank finances aircraft, maintaining only a security interest, it becomes an owner when it repossesses the aircraft. In this case, there could be a definite need for both liability and physical-damage coverage. The coverage may be written at the time of repossession or negotiated in advance of the need for it. The bank should not attempt to continue coverage for its exposure under the borrower's policy.

All-Risk Physical Damage

To protect the bank's security interest in an aircraft hull, borrowers should be required to maintain full-value, all-risk physical-damage insurance (both ground-risk and in-flight coverage) in favor of the bank. However, a number of warranties in aircraft insurance policies could void the contract, so bankers are further advised to require that a borrower's hull insurance policy contain a breach-of-warranty endorsement to protect the bank if the borrower or owner violates provisions of the policy. The underwriter should agree to give the bank at least 30 days' advance notice of any change in the policy. Depending on the use of the aircraft, special consideration should be given to the territorial limits of coverage, as well as to confiscation protection. Since breach-of-warranty endorsements, like aircraft insurance policies, are far from standard, it is important that the bank understand and agree with the underwriter's language. It is particularly appropriate to review the consequences of potential recovery to the lien holder if the aircraft is damaged while a delinquency exists on the note.

Bank as Lessor

If the bank's security interest is that of the lessor, aviation liability insurance should be carried by the bank as lessor and also by the customer as lessee. In certain cases, it may be appropriate to require the lessee, through his or her underwriter, to provide the equivalent of the breach-of-warranty endorsement to the liability program and physical-damage coverage. The bank may also consider obtaining contingent lessor's liability.

Airport Premises and Hangar-Keepers

Airport-premises and hangar-keeper's insurance apply if the bank repossesses real estate on which an airport facility exists and continues to operate, or if the bank permits use of the facility pending further sale. In either case, the bank may assume liability exposures associated with the control tower, as well as airport-premises liability. Both the bank's comprehensive general liability and aviation liability programs should be reviewed for proper coverage.

If the bank owns or operates a hangar for its aircraft and attempts to share the burden of costs with others by renting aircraft space, it can pick up exposure to hangar-keeper's liability, unless the contract is properly worded. Appropriate consideration should be given to hold-harmless indemnification clauses, any regular or special insurance requirements, and waivers of subrogation.

Accidental Death and Dismemberment and Travel

Accidental death and dismemberment and travel insurance is another aspect of aviation insurance that banking institutions should consider. Many insurance programs for accidental death and dismemberment and corporate business travel accidents exclude coverage in corporate-owned, -leased, or -hired aircraft. Banks need to review the language of these policies carefully to be certain that they provide necessary and adequate coverages for the use of such aircraft.

RECORDKEEPING

The diversity of available insurance policies and their coverages emphasize the need for banks to maintain a concise, easily referenced schedule of their insurance coverage, referred to as the ''schedule of insurance.'' These records should include the following information:

- insurance coverages provided, with major exclusions detailed
- the underwriter
- deductible amounts
- upper limits on policies
- terms of the policies
- dates that premiums are due
- premium amounts
- claim-reporting procedures

In preparation for policy renewal, the bank's risk manager and insurance broker organize much of the bank's relevant insurance data into a ''submission.'' The submission may include—

- historical, current, and forecasted exposure information, such as sales, number and type of employees, property characteristics and values, and number and type of autos;
- loss and claim history by line of insurance, including detailed information on large claims, loss development, and litigation;
- information on company risk-management policies and financials; and
- specifications on desired coverages, terms and conditions, limits, deductibles, and payment plans.

The submission is delivered to the insurance company underwriter and forms the basis for determining premiums, rates, limits, and the program structure. The information may give the examiner a sense of why premiums and coverages change from year to year and whether purchased limits are sufficient.

Banks should retain the original policies and supporting documents for appropriate time periods. Records of losses should also be maintained, regardless of whether the bank was reimbursed. This information indicates areas where internal controls may need to be improved and is useful in measuring the level of risk exposure in a particular area.

APPENDIX—COMPARATIVE DATA

To help the examiner assess the adequacy of a bank's insurance coverage, this appendix provides several tables compiled by the American Bankers Association (ABA). The tables show the different types of insurance and the amount of insurance coverage carried by banks, which are grouped by asset size. However, a bank's level of risk exposure is influenced by many variables, only one of which is asset size. Therefore, the examiner must assess the overall soundness of the bank's risk- and insurance-management program, rather than suggest an average coverage that may be inappropriate for the particular bank.

Bank Insurance: FIB and Other Insurance Coverage

The following tables appeared in the "ABA Bank Insurance Survey Report 2000" and were compiled from information submitted by banks during 2000. The survey includes data from 199 banks using a probability sample of 2,258 banks of various asset sizes.

Table 1—Number of Banks in the United States and Survey Participants

	Asset size (in millions)					
	Less than $150	*$150–299*	*$300–999*	*$1,000–4,999*	*$5,000–9,999*	*$10,000 and more*
Number of banks in U.S.[1] (as of 12/31/99)	6,508	1,298	875	303	59	79
Number of survey participants	33	49	53	38	13	13

1. FDIC, Report of Condition and Income.
SOURCE: "ABA Bank Insurance Survey Report 2000."

Table 2—Summary of Financial Institution Bond Coverage[1]

Asset size (in millions)	Coverage limits (in thousands): Per-loss median coverage	Most frequent amount of per-loss coverage	Aggregate coverage per $1 million total assets—minimum, maximum, and median
$ 1–99	$ 1,525	$ 1,000/ 2,000[2]	$12, 87, & 31
100–249	2,800	2,800	6, 32, & 13
250–499	4,000	5,000	7, 31, & 14
500–999	5,000	5,000	6, 21, & 10
1,000–4,999	10,000	10,000	3, 23, & 11
5,000–9,999	20,000	25,000	3, 14, & 7
10,000–19,999	25,000	25,000	2, 9, & 4
20,000 & over	87,500	100,000	1, 8, & 4

1. The summary of financial institution bond coverage is not a recommended amount of coverage. It is a statistical summary by asset size for such coverage.
2. Tie for most frequent coverage.

Source: "ABA Bank Insurance Survey Report 2000."

Table 3—Excess Insurance Coverages Carried

Percentage of banks

	Asset size (in millions): Less than $150	$150–299	$300–999	$1,000–4,999	$5,000–9,999	$10,000 and more
Duplicate of bond[1]						
Excess clause A or form 28	23.8%	40.0%	13.6%	10.3%	–%	9.1%
Excess clause B	9.5	–	–	3.4	–	9.1
Excess clause C	9.5	–	–	3.4	–	9.1
Excess clause D	9.5	–	–	3.4	–	9.1
Excess clause E	9.5	–	–	3.4	–	9.1
All-risk policies[2]						
All-risk securities	–	–	4.5	–	–	27.3
All-risk premises	–	3.3	4.5	3.4	–	18.2
All-risk transit	–	–	2.3	–	–	27.3
Fill-in policies[3]	–	–	–	–	9.1	36.4

1. Excess coverage that duplicates the insurance under the financial institution bond (FIB).
2. Cover all risk of physical loss or damage to securities and can be arranged to cover premises or transit.
3. Policies purchased to fill in the deductible on the FIB.

Source: "ABA Bank Insurance Survey Report 2000."

Table 4—Other Insurance Policies Carried by Banks[1]

Percentage of banks

	Asset size (in millions)					
	Less than $150	*$150–299*	*$300–999*	*$1,000–4,999*	*$5,000–9,999*	*$10,000 and more*
Directors' and officers' liability	83.9%	95.8%	98.1%	94.7%	100.0%	100.0%
Excess directors'/officers'	6.5	12.5	5.7	18.4	53.8	53.8
Trust department errors and omissions	3.2	45.8	58.5	55.3	69.3	76.9
Bankers' professional liability	38.7	47.9	62.3	63.2	84.6	92.3
Securities liability	6.5	20.9	22.7	42.1	76.9	92.3
Brokerage services	6.5	20.9	26.4	44.7	76.9	92.3
Insurance agent errors and omissions	12.9	25.0	30.2	50.0	84.6	92.3
Notary errors and omissions	19.4	20.9	32.1	42.1	61.5	76.9
Mortgage errors and omissions	32.3	39.6	39.6	50.0	69.2	69.2
Fiduciary liability (ERISA) for own employee benefits program	25.8	66.7	79.3	76.3	92.3	100.0
Safe deposit coverage	32.3	35.4	26.4	42.1	53.8	46.2
Legal liability	29.0	35.4	24.5	42.1	53.8	46.2
Customers	19.4	25.0	18.9	23.7	38.5	15.4
Electronic data processing	58.1	60.4	64.2	78.9	76.9	84.6
Equipment	45.2	54.2	62.3	78.9	69.2	84.6
Media	38.7	47.9	60.4	76.3	61.5	84.6
Extra expense	35.5	45.8	52.8	76.3	53.9	84.6
Business interruption	22.6	22.9	34.0	42.1	30.8	69.2
General liability	87.1	83.3	98.1	97.4	100.0	100.0
Umbrella and excess liability	61.3	91.7	100.0	100.0	100.0	100.0
Kidnap/extortion	48.4	31.3	45.3	68.4	76.9	92.3
Threats to persons	38.7	31.3	39.6	68.4	76.9	84.6
Threats to property	25.8	18.8	34.0	55.3	69.2	76.9
Building and contents	80.6	87.5	92.5	97.4	100.0	100.0
Workers' compensation	93.5	89.6	100.0	100.0	100.0	92.3
Insurance/guaranteed-cost policy	64.5	62.5	79.2	81.6	92.3	84.6
State fund	32.3	33.3	18.9	26.3	38.5	30.8
Self-insurance	–	8.3	–	7.9	23.1	38.5
Electronic and computer crime	9.7	12.5	9.4	31.5	23.1	38.5
Mail	6.4	39.6	35.9	76.3	69.2	100.0

1. Including policies as part of a package plan (other than the financial institution bond (FIB)).

SOURCE: "ABA Bank Insurance Survey Report 2000."

Table 4—Other Insurance Policies Carried by Banks—continued

	Asset size (in millions)					
	Less than $150	*$150–299*	*$300–999*	*$1,000–4,999*	*$5,000–9,999*	*$10,000 and more*
Automobile	64.5%	97.9%	98.1%	97.4%	100.0%	100.0%
Physical damage	45.2	93.8	94.4	92.1	92.3	53.8
Collision	45.2	93.8	94.4	89.5	92.3	38.5
Comprehensive	45.2	93.8	94.4	92.1	92.3	53.8
Liability	64.5	97.9	98.1	97.4	100.0	100.0
Leased vehicle contingent liability coverage	12.9	16.7	32.1	39.5	69.2	92.3
Mortgage insurance	41.9	75.0	84.9	89.5	84.6	100.0
Mortgage errors and omissions	41.9	68.8	73.6	76.3	69.2	92.3
Mortgage impairment	25.8	39.6	50.9	76.3	53.8	92.3
All-risk (difference-in-conditions)	6.5	18.8	18.9	21.1	30.8	38.5
Other real estate insurance—foreclosed property	16.1	62.5	60.4	65.8	84.6	100.0
IRA/Keogh liability	35.5	45.8	52.8	34.2	38.5	30.8
Entity errors and omissions	12.9	35.4	28.3	18.4	–	30.8
Employment practices liability	51.6	72.9	79.2	71.1	69.2	69.2

Table 5—Average FIB Policy Limits Per Bank
($ millions)

	Asset size (in millions)					
	Less than $150	*$150–299*	*$300–999*	*$1,000–4,999*	*$5,000–9,999*	*$10,000 and more*
Per loss						
Clause A (employee dishonesty)	$1.7	$3.2	$5.4	$12.0	$22.1	$ 68.6
Clause D (check forgery)	0.8	2.2	4.1	8.9	26.7	55.0
Clause E (securities forgery)	0.8	2.2	3.5	8.9	26.7	66.7
Clause F (counterfeit currency)	1.4	3.2	5.3	11.0	26.7	66.7
Kidnap/extortion rider						
Threats to persons	0.9	1.2	2.2	2.8	–	–
Threats to property	1.0	1.2	2.2	3.1	–	–
Trading loss rider	0.8	2.9	2.9	7.1	–	–
Central handling of securities	1.3	1.8	3.1	3.6	–	–
Automated teller machines rider (unattended ATMs)	0.1	0.2	0.4	0.1	0.2	35.9
Computer system rider (other EFT rider or separate rider for computer systems)	1.2	2.6	4.6	9.1	–	–
Aggregate limit buyback	–	–	–	–	–	–
Safe deposit						
Legal liability	0.6	1.2	1.8	3.9	9.5	10.2
Customer property	0.7	1.3	1.9	3.5	12.1	–
Unauthorized signature rider	0.6	1.3	2.0	2.9	12.4	–
Fraudulent mortgages rider	0.4	1.2	1.6	4.6	18.1	115.0
Check kiting rider	0.2	0.4	1.4	32.5	–	–
Counterfeit check rider	0.7	1.7	4.1	50.1	–	–
Service contractor rider	–	0.9	2.5	5.7	–	31.3
Money order issuer's rider	–	1.2	6.0	–	–	–
Transit cash rider	0.4	1.3	1.9	3.1	6.8	45.3
Stop payment rider	0.1	0.1	0.1	0.3	0.3	0.5

SOURCE: "ABA Bank Insurance Survey Report 2000."

Table 5—Average FIB Policy Limits Per Bank—continued

	Asset size (in millions)					
	Less than $150	*$150–299*	*$300–999*	*$1,000–4,999*	*$5,000–9,999*	*$10,000 and more*
Aggregate						
Clause A (employee dishonesty)	$1.9	$3.6	$ 7.2	$23.8	$44.5	$120.5
Clause D (check forgery)	0.7	3.4	6.8	17.9	–	–
Clause E (securities forgery)	0.9	2.5	4.8	19.2	–	–
Clause F (counterfeit currency)	–	2.9	10.8	19.0	–	–
Kidnap/extortion rider						
Threats to persons	0.8	1.7	1.6	–	–	–
Threats to property	0.9	1.6	–	–	–	–
Trading loss rider	0.6	2.6	5.5	15.7	–	175.0
Central handling of securities	–	–	–	–	–	–
Automated teller machines rider (unattended ATMs)	0.1	0.1	0.2	0.1	–	–
Computer system rider (other EFT rider or separate rider for computer systems)	0.7	2.2	3.4	23.0	–	–
Aggregate limit buyback	–	–	–	–	–	–
Safe deposit						
Legal liability	0.6	1.3	1.3	4.8	18.3	–
Customer property	0.5	1.3	1.4	3.0	–	–
Unauthorized signature rider	0.9	1.9	5.2	11.8	–	–
Fraudulent mortgages rider	–	1.7	2.6	11.4	–	–
Check kiting rider	–	0.2	0.1	–	–	–
Counterfeit check rider	–	–	–	17.5	–	–
Service contractor rider	–	–	–	20.0	–	–
Money order issuer's rider	–	–	–	–	–	–
Transit cash rider	0.2	1.4	2.9	19.6	–	–
Stop payment rider	0.1	0.4	0.3	4.7	–	–

Table 6—Average Policy Limits for Excess Insurance
($ millions)

	Asset size (in millions)					
	Less than $150	*$150–299*	*$300–999*	*$1,000–4,999*	*$5,000–9,999*	*$10,000 and more*
Duplicate of bond						
Excess clause A or form 28	$1.0	$1.4	$1.0	$5.3	–	–
Excess clause B	1.0	–	–	–	–	–
Excess clause C	1.0	–	–	–	–	–
Excess clause D	1.0	–	–	–	–	–
Excess clause E	1.0	–	–	–	–	–
All-risk policies						
All-risk securities	–	–	–	–	–	–
All-risk premises	–	–	–	–	–	–
All-risk transit	–	–	–	–	–	–

SOURCE: "ABA Bank Insurance Survey Report 2000."

Table 7—Average Policy Limits Per Bank[1]
($ millions)

	Asset size (in millions)					
	Less than $150	$150–299	$300–999	$1,000–4,999	$5,000–9,999	$10,000 and more
Directors' and officers' liability						
Each director	$1.8	$ 3.1	$ 6.2	$ 10.8	$ 19.4	$ 31.1
Aggregate director/officer	2.0	3.3	5.5	10.9	16.8	31.1
Corporate reimbursement	1.5	2.8	5.7	10.3	15.5	38.0
Excess directors'/officers'	–	1.5	3.5	8.3	15.0	30.0
Trust department errors and omissions	–	2.0	2.9	4.6	9.6	24.0
Discretionary trust assets per bank	–	49	257	657	5,083	9,198
Bankers' professional liability	0.7	1.5	4.9	5.9	13.1	38.6
Securities liability	–	1.6	5.9	6.3	11.0	35.7
Brokerage services	–	2.3	5.4	5.8	10.0	35.7
Insurance agent errors and omissions	1.6	2.0	4.3	5.2	11.0	38.6
Notary errors and omissions	0.5	1.1	3.1	5.3	12.5	40.8
Mortgage errors and omissions	1.0	1.5	3.0	5.5	11.4	39.2
Fiduciary liability (ERISA) for own employee benefits program	1.1	1.4	3.1	3.9	10.3	25.5
Safe deposit coverage						
Legal liability	0.9	1.6	2.6	9.0	10.6	11.0
Customers	0.7	1.7	2.7	6.0	15.0	–
Electronic data processing						
Equipment	0.2	0.7	1.9	4.0	19.7	176.5
Media	0.1	0.1	1.0	1.8	16.1	123.4
Extra expense	0.3	0.2	0.9	1.6	2.0	67.5
Business interruption	0.5	0.6	1.4	2.3	5.3	92.9
General liability	1.8	1.9	1.6	2.2	1.3	3.6
Umbrella and excess liability	2.8	5.8	8.4	13.9	42.5	68.7
Kidnap/extortion[1]						
Threats to persons	1.1	2.0	3.2	4.4	10.8	12.5
Threats to property	1.0	1.8	3.9	4.5	10.8	10.7
Building and contents	1.3	6.5	14.9	52.0	150.6	493.6
Electronic and computer crime[1]	–	1.7	5.3	14.6	41.7	51.7

1. Including policies as part of a package plan (other than the FIB).

SOURCE: "ABA Bank Insurance Survey Report 2000."

Table 7—Average Policy Limits Per Bank—continued

	Asset size (in millions)					
	Less than $150	*$150–299*	*$300–999*	*$1,000–4,999*	*$5,000–9,999*	*$10,000 and more*
Automobile						
Liability	$ 1.0	$ 0.9	$ 1.0	$ 1.0	$ 1.0	$ 1.1
Number of owned vehicles per bank	2	4	9	25	83	134
Leased vehicle contingent liability coverage	1.0	0.9	0.8	1.0	0.7	1.1
Mortgage insurance						
Mortgage errors and omissions	0.8	0.9	1.3	2.0	–	10.7
Mortgage impairment	1.0	1.3	1.5	2.9	–	10.0
All-risk (difference-in-conditions)	1.0	0.6	1.6	1.8	–	13.3
Mortgage loan outstandings per bank	27	86	206	686	3,251	11,245
Other real estate insurance—foreclosed property	–	1.6	1.4	2.8	4.0	40.6
IRA/Keogh liability	1.2	1.2	3.0	4.6	10.5	–
Entity errors and omissions	1.4	2.1	3.2	3.5	–	–
Employment practices liability	0.5	1.6	2.1	5.3	11.7	40.0

Table 8—Selected Clauses and Riders Maintained Under the FIB
Percentage of banks

	Asset size (in millions)					
	Less than $150	*$150–299*	*$300–999*	*$1,000–4,999*	*$5,000–9,999*	*$10,000 and more*
Clause D (check forgery)	100.0%	97.9%	98.1%	100.0%	100.0%	92.3%
Clause E (securities forgery)	90.6	97.9	100.0	100.0	100.0	100.0
Clause F (counterfeit currency)	84.4	95.8	100.0	86.8	92.3	100.0
Kidnap/extortion rider						
Threats to persons	75.0	77.1	62.3	34.2	7.7	23.1
Threats to property	62.5	70.8	58.5	28.9	15.4	23.1
Trading loss rider	46.9	62.5	75.5	76.3	84.6	76.9
Central handling of securities	18.8	27.1	15.1	31.6	53.8	84.6
Automated teller machines rider (unattended ATMs)	50.0	72.9	79.2	89.5	84.6	92.3
Computer system rider (other EFT or separate rider for computer systems)	78.1	87.5	92.5	73.7	61.5	69.2
Aggregate limit buyback	12.5	6.3	9.4	5.3	7.7	30.8
Safe deposit						
Legal liability	65.6	72.9	71.7	60.5	76.9	69.2
Customer property	34.4	47.9	54.7	39.5	61.5	30.8
Unauthorized signature rider	50.0	64.6	58.5	73.7	84.6	92.3
Fraudulent mortgages rider	68.8	83.3	79.2	73.7	76.9	92.3
Check kiting rider	34.4	52.1	28.3	26.3	17.7	30.8
Counterfeit check rider	28.1	39.6	32.1	28.9	23.1	69.2
Service contractor rider	9.4	22.9	28.3	39.5	46.2	84.6
Money order issuer's rider	9.4	12.5	15.1	17.9	30.8	38.5
Transit cash rider	65.6	68.8	77.4	76.3	69.2	76.9
Stop payment rider	75.0	87.5	77.4	76.3	76.9	84.6

SOURCE: "ABA Bank Insurance Survey Report 2000."

Table 9—Type of Electronic and Computer Crime Coverage Maintained Under the FIB or Other Policy/Rider

Percentage of banks

	Asset size (in millions)					
	Less than $150	*$150–299*	*$300–999*	*$1,000–4,999*	*$5,000–9,999*	*$10,000 and more*
Electronic funds transfer	36.4%	65.3%	69.8%	68.4%	92.3%	100.0%
Bank proprietary systems	18.2	53.1	52.8	50.0	76.9	100.0
Software programmers, consultants	12.1	28.6	39.6	28.9	53.8	76.9
ATM systems	24.2	53.1	52.8	60.5	69.2	76.9
Telephone voice instructions	24.2	51.0	54.7	68.4	92.3	100.0
Telephone-toll fraud	6.1	14.3	24.5	26.3	53.8	69.2
Computer virus	15.2	26.5	35.8	50.0	84.6	84.6
Software piracy	9.1	12.2	18.9	15.8	38.5	61.5
Computer extortion	15.2	30.6	37.7	34.2	76.9	92.3
Facsimile transmission	24.2	46.9	49.1	57.9	100.0	92.3
E-risk	–	10.2	15.1	10.5	7.7	15.4

SOURCE: "ABA Bank Insurance Survey Report 2000."

1. To determine whether insurance is effectively integrated into the operational-risk-management program, and whether the insurance is appropriate, in light of the institution's internal-control environment.
2. To determine if insurance coverage adequately protects against significant or catastrophic loss.
3. To determine if recordkeeping practices are sufficient to enable effective risk and insurance management.
4. To ascertain if, and ensure that, the risk manager has initiated corrective action when policies, practices, procedures, or internal controls are deficient or when violations of banking laws and regulations have been noted.

1. If selected for implementation, complete or update the ‘‘Bank Risk and Insurance Management’’ section of the internal control questionnaire.
2. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examination procedures. From the examiner who is assigned to ‘‘internal control,’’ obtain a listing of any deficiencies noted in the latest review conducted by internal or external auditors and risk managers. Determine if appropriate corrections have been made.
3. Determine if the bank has designated a qualified risk manager, with expertise in insurance programs, to be responsible for loss control. If not, determine which officer handles the risk- and insurance-management function and whether external consultants are employed in designing the insurance program.
4. Obtain the bank’s schedule of insurance policies in force and the renewal submissions. If the bank does not maintain a schedule, request that the bank complete a schedule of existing insurance coverage.
   a. Determine whether there have been any material changes in insurance coverage, limits, or deductibles since the last examination and the reasons for such changes. Do the changes reflect—
      - revised business strategies, the bank structure, operating processes, or technology systems that affect insurable risks, and
      - shifts to self-insurance or co-insurance or a change in insurance carriers?
   b. If there have been material changes, determine how they are being managed.
5. Using the bank-prepared summary of insurance coverage, determine that coverage conforms to the guidelines for maximum loss exposure, as established by the board of directors.
   a. Determine whether the use of insurance is in accordance with board-approved risk-management policies and guidelines.
   b. If the bank self-insures, determine what methods are used for this purpose; how the value of self-insurance is quantified; and how ‘‘premiums’’ are accounted for, funded, allocated, and tracked.
6. Determine whether insurance coverage provides adequate protection for the bank. The quality of internal controls and the audit function must be considered when making this assessment.
   a. Determine whether the bank manages its insurance coverage as an element of the operational-risk-management program.
   b. Determine whether the insurance program is managed on a corporate-wide basis or within each business unit.
   c. Identify any products, processes, or systems that the bank is not able to obtain insurance coverage for and determine how the associated risk is being managed.
   d. Determine whether the bank maintains a database of operational-loss events, the comprehensiveness of the database, and the claims history of operational losses.
   e. Review the due-diligence process used to assess the qualifications of providers of insurance coverage, including primary reinsurers.
7. If the bank’s fidelity insurance has lapsed, determine that the appropriate Federal Reserve Bank has been notified.
8. Determine that the bank has adequate procedures to ensure that—
   a. reports of losses are filed with the bonding company pursuant to policy provisions,
   b. premiums are paid before policy expiration dates,
   c. policies are renewed without a lapse of coverage at expiration dates, and
   d. material changes in exposures are reported to the bank’s insurance agent or broker and result in appropriate insurance-policy endorsements.

If the procedures are deficient, verify that reports have been filed as required and premiums have been paid.

9. Review any significant financial institution bond claims that were filed since the last examination to determine—

a. any adverse effect on the bank's condition,
b. whether the incident (or incidents) reflects any deficiencies with respect to internal controls and procedures, and
c. whether management has taken appropriate steps to correct any deficiencies and made appropriate reports to the board of directors.

10. Prepare, in appropriate report form, and discuss with appropriate officers—
    a. recommended corrective action when policies, practices, procedures, or internal controls are deficient;
    b. recommended improvements in the risk-management program that relate to insurance;
    c. important areas in which insurance coverage is either nonexistent or inadequate in view of current circumstances; and
    d. any other deficiencies noted.
11. Update the workpapers with any information that will facilitate future examinations.

Review the bank's internal controls, policies, practices, and procedures for its own insurance coverage. The bank's risk-management system should be documented completely and concisely and should include, where appropriate, the risk-assessment matrix, a narrative description, flowcharts, the schedule of insurance coverage, policy forms, renewal submissions, and other pertinent information.

BANK RISK AND INSURANCE MANAGEMENT

1. Does the bank have established insurance guidelines that provide for—
   a. a reasonably frequent, and at least annual, determination of risks the bank assumes or transfers, including high-dollar and low-probability events?
   b. limits as to the amount of risk that may be retained or self-insured?
   c. periodic appraisals of major fixed assets to be insured?
   d. a credit or financial analysis of the insurance companies who have issued policies to the bank?
2. Does the bank have a risk manager who is responsible for assessing and developing controls to deal with the consolidated risks of the institution?
3. Is the bank's insurance program managed as an element of its overall operational-risk-management program; that is, are insurance coverages reviewed and coordinated by the person handling the operational-risk-management function?
4. Does the bank use the services of a professionally knowledgeable insurance agent, broker, direct writer, or consultant to assist in selecting and providing advice on alternative means of providing insurance coverage?
5. Does the bank's security officer coordinate his or her activities with the person responsible for handling the operational-risk-management function?
6. Does the bank maintain a concise, easily referenced schedule of existing insurance coverage?
7. Does the bank maintain records, by type of risk, to facilitate an analysis of the bank's experience in costs, claims, losses, and settlements under the various insurance policies in force?
8. Is a complete schedule of insurance coverage presented to the board of directors at least annually for review and approval? Does the schedule include the respective insurance premiums (net costs), claims, and loss experience, and is this information reviewed as part of this process?

CONCLUSION

1. Is the foregoing information an adequate basis for evaluating internal control; that is, there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
2. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

Banking organizations have long been engaged in the sale of insurance products and annuities, although these activities historically have been subject to several restrictions. For example, until recently, national banks could sell most types of insurance, but only through an agency located in a small town. Bank holding companies also were permitted to engage in only limited insurance agency activities under the Bank Holding Company Act. State-chartered banks, on the other hand, generally have been permitted to engage in insurance sales activities as agent to the extent permitted by state law.

The Gramm-Leach-Bliley Act of 1999 (the GLB Act), however, authorized national banks and state-chartered member banks to sell all types of insurance products through a financial subsidiary. *The GLB Act generally did not change the powers of banks to sell insurance directly.* As a result of the GLB Act and marketplace developments, many banking organizations are increasing the range and volume of their insurance and annuities sales activities. To the extent permitted by applicable law, banking organizations may conduct insurance and annuity sales activities through a variety of structures and delivery channels, including ownership of an insurance underwriter or an insurance agency or broker, the employment by a bank of licensed agents, a joint marketing arrangement with a producer,[1] independent agents located at a bank's office, direct mail, telemarketing, and Internet marketing.

A banking organization may also conduct insurance or annuity sales activities through a managing general agent (MGA). An MGA is a wholesaler of insurance products and services to insurance agents. The MGA has a contractual agreement with an insurance carrier to assume functions for the carrier, which may include marketing, accounting, data processing, policy recordkeeping, and monitoring or processing claims. The MGA may rely on various local agents or agencies to sell the carrier's products. Most states require an MGA to be licensed.

OVERVIEW AND SCOPE

The following guidance pertains to state member banks that are either directly or indirectly engaged in the sale of insurance or annuity products. Examiner guidance on performing appropriate risk assessments of a state member bank's insurance and annuity sales activities is included.[2] Additionally, guidance is provided for examining a state member bank's compliance with the consumer protection rules relating to insurance and annuities sales activities that are contained in the Board's December 2000 revisions to Regulation H (subpart H) (12 CFR 208.81–86), "Consumer Protection in Sales of Insurance" (CPSI). Subpart H, which became effective on October 1, 2001, implements the consumer protection requirements of the GLB Act, which are codified at 12 USC 1831x. (See 65 *Fed. Reg.* 75841 (December 4, 2000).) The regulation applies not only to the sale of insurance products or annuities by the bank, but also to activities of any person engaged in insurance product or annuity sales on behalf of the bank, as discussed in this guidance. The guidance is generally not applicable to debt-cancellation contracts and debt-suspension agreements, unless these products are considered to be insurance products by the state in which the sales activities are conducted.

The GLB Act permits state member banks that are not authorized by applicable state law to sell insurance directly to do so through a financial subsidiary.[3] A financial subsidiary engaged in insurance sales may be located wherever state

1. The term "producer" refers broadly to persons, partnerships, associations, limited liability corporations, etc., that hold a license to sell or solicit contracts of insurance to the public. Insurance agents and agencies are producers who, through a written contractual arrangement known as a direct appointment, represent one or more insurance underwriters. Independent agents and agencies are those producers that sell products underwritten by one or more insurance underwriters. Captive agents and agencies represent a specific underwriter and sell only its products. Brokers are producers that represent the purchaser of insurance and obtain bids from competing underwriters on behalf of their clients. State insurance laws and regulations often distinguish between an insurance agent and a broker; in practice, the terms are often used interchangeably.

2. The term "risk assessment" denotes the work product described in SR-97-24, "Risk-Focused Framework for Supervision of Large Complex Institutions," and entails an analysis of (1) the level of inherent risk by type of risk (operational, legal, market, liquidity, credit, and reputation risk) for a business line or business function, (2) the adequacy of management controls over that business line or business function, and (3) the direction of the risk (increasing, decreasing, or stable).

3. Rules pertaining to state member bank financial subsid-

law permits the establishment and operation of an insurance agency. Such subsidiaries, however, would be subject to state licensing and other requirements.

The Federal Reserve is responsible for evaluating the consolidated risk profile of a state member bank. This reponsibility includes determining the risks posed to the state member bank from the insurance and annuity sales activities it conducts directly or indirectly, as well as determining the effectiveness of the bank's risk-management systems. However, the GLB Act also established a regulatory framework that is designed to ensure that the Federal Reserve coordinates with, and relies to the extent possible on information from, the state insurance authorities when it is supervising the insurance activities a state member bank conducts through a functionally regulated subsidiary.

Consistent with the Federal Reserve's risk-focused framework for supervising banking organizations, resources allocated to the review of insurance sales activities should be commensurate with the significance of the activities and the risk they pose to the bank. The scope of the review depends on the significance of the activity to the state member bank and the extent to which the bank is directly involved in the activity. Examiner judgment is required to tailor the reviews, as appropriate, on the basis of the legal, organizational, and risk-management structure of the state member bank's insurance and annuity sales activities and on other relevant factors.[4]

SUPERVISORY APPROACH FOR THE REVIEW OF INSURANCE AND ANNUITY SALES ACTIVITIES

Supervisory Objective

The primary objective for the review of a state member bank's insurance and annuity sales activities is to determine the level and direction of risk such activities pose to the state member bank. The review includes insurance and annuity sales activities the state member bank conducts directly, by or in conjunction with a subsidiary or affiliate, or through a third-party arrangement. Primary risks that may arise from insurance sales activities include operational, legal, and reputational risk. If the state member bank does not adequately manage these risks, they could have an adverse impact on its earnings and capital. The examiner should produce (1) a risk assessment that summarizes the level of inherent risk to the state member bank by risk category and (2) an assessment of the adequacy of board of directors and management oversight of the insurance and annuity sales activities, including their internal control framework. For those state member banks selling insurance or annuity products, or that enter into arrangements under which another party sells insurance or annuity products at the bank's offices or on behalf of the bank, a second objective of the review is to determine the bank's compliance with the consumer protection provisions of the GLB Act and the CPSI regulation.

State Regulation of Insurance Activities

Historically, insurance activities have primarily been regulated by the states. In 1945, Congress passed the McCarran-Ferguson Act, which granted states the power to regulate most aspects of the insurance business. The McCarran-Ferguson Act states that "no act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any state for the purpose of regulating the business of insurance, or which imposes a fee or tax upon such business, unless such Act specifically relates to the business of insurance" (15 USC 1012(b)).

State regulation of insurance producers is centered on the protection of the consumer and consists primarily of licensing and continuing education requirements for producers. A producer generally must obtain a license from each state in which it sells insurance and for each product sold. Each state in which a producer sells insurance has regulatory authority over the producer's activities in the state.

The GLB Act does include several provisions that are designed to keep states from (1) unfairly regulating a bank to prevent it from engaging in

iaries are found in the Board's Regulation H (12 CFR 208.71–77).

4. See SR-02-01, "Revisions to Bank Holding Company Supervision Procedures for Organizations with Total Consolidated Assets of $5 Billion or Less," and section 1000.1 for a discussion of the Federal Reserve's risked-focused examinations and the risk-focused supervision program for community banking organizations. See also SR-97-24.

authorized insurance activities or (2) otherwise discriminating against banks engaged in insurance activities. These provisions are complex and beyond the scope of this guidance. However, the GLB Act generally does not prohibit a state from requiring a bank or bank employee engaged in insurance sales, solicitation, or cross-marketing activities to be licensed within the state.

State insurance regulatory authorities do not conduct routine, periodic examinations of an insurance producer. A state examination of an insurance producer is generally conducted only on an ad hoc basis and is primarily based on the volume and severity of consumer complaints. The state examination may also be based in part on the producer's market share and on previous examination findings. Additionally, a review of a producer would typically not assess its financial condition.

A state's market conduct examination of *insurance sales practices* is focused at the insurance-underwriter level.[5] The insurance underwriter is generally held accountable for compliance with state insurance laws to protect the consumer from the unfair sales practices of any producer that markets the insurance underwriter's products. Market conduct examinations of an insurance underwriter may potentially uncover a concern about a particular producer, such as a bank-affiliated producer.[6] However, in the past, a state insurance regulatory authority has not typically examined a producer unless the producer is owned by the insurance underwriter.

Generally, market conduct examinations include reviews of the insurance underwriters' complaint handling, producer licensing, policyholder service, and marketing and sales practices. Typically, a state authority will direct a corrective action for insurance sales activity at the underwriter. The states generally have specific guidance for their market conduct examinations of life, health, and property/casualty[7] lines of business—guidance that corresponds to regulations related to advertising, misrepresentations, and disclosures for these different business lines. The reports of examination issued by the state insurance departments are usually available to the public.

Because the underwriter, not the producer, is liable to the insured, the failure of an insurance producer generally would not result in financial loss to consumers or state guarantee funds. Consequently, there are no regulatory capital requirements for insurance producers, nor do states require regulatory reporting of financial statement data on insurance producers. While the underwriter is ultimately liable to the insured, in some instances, a producer and its owner may be held liable for misrepresentations, as well as for violations of laws and regulations.

Functional Regulation

Under the GLB Act, banking supervisors' reviews of insurance or securities activities conducted in a bank's functionally regulated subsidiary are not to be extensions of more traditional bank-like supervision. Rather, to the extent possible, bank supervisors are to rely on the functional regulators to appropriately supervise the insurance and securities activities of a functionally regulated subsidiary. A functionally regulated subsidiary includes any subsidiary of a bank that (1) is engaged in insurance activities and subject to supervision by a state insurance regulator or (2) is registered as a broker-dealer with the Securities and Exchange Commission. The GLB Act does *not* limit the Federal Reserve's supervisory authority with respect to a *bank* or the insurance activities conducted by a bank. The functional regulators for insurance sales activities, including the activities of insurance producers, consist of the insurance departments in each of the 50 states, the District of Columbia, Puerto Rico, the U.S. Virgin Islands, American Samoa, and Guam.

5. Generally, market conduct reviews of *insurance underwriters* are conducted on an ad hoc basis, triggered primarily by the volume and severity of consumer complaints, and are based on the underwriter's market share or on previous examination findings. In some states, however, market conduct reviews of insurance underwriters are conducted on a periodic, three- to five-year schedule.

6. The terms "insurance underwriter," "insurer," "insurance carrier," and "insurance company" are industry terms that apply similarly to the party to an insurance arrangement who undertakes to indemnify for losses, that is, the party that assumes the principal risk under the contract.

7. Property insurance indemnifies a person who has an interest in a physical property for loss of the property or the loss of its income-producing abilities. Casualty insurance is primarily concerned with the legal liability for losses caused by injury to persons or damage to the property of others. It may also include such diverse forms of insurance as crime insurance, boiler and machinery insurance, and aviation insurance. Many casualty insurers also underwrite surety bonds.

The GLB Act places certain limits on the ability of the Federal Reserve to examine, obtain reports from, or take enforcement action against a functionally regulated nondepository subsidiary of a state member bank. For purposes of these limitations, a subsidiary licensed by a state insurance department to conduct insurance sales activities is considered functionally regulated only with respect to its insurance activities and any activities incidental to these activities.[8]

The GLB Act indicates that the Federal Reserve must rely, to the fullest extent possible, on information obtained by the appropriate state insurance authority of a nondepository insurance agency subsidiary of a state member bank. In addition, the Federal Reserve may examine a functionally regulated subsidiary of a state member bank only in the following situations:

- The Federal Reserve has reasonable cause to believe that the subsidiary is engaged in activities that pose a material risk to an affiliated depository institution, as determined by the responsible Reserve Bank and Board staff.
- After reviewing relevant information (including information obtained from the appropriate functional regulator), it is determined that an examination is necessary to adequately understand and assess the banking organization's systems for monitoring and controlling the financial and operational risks that may pose a threat to the safety and soundness of an affiliated depository institution.
- On the basis of reports and other available information (including information obtained from the appropriate functional regulator), there is reasonable cause to believe that the subsidiary is not in compliance with a federal law that the Federal Reserve has specific jurisdiction to enforce with respect to the subsidiary (including limits relating to transactions with affiliated depository institutions), and the Federal Reserve cannot assess such compliance by examining the state member bank or other affiliated depository institution.

Other similar restrictions limit the ability of the Federal Reserve to obtain a report directly from, or take enforcement action against, a functionally regulated nonbank subsidiary of a state member bank. These GLB Act limitations do *not* apply to a state member bank even if the state member bank is itself licensed by a state insurance regulatory authority to conduct insurance sales activities.

Staff who are conducting reviews of state member bank insurance or annuity sales activities should be thoroughly familiar with SR-00-13, which provides guidance on reviews of functionally regulated state member bank subsidiaries. Reserve Bank staff may conduct an examination of a functionally regulated subsidiary, or request a specialized report from a functionally regulated subsidiary, only after obtaining approvals from the appropriate staff of the Board's Division of Banking Supervision and Regulation.

When preparing or updating the risk assessment of a state member bank's insurance or annuity sales activities, Federal Reserve staff, when appropriate, should coordinate their activities with the appropriate state insurance authorities. The Federal Reserve's supervision of state member banks engaged in insurance sales activities is not intended to replace or duplicate the regulation of insurance activities by the appropriate state insurance authorities.

Information Sharing with the Functional Regulator

The Federal Reserve and the National Association of Insurance Commissioners (NAIC) approved a model memorandum of understanding (MOU) on the sharing of confidential information between the Federal Reserve and individual state insurance departments.[9] The Board also approved the delegation of authority to the Board's general counsel to execute agreements with individual states, based on this MOU. Examiners should follow required Board administrative procedures before sharing any confidential information with a state insurance regulator. (These procedures generally require Federal Reserve staff to identify and forward to Board staff for review any confidential information that may be appropriate to share with the applicable

8. For example, if a state member bank subsidiary engages in mortgage lending and is also licensed as an insurance agency, it would be considered a functionally regulated subsidiary only to the extent of its insurance sales activities.

9. The NAIC is the organization of insurance regulators from the 50 states, the District of Columbia, and the four U. S. territories. The NAIC provides a forum for the development of uniform policy among the states and territories. The NAIC is not a governmental or regulatory body.

state insurance regulator concerning insurance sales activities conducted by state member banks.) The Board's Division of Consumer and Community Affairs CP Letter 2001-11 outlines the procedures for sharing consumer complaint information with state insurance regulators.

STATUTORY AND REGULATORY REQUIREMENTS AND POLICY GUIDANCE

Privacy Rule and the Fair Credit Reporting Act

State member banks that sell insurance to consumers must comply with the privacy provisions under title V of the GLB Act (12 USC 6801–6809), as implemented by the Board's Regulation P (12 CFR 216) (the privacy rule). Functionally regulated state member bank nonbank insurance agency subsidiaries are not covered by the Federal Reserve's privacy rule; however, they must comply with the privacy regulations (if any) issued by their relevant state insurance regulator.

The privacy rule regulates a state member bank's treatment of nonpublic personal information about a "consumer," an individual who obtains a financial product or service (such as insurance) from the institution for personal, family, or household purposes. The privacy rule generally requires a bank to provide a notice to each of its customers that describes its privacy policies and practices no later than when the bank establishes a business relationship with the customer. The privacy rule also generally prohibits a bank from disclosing any nonpublic personal information about a consumer to any nonaffiliated third party, unless the bank first provides to the consumer a privacy notice and a reasonable opportunity to prevent (or "opt out") of the disclosure, and the consumer does not opt out. The privacy rule permits a financial institution to provide a joint notice with one or more of its affiliates or other financial institutions, as identified in the privacy notice itself, provided that the notice is accurate with respect to the institution and the other institutions.

While the privacy rule applies to the sharing of nonpublic personal information by a bank with nonaffiliated third parties, the sharing of certain consumer information with affiliates or nonaffiliates may be subject to the Fair Credit Reporting Act (FCRA) as well. For example, under the FCRA, if a bank wants to share with its insurance subsidiary information from a credit report or from a consumer application for credit (such as the consumer's assets, income, or marital status), the bank must first notify the consumer about the intended sharing and give the consumer an opportunity to opt out. The same rules would apply to an insurance company that wants to share information from credit reports or from applications for insurance with an affiliate or a third party.

Anti-Tying Prohibitions

Federal law (section 106 (b) of the BHC Act Amendments of 1970 (12 USC 1972(b)) generally prohibits a bank from requiring that a customer purchase a product or service from the bank or an affiliate as a prerequisite to obtaining another product or service (or a discount on the other product or service) from the bank. This prohibition applies whether the customer is retail or institutional, or whether the transaction is on bank premises or off premises. For example, a state member bank may not require that a customer purchase insurance from the bank or a subsidiary or affiliate of the bank in order to obtain a loan from the bank (or a reduced interest rate on the loan).[10]

Policy Statement on Income from Sale of Credit Life Insurance

The Federal Reserve Board's Policy Statement on Income from Sale of Credit Life Insurance (see the *Federal Reserve Regulatory Service* at 3-1556) sets forth the principles and standards that apply to a bank's sales of credit life insurance and the limitations that apply to the receipt of income from those sales by certain individuals and entities associated with the bank. See also the examination procedures related to this policy statement in section 2130.3.

10. See "Tie-In Considerations of the BHC Act," section 3500.0, of the *Bank Holding Company Supervision Manual.*

RISK-MANAGEMENT PROGRAM

Elements of a Sound Insurance or Annuity Sales Program

A state member bank engaged in insurance or annuity sales activities should—

- conduct insurance sales programs in a safe and sound manner;
- have appropriate written policies and procedures in place that are commensurate with the volume and complexity of its insurance sales activities;
- obtain its board of directors' approval of the scope of the insurance and annuity sales program and of written policies and procedures for the program;
- effectively oversee the sales program activities, including third-party arrangements;
- have an effective, independent internal audit and compliance program;
- appropriately train and supervise the employees conducting insurance and annuity sales activities;
- take reasonable precautions to ensure that disclosures to customers for insurance and annuity sales and solicitations are complete and accurate and are in compliance with applicable laws and regulations;
- ensure compliance with all applicable federal, state, or other jurisdiction regulations, including compliance with sections 23A and 23B of the Federal Reserve Act as that act applies to affiliate transactions; and
- have controls in place to ensure accurate and timely financial reporting.

Every state member bank conducting insurance or annuity sales activities should have appropriate, board-approved policies, procedures, and controls in place to monitor and ensure that it complies with both federal and state regulatory requirements. Consistent with the principle of functional regulation, the Federal Reserve will rely primarily on the appropriate state insurance authorities to monitor and enforce compliance with applicable state insurance laws and regulations, including state consumer protection laws and regulations governing insurance sales.

Sales Practices and Handling of Customer Complaints

Every state member bank engaged in insurance or annuity sales activities should have board-approved policies and procedures for handling customer complaints related to these sales. The customer complaint process should provide for the recording and tracking of all complaints and require periodic reviews of complaints by compliance personnel. A state member bank's board of directors and senior management should also review complaints if the complaints involve significant compliance issues that may pose a risk to the state member bank.

Third-Party Arrangements

State member banks, to the extent permitted by applicable law, may enter into agreements with third parties, including unaffiliated agents or agencies, to sell insurance or annuities or provide expertise and services that otherwise would have to be developed in-house. Many banks hire third parties to assist in establishing an insurance program or to train their own insurance staff. A bank may also find it advantageous to offer more specialized insurance products through a third-party arrangement.

A state member bank's management should conduct a comprehensive review of an unaffiliated third party before entering into any arrangement to conduct insurance or annuity sales with the third party. The review should include an assessment of the third party's financial condition, management experience, reputation, and ability to fulfill its contractual obligations to the state member bank, which includes compliance with applicable consumer protection laws and regulations.

The state member bank's board of directors or its designated committee should approve any agreements with third parties. Agreements should outline the duties and responsibilities of each party; describe the third-party activities permitted on the institution's premises; address the sharing or use of confidential customer information; and define the terms for use of the state member bank's office space, equipment, and personnel. If an arrangement includes dual employees (for example, bank employees who are also employed by an independent third party), the agreement must provide for written employment contracts that specify the duties of these employees and their compensation arrangements.

In addition, a third-party agreement should specify that the third party will comply with all applicable laws and regulations and will conduct its activities in a manner consistent with the CPSI regulation, if applicable. The agreement should authorize the banking organization to monitor the third party's compliance with its agreement, as well as authorize the bank to have access to third-party records considered necessary to evaluate compliance. A state member bank that contracts with a functionally regulated third party should obtain from and review, as appropriate, any relevant, publicly available regulatory reports of examination of the third party.[11] Finally, the agreement should provide for indemnification of the institution by the unaffiliated third party for any losses caused by the conduct of the third party's employees in connection with its sales activities.

The state member bank is responsible for ensuring that any third party or dual employee selling insurance at or on behalf of the bank is appropriately trained either by the bank or the third party with respect to compliance with the minimum disclosures and other requirements of the CPSI regulation and applicable state regulations. The banking organization should obtain and review copies of third-party training and compliance materials to monitor the third party's performance of its disclosure and training obligations.

Designation, Training, and Supervision of Personnel

A state member bank hiring personnel to sell insurance or annuities should investigate the backgrounds of the prospective employees. When a candidate for employment has previous insurance industry experience, the state member bank should have procedures to determine whether the individual has been the subject of any disciplinary actions by state insurance regulators.[12]

The state member bank should require its own insurance or annuity sales personnel or third-party sales personnel selling at or on behalf of the bank to receive appropriate training and licensing. Training should cover appropriate policies and procedures for the bank's sales of insurance and annuity products. Personnel who are referring potential or established customers to a licensed insurance producer should also be trained to ensure that referrals are made in conformance with the CPSI regulation, if applicable. The training should also include procedures and guidance to ensure that an unlicensed or referring individual cannot be deemed to be acting as an insurance agent that is subject to licensing requirements.

When insurance or annuities are sold by a state member bank or third parties at an office of, or on behalf of, the organization, the institution should have policies and procedures to designate, by title or name, the individuals responsible for supervising insurance sales activities, as well as for supervising the referral activities of bank employees not authorized to sell these products. A state member bank also should designate supervisory personnel responsible for monitoring compliance with any third-party agreement, as well as with the CPSI regulation, if applicable.

Compliance

State member banks should have policies and procedures to ensure that insurance or annuity sales activities are conducted in compliance with applicable laws and regulations (including the CPSI regulation for sales conducted by or on behalf of the state member bank) and the institution's internal policies and procedures. Compliance procedures should identify any potential conflicts of interest and how such conflicts should be addressed. For example, sales-compensation programs should be conducted in a manner that would not expose the bank to undue legal or reputation risks. The compliance procedures should also provide for a system to monitor customer complaints and their resolution. Where applicable, compliance procedures also should call for verification that third-party sales are being conducted in a manner consistent with the governing agreement with the banking organization.

The compliance function should be conducted independently of the insurance and annuity prod-

11. The reports of examination issued by state insurance regulators are generally public documents. Many states do not conduct periodic examinations of insurance sales activities.

12. Information from the states on the issuance and termination of producer licenses and on producers' compliance with continuing education requirements is available from the NAIC database known as the National Insurance Producer Registry (NIPR).

uct sales and management activities. Compliance personnel should determine the scope and frequency of their reviews, and findings of compliance reviews should be reported directly to the state member bank's board of directors or to its designated board committee.

RISK ASSESSMENT OF INSURANCE AND ANNUITY SALES ACTIVITIES

A risk assessment of insurance activities may be accomplished in the course of conducting a regularly scheduled state member bank examination or as a targeted review. The purpose of preparing the risk assessment is to determine the level and direction of risk to the bank arising from its insurance and annuity sales activities. Risks to state member banks engaged in insurance and annuity sales programs consist primarily of legal, reputational, and operational risk, all of which may lead to financial loss. After completing the risk assessment, if material concerns remain, the Board's Division of Banking Supervision and Regulation staff should be consulted for further guidance.

Legal and reputational risk may arise from a variety of sources, such as fraud; noncompliance with statutory or regulatory requirements, including those pertaining to the handling of premiums collected on behalf of the underwriter; claims processing; insurance and annuity sales practices; and the handling of ''errors and omissions'' claims.[13] Other sources of legal and reputational risk may arise from failing to safeguard nonpublic customer information, a high volume of customer complaints, or public regulatory sanctions against a producer.

Legal and reputational risks may also arise from an agent's obligation to provide a customer with products that are suited to the customer's particular needs and are priced and sold in accordance with state regulations. Additionally, an agent or agency may be liable for failing to carry out the appropriate paperwork to bind a policy that it has sold to a customer, or for making an error in binding the policy. State insurance departments generally are permitted by law to suspend or revoke a producer's license and assess monetary penalties against a producer if warranted.

Operational risk may arise from errors in processing sales-related information or from a lack of appropriate controls over systems or staff responsible for carrying out the insurance or annuity sales activities. Additionally, state member banks that have recently commenced insurance or annuity sales activities, or that are expanding their insurance or annuity sales business, also are exposed to risk arising from inadequate strategic and financial planning associated with the activities, which could result in financial loss. Examiners should be attuned to risks that may arise from inadequate controls over insurance activities, a rapid expansion of the insurance or annuity sales programs offered by the state member bank, the introduction of new products or delivery channels, and legal and regulatory developments.

Operational risk may arise from inadequate premium-payment procedures and trust-account-balance administration by an agency. When the insurance agency bills the insured, the agent must comply with requirements for forwarding the payments to the insurer and for safekeeping the funds. Inadequate internal controls over this activity may result in the inappropriate use of these funds by the agent or agency. The state member bank should ensure that appropriate controls are in place to verify that all funds that are owed to the insurer or the insured are identified in the trust account and that the account is in balance.

When conducting a risk assessment, the examiner should first obtain relevant information to determine the existence and scale of insurance or annuity sales activity. Such information is available in the state member bank's Uniform Bank Performance Report (UBPR) and in other System reports on insurance activities. Relevant reports, including applicable balance sheets and income statements for the insurance and annuity sales activities, may also be obtained from the state member bank. When preparing a risk assessment for an insurance or annuity sales activity that is conducted by a functionally regulated nonbank subsidiary of a state member bank, examiners should rely, to the fullest extent possible, on information available from the state member bank and the appropriate state insurance regulator for the subsidiary. If information that is needed to assess the risk cannot be obtained from the state member bank or the

13. Errors and omissions insurance indemnifies the insured against loss sustained because of an error or oversight by the insured. For instance, an insurance agency generally purchases this type of coverage to protect itself against such things as failing to issue a policy.

applicable functional regulator, the examiner should consult with the appropriate designated Board staff. Requests should not be made directly to a functionally regulated nonbank insurance and annuity sales subsidiary of a state member bank without first obtaining approval from the appropriate Board staff.

CONSUMER PROTECTION IN SALES OF INSURANCE RULES

Overview of the CPSI Regulation

The CPSI regulation is applicable to all insured depository institutions.[14] The regulation, however, generally does not apply to nonbank affiliates or subsidiaries of a state member bank unless the company engages in the retail sale of insurance products or annuities at an office of, or on behalf of, an insured depository institution. Interpretations of the regulation issued by the federal banking agencies are found in appendix A of this section. Federal Reserve examiners are responsible for reviewing state member banks' compliance with the regulation.

The regulation applies to the retail sale of insurance products and annuities by banks or by any other person at an office of a bank, or acting on behalf of a bank. For purposes of the CPSI regulation, ''office'' means the premises of the bank where retail deposits are accepted. The regulation applies only to the retail sale of insurance or annuity products—that is, when the insurance is sold or marketed to an individual primarily for personal, family, or household purposes.

Misrepresentations Prohibited

The regulation prohibits a bank or other covered person from engaging in any practice or using any advertisement at any office of, or on behalf of, the bank or a subsidiary of the bank if the practice or advertisement could mislead any person or otherwise cause a reasonable person to erroneously believe—

- that the insurance product or annuity is backed by the federal government or the bank or is insured by the Federal Deposit Insurance Corporation (FDIC);
- that an insurance product or annuity does not have investment risk, including the potential that principal may be lost and the product may decline in value, when in fact the product or annuity does have such risks; or
- in the case of a bank or subsidiary of the bank at which insurance products or annuities are sold or offered for sale, that (1) the bank may condition approval of an extension of credit to a consumer by the bank or subsidiary on the purchase of an insurance product or annuity from the bank or a subsidiary of the bank, and (2) the consumer is not free to purchase the insurance product or annuity from another source.

The regulation also incorporates the anti-tying provisions of section 106(b) of the Bank Holding Company Act Amendments of 1970 (12 USC 1972). Additionally, banks are prohibited from selling life or health insurance products if the status of the applicant or insured as a victim of domestic violence or as a provider of services to domestic violence victims is considered as a factor in decision making on the product, except as expressly authorized by state law.

Insurance Disclosures

The CPSI regulation also requires that a bank or a person selling insurance at an office of, or on behalf of, a bank make the following affirmative disclosures (to the extent accurate), both orally and in writing, before the completion of the initial sale of an insurance product or an annuity to a consumer. However, sales by mail or, if the consumer consents, via electronic media (such as the Internet) do not require oral disclosure.

- The insurance product or annuity is not a deposit or other obligation of, or guaranteed by, the bank or an affiliate of the bank.
- The insurance product or annuity is not insured by the FDIC or any other U.S. government agency, the bank, or (if applicable) an affiliate of the bank.
- The insurance product or annuity, if applicable, has investment risk, including the possible loss of value.

14. The CPSI regulation applies to all federally insured depository institutions, including all federally chartered U.S. branches and state-chartered insured U.S. branches of foreign banking organizations.

For telephone sales, written disclosures must be mailed within three business days. The above disclosures must be included in advertisements and promotional materials for insurance products and annuities, unless the advertisements or promotional materials are of a general nature and describe or list the nature of services or products offered by the bank. Disclosures must be conspicuous and readily understandable.

Credit Disclosures

When an application for credit is made in connection with the solicitation, offer, or sale of an insurance product or annuity, the consumer must be notified that the bank may not condition the extension of credit on either (1) the consumer's purchase of an insurance product or annuity from the bank or any of its affiliates or (2) the consumer's agreement not to obtain, or a prohibition on the consumer from obtaining, an insurance product or annuity from an unaffiliated entity. These disclosures must be made both orally and in writing; however, applications taken by mail or, if the consumer consents, via electronic media, do not require oral disclosure. For telephone applications, the written disclosure must be mailed within three business days. The disclosures must be conspicuous and readily understandable.

Consumer Acknowledgment

The bank must obtain written or electronic acknowledgments of the consumer's receipt of the disclosures described above at the time they are made or at the completion of the initial purchase. For telephone sales, the bank must receive an oral acknowledgment and make a reasonable effort to obtain a subsequent written or electronic acknowledgment.

Location

Insurance and annuity sales activities must take place, to the extent practicable, in an area physically segregated from one where retail deposits are routinely accepted from the general public (such as teller windows). The bank must clearly identify and delineate areas where insurance and annuity sales activities occur.

Referrals

Any person who accepts deposits from the public in an area where deposits are routinely accepted may refer a consumer to a qualified person who sells insurance products or annuities only if the person making the referral receives no more than a one-time, nominal fee of a fixed dollar amount for the referral. The amount of the referral fee may *not* depend on whether a sale results from the referral.

Qualifications

A bank may not permit any person to sell or offer insurance products or annuities at its office or on its behalf, unless that person is at all times properly qualified and licensed under applicable state law for the specific products being sold or recommended.

Relationship of the CPSI Regulation to State Regulation

The GLB Act contains a legal framework for determining the effect of the CPSI regulation on state laws governing the sale of insurance, including state consumer protection standards. In general, if a state has legal requirements that are inconsistent with, or contrary to, the CPSI regulation, initially the federal regulation does not apply in the state. However, the federal banking agencies may, after consulting with the state involved, decide to preempt any inconsistent or contrary state laws if the agencies find that the CPSI regulation provides greater protections than the state laws. It is not expected that there will be significant conflict between state and federal laws in this area. If the consumer protection laws of a particular state appear to be inconsistent with and less stringent (that is, provide less consumer protection) than the CPSI regulation, examiners should inform the staff of the Board's Division of Banking Supervision and Regulation.

Relationship to Federal Reserve Guidance on the Sale of Nondeposit Investment Products

When a bank sells insurance products or annuities that also are securities (such as variable life insurance annuities), it must conform with the applicable Federal Reserve and interagency guidance pertaining to a bank's retail sales of nondeposit investment products (NDIPs).[15] If the CPSI regulation and the guidance pertaining to NDIPs conflict, the CPSI regulation prevails.

Examining a State Member Bank for Compliance with the CPSI Regulation

Examinations for compliance with the CPSI regulation should be conducted consistent with the risk-focused supervisory approach when a state member bank sells insurance products or annuities directly, or when a third party sells insurance or annuities at or on behalf of, a state member bank. To the extent practicable, the examiner should conduct the review at the state member bank. In certain instances, however, the examiner's review at the state member bank may identify potential supervisory concerns about the state member bank's compliance with the CPSI regulation as it pertains to insurance or annuities sales conducted by a functionally regulated nonbank affiliate or subsidiary of the state member bank that is selling insurance products or annuities at or on behalf of the state member bank.

If the examiner determines that an on-site review of a functionally regulated nonbank affiliate or subsidiary of the state member bank is appropriate to adequately assess the state member bank's compliance with the CPSI regulation, the examiner should discuss the situation with staff of the Board's Division of Banking Supervision and Regulation. The approval of the Division of Banking Supervision and Regulation's officer that is responsible for the supervisory policy and examination guidance pertaining to insurance and annuity sales activities should be obtained before examining or requesting any information directly from a functionally regulated nonbank affiliate or subsidiary of the state member bank that is selling insurance or annuity products at or on behalf of the state member bank.

The examination guidelines described in section 4043.3 apply to retail sales, solicitations, advertisements, or offers of insurance products and annuities by any state member bank or any other person that is engaged in such activities at an office of the bank or on behalf of the state member bank. For purposes of the CPSI regulation, activities "on behalf of a state member bank" include activities in which a person, whether at an office of the bank or at another location, sells, solicits, advertises, or offers an insurance product or annuity and in which at least one of the following applies:

- The person represents to a consumer that the sale, solicitation, advertisement, or offer of any insurance product or annuity is by or on behalf of the bank.
- The bank refers a consumer to a seller of insurance products or annuities, and the bank has a contractual arrangement to receive commissions or fees derived from the sale of an insurance product or annuity resulting from the bank's referral.
- Documents evidencing the sale, solicitation, advertising, or offer of an insurance product or annuity identify or refer to the bank.

15. Interagency Statement on Retail Sales of Nondeposit Investment Products, February 17, 1994. See SR-94-11.

APPENDIX A—JOINT INTERPRETATIONS OF THE CONSUMER PROTECTION IN SALES OF INSURANCE REGULATION

In response to a banking association's inquiries, the federal banking agencies jointly issued interpretations regarding the Consumer Protection in Sales of Insurance (CPSI) regulation.[1] A joint statement, issued on August 17, 2001, contains responses to a set of questions relating to disclosure and acknowledgment, the scope of applicability of the regulation, and compliance. Additionally, a February 28, 2003, joint statement responded to a request to clarify whether the disclosure requirements apply to renewals of pre-existing insurance policies sold before October 1, 2001, the effective date of the regulation. The issues raised and the banking agencies' responses are summarized below.

1. These letters, issued jointly by the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision, may be accessed on these agencies' web sites.

Disclosures

Credit Disclosures

A bank or other person who engages in insurance sales activities at an office of, or on behalf of, a bank (''a covered person'') must make the credit disclosures set forth in the regulation if a consumer is solicited to purchase insurance while the consumer's loan application is pending. A consumer's application for credit is still ''pending'' for purposes of the regulation if the depository institution has approved the consumer's loan application but not yet notified the consumer. Until the consumer is notified of the loan approval, the covered person must provide the credit disclosures if the consumer is solicited, offered, or sold insurance.

Disclosures for Sales by Mail and Telephone

The regulation requires a covered person to provide oral disclosures and to obtain an oral acknowledgment of these disclosures when sales activities are conducted by telephone. This requirement applies regardless of whether the consumer will also receive and acknowledge written disclosures in person, through the mail, or electronically.

Use of Short-Form Insurance Disclosures

There is no short form for the credit disclosures. A depository institution, however, may use the short-form insurance disclosures set forth below in visual media (such as television broadcasting, ATM screens, billboards, signs, posters, and written advertisements and promotional materials):

- NOT A DEPOSIT
- NOT FDIC-INSURED
- NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY
- NOT GUARANTEED BY THE BANK
- MAY GO DOWN IN VALUE

Acknowledgment of Disclosures

Reasonable efforts to obtain written acknowledgment. The banking agencies have not prescribed any steps that must be taken for a depository institution's efforts to obtain a written acknowledgment to be deemed ''reasonable'' in a transaction conducted by telephone. Examples of reasonable efforts, however, include—

- providing the consumer with a return-addressed envelope or similar means to facilitate the consumer's return of the written acknowledgment,
- making a follow-up phone call or contact,
- sending a second mailing, or
- similar actions.

The covered person should (1) maintain documentation that the written disclosures and the request for written acknowledgment of those disclosures were mailed to the consumer and (2) should record his or her efforts to obtain the signed acknowledgment. The ''reasonable efforts'' policy exception for telephone sales does not apply to other types of transactions, such as mail solicitations, in which a covered person must obtain from the consumer a written (in electronic or paper form) acknowledgment.

Appropriate form or format for acknowledgment provided electronically. Electronic acknowledgments are not required to be in a specific format but must be consistent with the provisions of the CPSI regulation applicable to consumer acknowledgments. That is, the electronic acknowledgment must establish that the consumer has acknowledged receipt of the credit and insurance disclosures, as applicable.

Retention of acknowledgments by an insurance company. If an insurance company provides the disclosures and obtains the acknowledgment on behalf of a depository institution, the insurance company may retain the acknowledgment. The depository institution is responsible for ensuring that sales made ''on behalf of'' the depository institution are in compliance with the CPSI regulation. An insurance company may maintain documentation showing compliance with the CPSI regulation, but the depository institution should have access to such records and the records should be readily available for review by examiners.

Form of written acknowledgment. There is no prescribed form for the written acknowledgment. The regulation requires, however, that a covered person obtain the consumer's acknowledgment of receipt of the complete insurance and credit disclosures.

Timing of acknowledgment receipt. A covered person must obtain the consumer's acknowledgment either at the time a consumer receives disclosures or at the time of the initial purchase of an insurance product.

Oral acknowledgment of oral disclosure. The CPSI regulation does not prescribe any specific wording for an oral acknowledgment. However, if a covered person has made the insurance and credit disclosures orally, an affirmative response to the question ''Do you acknowledge that you received this disclosure?'' is acceptable.

Scope of the CPSI Regulation

Applicability to Private Mortgage Insurance

Depending on the nature of a depository institution's involvement in an insurance sales transaction, the CPSI regulation may cover sales of private mortgage insurance. If the depository institution itself purchases the insurance to protect its interest in mortgage loans it has issued and merely passes the costs of the insurance on to the mortgage borrowers, the transaction is not covered by the regulation. If, however, a consumer has the option of purchasing the private mortgage insurance and (1) the depository institution offers the private mortgage insurance to a consumer or (2) any other person offers the private mortgage insurance to a consumer at an office of a depository institution, or on behalf of a depository institution, the transaction would be covered by the regulation.

Applicability to Federal Crop Insurance

The CPSI regulation does not apply to federal crop insurance that is sold for commercial or business purposes. However, if the crop insurance is purchased by an individual primarily for family, personal, or household purposes, it would be covered.

Solicitations and Applications Distributed Before, but Returned After, the Effective Date of the CPSI Regulation

Direct-mail solicitations and ''take-one'' applications that are distributed on or after October 1, 2001, must comply with the CPSI regulation. If a consumer seeks to purchase insurance after the effective date of the regulation in response to a solicitation or advertisement that was distributed *before* that date, the depository institution would be in compliance with the regulation if the institution provides the consumer, before the initial sale, with the disclosures required by the regulation. These disclosures must be both written and oral, except that oral disclosures are not required if the consumer mails in the application.

Renewals of Insurance

Renewals of insurance are not subject to the disclosure requirements (see ''Disclosures'' above) but are subject to other requirements of the CPSI regulation. A ''renewal'' of insurance means continuation of coverage involving the same type of insurance for a consumer as issued by the same carrier. A renewal need not be on the same terms and conditions as the original policy, provided that the renewal does not involve a different type of insurance and the consumer has previously received the disclosures required by the regulation at the time of the initial sale. An upgrade in coverage at a time when a policy is not up for renewal would be treated as a renewal, provided that the solicitation and sale of the upgrade does not involve a different type of insurance and the consumer has previously received the disclosures required by the regulation at the initial sale.

Disclosures Required with Renewals of Insurance Coverage

The banking agencies' interpretations clarified that the CPSI regulation does not *mandate* disclosures for renewals of policies sold before October 1, 2001. Accordingly, the regulation does not require the disclosures to be furnished at the time of renewal of a policy, including a pre-existing policy. However, renewals are subject to the other provisions of the regulation. Moreover, the banking agencies would expect that, consistent with applicable safety-and-soundness requirements, depository institutions would take reasonable steps to avoid customer confusion in connection with renewals of preexisting policies.

''On-Behalf-of'' Test and Use of Corporate Name or Logo

Under the CPSI regulation, an affiliate of a bank is not considered to be acting ''on behalf of'' a bank simply because the affiliate's marketing or other materials use a corporate name or logo that is common to the bank and the affiliate. In general, this exclusion applies even if a bank and its parent holding company have a similar, but not identical, name. For example, if the names of all of the affiliates of a bank holding company share the words ''First National,'' an affiliate would not be considered to be engaged in an activity ''on behalf of'' an affiliated bank simply by using the terms ''First National'' as part of a corporate logo or identity. The affiliate would, however, be considered to be acting ''on behalf of'' an affiliated bank if the name of the bank (for example, ''First National Bank'') appears in a document as the seller, solicitor, advertiser, or offeror of insurance. A transaction also would be covered if it occurs on the premises of a depository institution or if one of the other prongs of the ''on-behalf-of'' test is met.

Compliance

Appropriate Documentation of an Oral Disclosure or Oral Acknowledgment

There is no specific documentation requirement for oral disclosures or acknowledgments. However, other applicable regulatory reporting standards would apply. Appropriate documentation of an oral disclosure would clearly show that the covered person made the credit and insurance disclosures to a consumer. Similarly, appropriate documentation of an oral acknowledgment would clearly show that the consumer acknowledged receiving the credit and insurance disclosures. For example, a tape recording of the conversation (where permitted by applicable laws) in which the covered person made the oral disclosures and received the oral acknowledgment would be acceptable. Another example would be a contemporaneous checklist completed by the covered person to indicate that he or she made the oral disclosures and received the oral acknowledgment. A contemporaneous note to the consumer's file would also be adequate. The documentation should be maintained in the consumer's file so that it is accessible to examiners.

Setting for Insurance Sales

A depository institution must identify the areas where insurance sales occur and must clearly delineate and distinguish those areas from areas where the depository institution's retail deposit-taking activities occur. Although the banking agencies did not define how depository institutions could ''clearly delineate and distinguish'' insurance areas, signage or other means may be used.

APPENDIX B—GLOSSARY

For additional definitions of insurance terms, see section 4040.1.

Accident and health insurance. A type of coverage that pays benefits in case of sickness, accidental injury, or accidental death. This coverage may provide for loss of income when the insured is disabled and provides reimbursement for medical expenses when the insured is ill. The insurance can provide for debt payment if it is taken out in conjunction with a loan. (See *Credit life insurance.*)

Actuary. A professional whose function is to calculate statistically various estimates for the field of insurance, including the estimated risk of loss on an insurable interest and the appropriate level for premiums and reserves.

Admitted insurer. An insurance company licensed by a state insurance department to underwrite insurance products in that state.

Agency contract (or agreement). An agreement that establishes the contractual relationship between an agent and an insurer.

Agent. A licensed insurance company representative under contract to one or more insurance companies. Depending on the line of insurance represented, an agent's power may include soliciting, advertising, and selling insurance; collecting premiums; claims processing; and effecting insurance coverage on behalf of an insurance underwriter. Agents are generally compensated by commissions on policies sold, although some may receive salaries.

- *Captive or exclusive agent.* An agent who represents a single insurer.

- *General agent.* An agent who is contractually awarded a specific geographic territory for an individual insurance company. They are responsible for building their own agency and usually represent only one insurer. Unlike exclusive agents, who usually receive a salary in addition to commissions, general agents are typically compensated on a commission basis only.

- *Independent agent.* An agent who is under contractual agreements with at least two different insurers. Typically, all of the independent agent's compensation originates from commissions.

Aggregate excess-of-loss reinsurance. A form of ''excess-of-loss'' reinsurance that indemnifies the ceding company against the amount by which all of the ceding company's losses incurred during a specific period (usually 12 months) exceed either (1) a predetermined dollar amount or (2) a percentage of the company's subject premiums. This type of contract is also commonly referred to as *stop-loss reinsurance* or *excess-of-loss ratio reinsurance.*

Allied lines. Various insurance coverages for additional types of losses and against losses by additional perils. The coverages are closely associated with and usually sold with fire insurance. Examples include coverage against loss by perils other than fire, coverage for sprinkler-leakage damage, and business-interruption coverage.

Annuity. A contract that provides for a series of payments payable over an individual's life span or other term, on the basis of an initial lump-sum contribution or series of payments made by the annuitant into the annuity during the accumulation phase of the contract.

- *Fixed-annuity contracts* provide for payments to annuitants at fixed, guaranteed minimum rates of interests.

- *Variable-annuity contracts* provide for payments based on the performance of annuity investments. Variable-annuity contracts are usually sold based on a series of payments and offer a range of investment or funding options, such as stocks, bonds, and money market fund investments. The annuity principal and the investment return are not guaranteed as they depend on the performance of the underlying funding option.

Annuity payments may commence with the execution of the annuity contract (*immediate annuity*) or may be deferred until some future date (*deferred annuity*).

Assigned risk. A risk that is not usually acceptable to insurers and is therefore assigned to a group of insurers who are required to share in the premium income and losses, in accordance with state requirements, in order for the insurer to sell insurance in the state.

Assignment. The legal transfer of one person's interest in an insurance policy to another person or business.

Bank-owned life insurance (BOLI). Life insurance purchased and owned by a bank to fund its exposure arising from employee compensation and benefit programs. In a typical BOLI program, a bank insures a group of employees; pays the life insurance policy premiums; owns the cash values of the policies, which are booked on the bank's balance sheet as ''other assets''; and is the beneficiary of the policies upon the death of any insured employee or former employee.

Beneficiary. The person or entity named in an insurance policy as the recipient of insurance proceeds upon the policyholder's death or when an endorsement matures. A revocable beneficiary can be changed by the policyholder at any time. An irrevocable beneficiary can be changed by the policyholder only with the written permission of the beneficiary.

Binder. A written or oral agreement, typically issued by an insurer, agent, or broker for property and casualty insurance, to indicate acceptance of a person's application for insurance and to provide interim coverage pending the insurance company's issuance of a binding policy.

Blanket bond. Coverage for an employer for loss incurred as a result of employee dishonesty.

Boiler and machinery insurance. Insurance against the sudden and accidental breakdown of boilers, machinery, and electrical equipment, including coverage for damage to the equipment and property damage, including the property of others. Coverage can be extended to cover consequential losses, including loss from interruption of business.

Broker. A person who represents the insurance buyer in the purchase of insurance. Brokers do not have the power to bind an insurance company to an insurance contract. Once a contract is accepted, the broker is compensated for the transaction through a commission from the insurance company. An individual may be licensed as both a broker and an agent.

Bulk reinsurance. A transaction sometimes defined by statute as any quota-share, surplus aid, or portfolio reinsurance agreement through which an insurer assumes all or a substantial portion of the liability of the reinsured company.

Captive insurer. An insurance company established by a parent firm to insure or reinsure its own risks or the risks of affiliated companies. A captive may also underwrite insurable risks of unaffiliated companies, typically the risks of its customers or employees. For example, a bank may form a captive insurance company to underwrite its own directors' and officers' risks or to underwrite credit life or private mortgage insurance (third-party risks) related to its lending activities.

Cash surrender value of life insurance. The amount of cash available to a life insurance policyholder upon the voluntary termination of a life insurance policy before it becomes payable by death or maturity.

Casualty insurance. Coverage for the liability arising from third-party claims against the insured for negligent acts or omissions causing bodily injury or property damage.

Cede. To transfer to a reinsurer all or part of the insurance or reinsurance risk underwritten by an insurance company.

Ceding commission. The fee paid to a reinsurance company for assuming the risk of a primary insurance company.

Ceding company (also cedant, reinsured, reassured). The insurer that transfers all or part of the insurance or reinsurance risk it has underwritten to another insurer or reinsurer via a reinsurance agreement.

Cession. The amount of insurance risk transferred to the reinsurer by the ceding company.

Churning. The illegal practice wherein a customer is persuaded to unnecessarily cancel one insurance policy in favor of buying a purportedly superior policy, often using the cash surrender value of the existing policy to pay the early premiums of the new policy. In such a transaction, the salesperson benefits from the additional commission awarded for booking a new policy.

Claim. A request for payment of a loss under the terms of a policy. Claims are payable in the manner suited to the insured risk. Life, property, casualty, health, and liability claims generally are paid in a lump sum after the loss is incurred. Disability and loss-of-time claims are paid periodically during the period of disability or through a discounted lump-sum payment.

Coinsurance. A provision in property and casualty insurance that requires the insured to maintain a specified amount of insurance based on the value of the property insured. Coinsurance clauses are also found in health insurance and require the insured to share a percentage of the loss.

Combination-plan reinsurance. A reinsurance agreement that combines the excess-of-loss and the quota-share forms of coverage within one contract, with the reinsurance premium established as a fixed percentage of the ceding company's subject premium. After deducting the excess recovery on any one loss for one risk, the reinsurer indemnifies the ceding company on the basis of a fixed quota-share percentage. If a loss does not exceed the excess-of-loss retention level, only the quota-share coverage applies.

Commission. The remuneration paid by insurance carriers to insurance agents and brokers for the sale of insurance and annuity products.

Comprehensive personal liability insurance. A type of insurance that reimburses the policyholder if he or she becomes liable to pay money for damage or injury he or she has caused to others. This coverage does not include automobile liability but does include almost every activity of the policyholder, except business operations.

Contractholder. The person, entity, or group to whom an annuity is issued.

Credit for reinsurance. A statutory accounting procedure, set forth under state insurance regulations, that permits a ceding company to treat amounts due from reinsurers as assets, or as offsets to liabilities, on the basis of the reinsurer's status.

Credit life insurance. A term insurance product issued on the life of a debtor that is tied to repayment of a specific loan or indebtedness. Proceeds of a credit life insurance policy are used to extinguish remaining indebtedness at the time of the borrower's death. The term is applied broadly to other forms of credit-related insurance that provide for debt satisfaction in the event of a borrower's disability, accident or illness, and unemployment. Credit life insurance has historically been among the most common bank insurance products.

Credit score. A number that is based on an analysis of an individual's credit history and that insurers may consider as an indicator of risk for purposes of underwriting insurance. Where not prohibited by state law, insurers may consider a person's credit history when underwriting personal lines.

Debt-cancellation contract/debt-suspension agreement. A loan term or contract between a lender and borrower whereby, for a fee, the lender agrees to cancel or suspend payment on the borrower's loan in the event of the borrowers's death, serious injury, unemployment, or other specified events. The Office of the Comptroller of the Currency considers these products to be banking products. State law determines whether these products are bank or insurance products for state-chartered banks and insurance companies.

Deductible. The amount a policyholder agrees to pay toward the total amount of insurance loss. The deductible may apply to each claim for a loss occurrence, such as each automobile accident, or to all claims made during a specified period, as with health insurance.

Directors and officers liability insurance. Liability insurance covering a corporation's obligation to reimburse its directors or officers for claims made against them for alleged wrongful acts. It also provides direct coverage for company directors and officers themselves in instances when corporate indemnification is not available.

Direct premiums written. Premiums received by an underwriter for all policies written during a given time period by the insurer, excluding those received through reinsurance assumed.

Direct writer. An insurance company that deals directly with the insured through a salaried representative, as opposed to those insurers that use agents. This term also refers to insurers that operate through exclusive agents. In reinsurance, a direct writer is the company that originally underwrites the insurance policies ceded.

Disability income insurance. An insurance product that provides income payment to the insured when his or her income is interrupted or terminated because of illness or accident.

Endowment insurance. A type of life insurance contract under which the insured receives the face value of the policy if he or she survives the endowment period. Otherwise, the beneficiary receives the face value of the policy upon the death of the insured.

Errors and omissions (E&O) liability insurance. Professional liability insurance that covers negligent acts or omissions resulting in loss. Insurance agents are continually exposed to the claim that inadequate or inappropriate coverage was recommended, resulting in a lack of coverage for losses incurred. The agent or the carrier may be responsible for coverage for legitimate claims.

Excess-of-loss reinsurance. A form of reinsurance whereby an insurer pays the amount of each claim for each risk up to a limit determined in advance, and the reinsurer pays the amount of the claim above that limit up to a specific sum. It includes various types of reinsurance, such as catastrophe reinsurance, per-risk reinsurance, per-occurrence reinsurance, and aggregate excess-of-loss reinsurance.

Excess-per-risk reinsurance. A form of excess-of-loss reinsurance that, subject to a specified limit, indemnifies the ceding company against the amount of loss in excess of a specified retention for each risk involved in each occurrence.

Excess and surplus lines. Property/casualty coverage that is unavailable from insurers licensed by the state (admitted insurers) and must be purchased from a nonadmitted underwriter.

Exposure. The aggregate of all policyholder limits of liability arising from policies written.

Face amount. The amount stated on the face of the insurance policy to be paid, depending on the type of coverage, upon death or maturity. It does not include dividend additions or additional amounts payable under accidental death or other special provisions.

Facultative reinsurance. Reinsurance of individual risks by offer and acceptance wherein the reinsurer retains the faculty to accept or reject each risk offered by the ceding company.

Facultative treaty. A reinsurance contract under which the ceding company has the option to cede and the reinsurer has the option to accept or decline classified risks of a specific business line. The contract merely reflects how individual facultative reinsurance shall be handled.

Financial guarantee insurance. Financial guarantee insurance is provided for a wide array of financial risks. Typically, coverage is provided for the fulfillment of a specific financial obligation originated in a business transaction. The insurer, in effect, is lending the debtor its own credit rating to enhance the debtor's creditworthiness.

Financial strength rating. Opinion as to an insurance company's ability to meet its senior policyholder obligations and claims. For many years, the principal rating agency for property and casualty insurers and life insurers has been A.M. Best. Other rating agencies, such as Fitch, Moody's, Standard and Poor's, and Weiss, also rate insurers.

Fixed annuity. See *Annuity.*

Flood insurance. A special insurance policy to protect against the risk of loss or damage to property caused by flooding. Regular homeowners' policies do not pay for damages caused by flooding.

General liability insurance. A broad commercial policy that covers all business liability exposures, such as product liability, completed operations, premises and operations, independent contractors, and other exposures that are not specifically excluded.

Gross premiums written. Total premiums for insurance written during a given period, before deduction for reinsurance ceded.

Group insurance. Insurance coverage typically issued to an employer under a master policy for the benefit of employees. The insurer usually does not condition coverage of the people that make up the group upon satisfactory medical examinations or other requirements. The individual members of the group hold certificates as evidence of their insurance.

Health insurance. An insurance product that provides benefits for medical expenses incurred as a result of sickness or accident, as well as income payments to replace lost income when the insured is unable to work because of illness, accident, or disability. This product may be in the form of traditional indemnity insurance or managed-care plans and may be underwritten on an individual or group basis.

Incurred but not reported (IBNR). The loss-reserve value established by insurance and reinsurance companies in recognition of their liability for future payments on losses that have occurred but have not yet been reported to them. This definition is often erroneously expanded to include adverse loss development on reported claims. The term *incurred but not enough reported (IBNER)* is being increasingly used to reflect more accurately the adverse development on inadequately reserved reported claims.

Inland marine insurance. A broad field of insurance that covers cargo being shipped by air, truck, or rail. It includes coverage for most property involved in transporting cargo as well as for bridges, tunnels, and communications systems.

Key person life insurance. Life insurance designed to cover the key employees of an employer. It may be written on a group- or an individual-policy basis.

Lapse. The termination or discontinuance of a policy resulting from the insured's failure to pay the premium due.

Liability insurance. Protects policyholders from financial loss due to liability resulting from injuries to other persons or damage to their property.

Lines. A term used in insurance to denote insurance business lines, as in ''commercial lines'' and ''personal lines.''

Long-term care insurance. Health insurance designed to supplement the cost of nursing home care or other care facilities in the event of a long-term illness or permanent disability or incapacity.

Managing general agent. A managing general agent (MGA) is a wholesaler of insurance products and services to insurance agents. An MGA receives contractual authority from an insurer to assume many of the insurance company's functions. The MGA may provide insurance products to the public through local insurance agents as well as provide services to an insurance company, including marketing, accounting, data processing, policy maintenance, and claims-monitoring and -processing services. Many insurance companies prefer the MGA distribution and management system for their insurance products because it avoids the high cost of establishing branch offices. Most states require that an MGA be licensed.

Manuscript policy. A policy written to include specific coverage or conditions not provided in a standard policy.

Morbidity. The incidence and severity of illness and disease in a defined class of insured persons.

Mortality. The rate at which members of a group die in a specified period of time or die from a specific illness.

Mortgage guarantee insurance. A product that insures lenders against nonpayment by borrowers. The policies are issued for a specified time period. Lenders who finance more than 80 percent of the property's fair value generally require such insurance.

Mortgage insurance. Life insurance that pays the balance of a mortgage even if the borrower dies. Coverage typically is in the form of term life insurance, with the coverage declining as the debt is paid off.

Multiperil insurance. An insurance contract providing coverage against many perils, usually combining liability and physical damage coverage.

Net premiums written. The amount of gross premiums written, after deduction for premiums ceded to reinsurers.

Ninety-day loss rule. A state requirement for an insurer to establish a loss provision for reinsurance recoverables over 90 days past due.

Obligatory treaty. A reinsurance contract under which business must be ceded in accordance with contract terms and must be accepted by the reinsurer.

Policyholder. The person or entity who owns an insurance policy. This is usually the insured person, but it may also be a relative of the insured, a partnership, or a corporation.

Premium. The payment, or one of the periodic payments, a policyholder agrees to make for insurance coverage.

Private mortgage insurance (PMI). Coverage for a mortgage lender against losses due to a collateral shortfall on a defaulted residential real estate loan. Most banks require borrowers to take out a PMI policy if a downpayment of less than 20 percent of a home's value is made at the time the loan is originated. PMI does not directly benefit a borrower, although its existence provides the opportunity to purchase a home to many people who otherwise would not qualify for a loan.

Producer. A person licensed to sell, solicit, or negotiate insurance.

Professional designations and organizations. Three of the most common insurance professional designations are chartered life underwriter (CLU), chartered property casualty underwriter (CPCU), and chartered financial consultant (ChFC). Insurance agents also join professional organizations such as the American Society of Chartered Life Underwriters, the International Association of Financial Planning, the National Association of Life Underwriters, the National Association of Health Underwriters, the American Council of Life Insurance, the Life Insurance Marketing and Research Association, the Life Underwriter Training Council, and the Million Dollar Round Table.

Pro rata reinsurance. A generic term describing all forms of "quota-share" and "surplus reinsurance," in which the reinsurer shares a pro rata portion of the losses and premiums of the ceding company.

Property insurance. Coverage for physical damage or destruction of real property (buildings, fixtures, and permanently attached equipment) and personal property (movable items that are not attached to land) that occurs during the policy period as a result of, for example, fire, windstorm, explosion, or vandalism.

Protected cell. A structure available to captive insurers underwriting risks of unaffiliated companies whereby the assets associated with the self-insurance program of one organization are segregated to provide legal-recourse protection from creditors of protected cells providing insurance coverage to other organizations.

Quota-share reinsurance. A form of pro rata reinsurance indemnifying the ceding company for a fixed percent of loss on each risk covered in the contract in consideration of the same percentage of the premium paid to the ceding company.

Rebating. Directly or indirectly giving or offering to give any portion of the premium or any other consideration to an insurance buyer as an inducement to purchase or renew the insurance. Rebates are forbidden under most state insurance codes.

Reinsurance. Insurance placed by an underwriter (the ceding company or reinsured) in another company to transfer or reduce the amount of the risk assumed under the original insurance policy (or group of policies).

Reinsurance premium. The consideration paid by a ceding company to a reinsurer for the coverage provided by the reinsurer.

Residual market. Also known as the shared market, it covers applications for insurance that were rejected by underwriters in the voluntary market that is covered by agency direct-marketing systems, perhaps because of high loss experience by the insured party. The residual market includes government insurance programs, specialty pools, and shared market mechanisms such as assigned-risk plans.

Retrocession. A reinsurance transaction whereby a reinsurer (the retrocedant) cedes all or part of the reinsurance risks it has assumed to another reinsurer (the retrocessionaire).

Retrospective rating. An insurance plan in which the current year's premium is based on the insured's own loss experience for that same period, subject to a maximum and minimum.

Rider. A written attachment, also known as an endorsement, to an insurance policy that changes the original policy to meet specific requirements, such as increasing or decreasing benefits or providing coverage for specific property items beyond that provided for under the insurance company's standard contract terms.

Self-insured retention (SIR). The percentage of a risk or potential loss assumed by an insured, whether in the form of a deductible, self-insurance, or no insurance at all.

Separate accounts. Certain life insurance assets and related liabilities that are segregated and maintained to meet specific investment objectives of contract holders, particularly those assets and liabilities associated with pension plans and variable products offered by life insurers, wherein the customer and not the insurer retains most of the investment and interest-rate risk.

Split-dollar life insurance. An arrangement that typically involves an agreement between an employer and an employee whereby the premium payment, cash values, policy ownership, and death benefits may be split. There are many variations of split-dollar arrangements, including arrangements in which a trust is created to facilitate estate planning. Split-dollar life insurance is designed to serve as a supplemental benefit to a particular company executive. The arrangement typically involves the payment of the insurance premium by the employer, with the death benefit accruing to the employee.

Subrogation. An insurance carrier may reserve the ‘‘right of subrogation’’ in the event of a loss. This means that the company may choose to take action to recover the amount of a claim paid to a covered insured if a third party caused the loss. After expenses, the amount recovered must be divided proportionately with the insured to cover any deductible for which the insured was responsible.

Term life insurance. An insurance product that provides, for a specified period of time, death coverage only. Typically, it has no savings component and, therefore, no cash value. Because term insurance provides only mortality protection, it generally provides the most coverage per premium dollar. Most term life insurance policies are renewable for one or more time periods up to a stipulated maximum age; however, premiums generally increase with the age of the policyholder.

Title insurance. Insurance that protects banks and mortgagees against unknown encumbrances against real estate by indemnifying the mortgagor and property owner in the event that clear ownership of the property is clouded by the discovery of faults in the title. Title insurance policies may be issued to either the mortgagor or the mortgagee or both. Title insurance is written largely only by companies specializing in this class of insurance.

Treaty reinsurance. A reinsurance contract under which the reinsured company agrees to cede, and the reinsurer agrees to assume, risks of a particular class or classes of business.

Twisting. In insurance, twisting involves making misrepresentations to a policyholder to induce the policyholder to terminate one policy and take out another policy with another company, when it is not to the insured’s benefit. Twisting is a violation of the Unfair Trade Practices Act. Twisting is similar to the ‘‘churning’’ concept in securities sales, and it results in increased commissions for the inducing agent.

Umbrella liability insurance. This type of liability insurance provides excess liability protection over the ‘‘underlying’’ liability insurance coverage to supplement underlying policies that have been reduced or exhausted by loss.

Underwriting. The process by which a company determines whether it can accept an application for insurance and by which it may charge an appropriate premium for those applications selected. For example, the underwriting process for life insurance classifies applicants by identifying such characteristics as age, sex, health, and occupation.

Unearned reinsurance premium. The part of the reinsurance premium that is applicable to the unexpired portion of the policies reinsured.

Universal life insurance. A form of permanent insurance designed to provide flexibility in premium payments and death benefit protection. The policyholder can pay maximum premiums and maintain a high cash surrender value. Alternatively, the policyholder can make minimal payments in an amount only large enough to cover mortality and other expense charges.

Variable annuity. See *Annuity.*

Variable life insurance. A form of whole life, or universal life, insurance in which the policyholder’s cash value is invested in ‘‘separate accounts’’ of the insurer. These accounts are segregated from the insurance carrier’s other asset holdings. Such separate account investments are generally not available to a carrier’s general creditors in the event of the carrier’s insolvency. The policyholder assumes the investment and price risk. Because variable life policies have investment features, life insurance agents selling these policies must be registered representatives of a broker-dealer licensed by the National Association of Securities Dealers and registered with the Securities and Exchange Commission.

Vendors’ single-interest insurance. A form of force-placed insurance that is typically purchased by the bank to protect against loss or damage to loan collateral in which the bank has a security interest. The bank passes its expense for this insurance on to the consumer who has either refused or is unable to obtain property insurance.

Viatical settlement. The cashing in of a life insurance policy at a discount from face amount by policyholders who are often terminally ill and need the money for medical care. The purchaser becomes the policyholder as well as the beneficiary and assumes the premium payments of the policy.

Whole life insurance. A fixed-rate insurance product, with premiums and death benefits guaranteed over the duration of the policy. There is a cash value (essentially a savings account) that accrues to the policyholder tax deferred. A policyholder receives the cash value in lieu of death benefits if the policy matures or lapses before the insured's death. A policyholder also may borrow against the policy's accumulated cash value or use it to pay future premiums. For most whole life insurance policies, premiums are constant for the life of the insured's contract.

Insurance Sales Activities and Consumer Protection in Sales of Insurance
Examination Objectives
Effective date November 2003

Section 4043.2

1. To understand the volume and complexity of the state member bank's insurance or annuity program and insurance sales strategy.
2. To assess the financial results of the insurance and annuity sales activity compared with planned results.
3. To determine if the state member bank's insurance and annuity sales activities are effectively integrated into the risk-management, audit, and compliance functions and if the control environment is adequate.
4. To assess the adequacy of the state member bank's controls to ensure compliance with the applicable state and federal laws and regulations.
5. To assess the state member bank's level and direction of operational, legal, and reputational risks from the insurance or annuity sales activity.

The following objectives apply if insurance products or annuities are sold by a bank or another person at an office of, or on behalf of, the bank.

6. To assess the adequacy of the state member bank's oversight program for ensuring compliance with the Consumer Protection in Sales of Insurance (CPSI) regulation. (See section 4043.1.)
7. To assess the effectiveness of the state member bank's audit and compliance programs for the CPSI regulation.
8. To assess the state member bank's current compliance with the CPSI regulation.
9. To obtain commitments for corrective action when the state member bank is in violation of the CPSI regulation or when applicable policies, procedures, practices, or management oversight to protect against violations is deficient.

RISK ASSESSMENT OF INSURANCE AND ANNUITY SALES ACTIVITIES

The examiner should consider the following procedures, as appropriate, when conducting a risk assessment to determine the level and direction of risk exposure to the state member bank that is attributable to insurance or annuity sales activity. If there are specific areas of concern, the examiner should focus primarily on those areas.

1. *Scope of activities and strategies.* Assess the significance and complexity of the insurance or annuity sales program.
   a. Obtain a general overview of the scope of the state member bank's insurance or annuity sales activities and any anticipated or recent change in or expansion of such activities.
   b. Determine the state member bank's strategy for insurance or annuity sales, including strategies for cross-selling and referrals of insurance and banking products. Determine the institution's experience with any cross-marketing programs for both insurance business generated by the bank and bank business generated by insurance producers.
   c. Obtain two years' worth of income statements, balance sheets, and budget documents for the agency's activities. Compare the expected budget items with their actual results.
   d. Determine the volume and type of insurance or annuity products and services sold or solicited.
   e. Determine what other related services the state member bank provides in connection with its insurance or annuity sales activities, such as providing risk-management services to clients seeking advice on appropriate insurance coverages, claims processing, and other activities.
2. *Insurance sales products and concentrations.*
   a. Determine the composition of sales—
      - by line of business, such as property/casualty insurance, life insurance including annuities, and health insurance;
      - by the proportion of sales to commercial and retail customers; and
      - by the portion of sales that is credit related, such as credit life and credit health insurance.
   b. Determine any sales concentrations to particular entities, industries, or bank customers.
   c. Note any concentrations to large commercial accounts.
   d. Determine what insurance services are provided to the bank, its employees, and bank affiliates.
3. *Legal-entity and risk-management structure for insurance or annuity sales.*
   a. Obtain an organizational chart for the legal-entity and risk-management structure for the insurance or annuity sales activities.
   b. Determine—
      - whether the insurance or annuity sales activity is conducted in an affiliated producer, by the bank itself, through another distribution arrangement, or by a combination of these arrangements;
      - the names of any affiliated insurance agencies and the states where the affiliated insurance agencies are licensed;
      - the locations outside of the United States where insurance or annuities are sold or solicited; and
      - if any subsidiary agency operates as a financial subsidiary under the Gramm-Leach-Bliley Act.
   c. Determine if the insurance or annuity producer is acting as a managing general agent (MGA).[1] If so, determine—
      - the scope of the MGA activities;
      - the state member bank management's

1. MGAs do not assume underwriting risk. Through contractual arrangements with an insurer, MGAs have the authority to write policies on behalf of the insurer in certain instances, thereby binding the insurer to the policy. Certain minimum provisions governing MGA agreements are delineated in the applicable National Association of Insurance Commissioners (NAIC) model law.

assessment of the risk associated with the MGA activity; and
- what risk controls are in place to protect the state member bank from potential loss that may arise from the MGA's activities, such as loss arising from legal liability.

4. *Strategic and financial plans.* Assess management controls over the insurance and annuity sales activities.
   a. Ascertain the state member bank management's strategic and financial plans and goals for the insurance or annuity sales activity.
   b. Review the state member bank's due-diligence process for acquiring and pricing agencies, if applicable.
   c. Review the state member bank's financial budgets and forecasts for the activity, particularly plans for new products, marketing strategies and marketing arrangements, and the rate of actual and expected growth for the activity.
   d. Determine the cause for significant deviations from the plan.
   e. Determine if any agency acquired by the state member bank is providing the expected return on investment and if the agency's revenues are covering the debt servicing associated with the purchase, if applicable.
5. *Review of board and committee records and reports.*
   a. Review the reports of any significant state member bank oversight committees, including relevant board of directors and board committee minutes and risk-management reports.
   b. Determine if the board of directors, a board committee, or senior management of the state member bank reviews reports pertaining to consumer complaints and complaint resolution, information pertaining to litigation and associated losses, and performance compared with the organization's plan for the insurance and annuity sales activities.
6. *Policies and procedures.*
   a. Determine—
      - the adequacy of the state member bank's policies and procedures for conducting and monitoring insurance or annuity sales activities, including those policies designed to ensure adherence with federal and state laws and regulations pertaining to consumer protection;
      - whether there are appropriate policies and procedures for the handling of customer funds collected on behalf of the underwriter; accurate and timely financial reporting; complaint monitoring and resolution; effective system security and disaster-recovery plans; and policy-exception tracking and reporting; and
      - if the board of directors or its designated committee has formally approved the policies.
   b. Obtain a detailed balance sheet for agency subsidiaries, and determine if the assets held by insurance or annuity agency subsidiaries of the state member bank are all bank-eligible investments.
   c. Determine the independence of the state member bank's audit program applicable to the insurance and annuity sales activity. Determine if the audit program's scope, frequency, and resources are commensurate with the insurance or annuity sales activities conducted.
   d. Determine how the state member bank selects insurance underwriters with whom to do business, as well as how the state member bank monitors the continuing performance of the underwriters.
   e. Determine the adequacy of the oversight of the bank's board of directors over the insurance management team's qualifications, the training and licensing of personnel, and general compliance with state insurance regulations.
   f. Review the internal controls of the state member bank related to third-party arrangements, including arrangements for sales, processing, and auditing of insurance or annuity sales activities.
7. *Claims, litigation, and functional regulatory supervision.* Assess legal and reputational risk.
   a. Identify any significant litigation against the state member bank arising from its insurance or annuity sales activity and the likely impact of the litigation on the state member bank.
   b. Obtain the insurance agency's errors and omissions claims records for the past several years, including a listing of claims it has made and the amount of claims, the

claim status, and the amount of claim payments.
c. Review the state member bank's policies and procedures for tracking and resolving claims. Determine if they appear adequate and if they are adhered to.
d. Determine if the applicable functional regulator has any outstanding supervisory issues with the insurance agency.

8. *Consumer complaints.*
   a. Determine if bank managagement has policies and procedures in place to assess whether consumer complaints received are likely to expose the state member bank to regulatory action, litigation, reputational damage, or other significant risk.
   b. Obtain applicable consumer complaint files, and evaluate internal control procedures to ensure the complaints are being adequately addressed.
9. *Audit and compliance functions.*
   a. Determine the date of the most recent review of the insurance or annuity sales activities by the audit and compliance functions.
   b. Determine the adequacy of the state member bank's management policies and procedures for ensuring that any deficiencies noted in such reviews are corrected, and ascertain whether any such deficiencies are being adequately addressed.[2]
10. *Insurance underwriter oversight of agent/agency activities.*
    a. Determine if there are adequate policies and procedures to review and resolve any issues or concerns raised by an insurance underwriter regarding the producers used by, or affiliated with, the state member bank.[3]
    b. Determine whether any of the insurance underwriters conducted a periodic review of the producers that they engaged to sell insurance.
11. *State supervisory insurance authorities.*
    a. During discussions with state member bank management, determine whether state insurance regulators have raised any issues or concerns in correspondence or reports.
    b. Consult with the state insurance regulators, as appropriate, to determine any significant supervisory issues, actions, or investigations. (For multistate agencies, contacts with states may be prioritized on the basis of the location of the agency's head office or by a determination of the significance of sales by state. Both financial examinations and market conduct examinations conducted by the state insurance departments are targeted at insurance underwriters, not agencies. Therefore, information available from the states pertaining to agencies may be very limited.)
12. *Operational risk assessment.* Ascertain from the state member bank's management whether there are—
    a. any significant operational problems or concerns relating to insurance or annuity sales activities;
    b. policies and procedures in place to ensure accurate and timely reporting to the state member bank's management of insurance or annuity sales activity plans, financial results, and significant consumer complaints or lawsuits or compliance issues, such as errors and omissions claims;[4]
    c. appropriate policies and procedures at the state member bank to ensure accurate reporting of insurance or annuity sales activity on Federal Reserve regulatory reports (Determine from applicable Board or Reserve Bank contacts if there are any outstanding issues with respect to potential reporting errors on submitted Federal Reserve reports, bank call reports, or other applicable reports. If so, seek resolution of the issues.); and
    d. adequate disaster-recovery plans and procedures to protect the state member bank

2. Enforcement of the privacy provisions of the Gramm-Leach-Bliley Act as they relate to state member banks is the responsibility of the Board's Division of Consumer and Community Affairs. However, enforcement of the privacy provisions of the GLB Act with respect to the insurance activities of nondepository subsidiaries of a state member bank is the responsibility of the state insurance regulators.

3. Insurance underwriters generally have procedures to determine whether individual producers affiliated with agencies are selling the underwriters' products in conformance with applicable laws and regulations. The findings and conclusions of these reviews should be available to the state member bank's management.

4. Errors and omissions insurance should be in place to protect the state member bank against loss sustained because of an error or oversight, such as failure to issue an insurance policy. A tracking system to monitor errors and omission claims should be in place and monitored by the state member bank, as appropriate. See section 4040.1, ''Management of Insurable Risks.''

from loss of data related to insurance or annuity sales activities.

CONSUMER PROTECTION IN SALES OF INSURANCE REGULATION

The following procedures should be risk-focused in accordance with the Federal Reserve's risk-focused framework for supervising banking organizations. The procedures should be carried out as necessary to adequately assess the state member bank's compliance with the Consumer Protection in Sales of Insurance (CPSI) regulation.

1. Determine the role of the state member bank's board of directors and management in ensuring compliance with the CPSI regulation and applicable state consumer regulations.
2. Evaluate the management information system (MIS) reports the state member bank's board or designated committee rely on to monitor compliance with the consumer regulations and to track complaints and complaint resolution.
3. Review the state member bank's policies and procedures to ensure they are consistent with the CPSI regulation, and conduct transaction testing, as necessary, in the following areas.[5]
   a. disclosures, advertising, and promotional materials
   b. consumer acknowledgments
   c. physical separation from areas of deposit-taking activities
   d. qualifications and licensing for insurance personnel
   e. compliance programs and internal audits
   f. hiring, training, and supervision of insurance or annuity sales personnel employed directly by the bank, or of third parties selling insurance or annuity products at a state member bank office or on behalf of the state member bank
   g. compensation practices and training for personnel making referrals
4. If a third party sells insurance or annuities at the state member bank's offices, or on behalf of the bank, review the state member bank's policies and procedures for ensuring that the third party complies with the CPSI regulation and other relevant policies and procedures of the bank.
5. Review the bank's process for identifying and resolving consumer complaints related to the sale of insurance products and annuities.
6. Obtain and review the record of consumer complaints related to the CPSI regulation. (These records are available from the Board's Division of Consumer and Community Affairs database. See CP letter 2001-11.)
7. Include examination findings, as appropriate, in the commercial bank examination report or in other communications to the bank, as appropriate, that pertain to safety-and-soundness reviews of the bank.

5. If the examiner determines that transaction testing of a functionally regulated nonbank affiliate of the state member bank is appropriate in order to determine the state member bank's compliance with the CPSI regulation, the examiner should first consult with and obtain approval from appropriate staff of the Board's Division of Banking Supervision and Regulation.

RISK ASSESSMENT OF INSURANCE AND ANNUITY SALES ACTIVITIES

Program Management

1. Does the state member bank have a comprehensive program to ensure that its insurance and annuity sales activities are conducted in a safe and sound manner?
2. Does the state member bank have appropriate written policies and procedures commensurate with the volume and complexity of the insurance or annuity sales activities?
3. Has bank management obtained the approval of the bank's board of directors for the program scope and the associated policies and procedures?
4. Have reasonable precautions been taken to ensure that disclosures to customers for insurance or annuity sales and solicitations are complete and accurate, and are in compliance with applicable laws and regulations?
5. Does the state member bank effectively oversee the insurance or annuity sales activities, including those involving third parties?
6. Does the state member bank have an effective independent internal audit and compliance program in place to monitor retail sales of insurance or annuity products?
7. Does the bank appropriately train and supervise employees conducting insurance or annuity sales activities?

Management Information Systems

8. Does the state member bank's insurance program management plan establish the appropriate management information systems (MIS) necessary for the board of directors to properly oversee the bank's insurance or annuity sales activities?
9. Does MIS provide sufficient information to allow for the evaluation and measurement of the effect of actions taken to identify, track, and resolve any issues relative to compliance with the Consumer Protection in Sales of Insurance (CPSI) regulation?
10. Does MIS include sales volumes and trends, profitability, policy exceptions and associated controls, customer complaints, and other information providing evidence of compliance with laws and established policies?

Compliance Programs and Internal Audits

11. Are there policies and procedures in place to ensure that insurance or annuity sales activities are conducted in compliance with applicable laws and regulations?
12. Do compliance procedures identify potential conflicts of interest and how such conflicts should be addressed?
13. Do the compliance procedures provide a system to monitor customer complaints and track their resolution?
14. When applicable, do compliance procedures call for verification that third-party sales are being conducted in a manner consistent with the agreement governing the third party's arrangement with the state member bank?
15. Is the compliance function conducted independently of the insurance or annuity sales and management activities?
16. Do compliance personnel determine the scope and frequency of the insurance-product review?
17. Are findings of insurance or annuity sales activity compliance reviews periodically reported directly to the state member bank's board of directors or a designated committee thereof?

CONSUMER PROTECTION IN SALES OF INSURANCE REGULATION

If applicable, review the state member bank's internal controls, policies, practices, and procedures for retail insurance or annuity sales activities conducted by the bank on bank premises or on behalf of the bank. The bank's program management for such activities should be well documented and should include appropriate personnel training, as well as compliance and audit-function coverage of all efforts to ensure compliance with the provisions of the Board's CPSI regulation.

Advertising and Promotional Materials

1. Do advertising materials associated with the insurance or annuity sales program create an erroneous belief that—
   a. an insurance product or annuity sold or offered for sale by the state member bank, or on behalf of the bank, is backed by the federal government or the bank, or that the product is insured by the FDIC?
   b. an insurance product or annuity that involves investment risk does not, in fact, have investment risk, including the potential that principal may be lost and the product may decline in value?
2. Does a review of advertising for insurance products or annuities sold or offered for sale create an erroneous impression that—
   a. the state member bank or an affiliate or subsidiary may condition the grant of an extension of credit to a consumer on the purchase of an insurance product or annuity by the consumer from the bank or an affiliate or subsidiary of the bank?
   b. the consumer is not free to purchase an insurance product or annuity from another source?

Disclosures

3. In connection with the initial purchase of an insurance product or annuity by a consumer, does the initial disclosure to the consumer, except to the extent the disclosure would not be accurate, state that—
   a. the insurance product or annuity is not a deposit or other obligation of, or is not guaranteed by, the state member bank or an affiliate of the bank?
   b. the insurance product or annuity is not insured by the FDIC or any other agency of the United States, the state member bank, or (if applicable) an affiliate of the bank?
   c. in the case of an insurance product or annuity that involves an investment risk, there is risk associated with the product, including the possible loss of value?
4. In the case of an application for credit, in connection with which an insurance product or annuity is solicited, offered, or sold, is a disclosure made that the state member bank may not condition an extension of credit on either—
   a. the consumer's purchase of an insurance product or annuity from the bank or any of its affiliates?
   b. the consumer's agreement not to obtain, or a prohibition on the consumer's obtaining, an insurance product or annuity from an unaffiliated entity?
5. Are the disclosures under question 3 above provided orally and in writing before the completion of the initial face-to-face sale of an insurance product or annuity to a consumer?
6. Are the disclosures under question 4 above made orally and in writing at the time the consumer applies in a face-to-face interaction for an extension of credit in connection with which insurance is solicited, offered, or sold?
7. If a sale of an insurance product or annuity is conducted by telephone, are the disclosures under question 3 above provided in writing, by mail, within three business days?
8. If an application for credit is by telephone, are the disclosures under question 4 above provided by mail to the consumer within three business days?
9. Are the disclosures under questions 3 and 4 above provided through electronic media, instead of on paper, only if the consumer affirmatively consents to receiving the disclosures electronically, and only if the disclosures are provided in a format that the consumer may retain or obtain later?
10. Are disclosures made through electronic media, for which paper or oral disclosures are not required, presented in a meaningful form and format?
11. Are disclosures conspicuous, simple, direct, readily understandable, and designed to call attention to the nature and significance of the information provided?

12. Are required disclosures presented in a meaningful form and format?

Consumer Acknowledgment

13. At the time a consumer receives the required disclosures, or at the time of the consumer's initial purchase of an insurance product or annuity, is a written acknowledgment from the consumer that affirms receipt of the disclosures obtained?
14. If the required disclosures are provided in connection with a transaction that is conducted by telephone—
    a. has an oral acknowledgment of receipt of the disclosures been obtained, and is sufficient documentation maintained to show that the acknowledgment was given?
    b. have reasonable efforts to obtain a written acknowledgment from the consumer been made?

Physical Separation from Deposit Activities

15. Does the state member bank, to the extent practicable—
    a. keep the area where the bank conducts transactions involving the retail sale of insurance products or annuities physically segregated from the areas where retail deposits are routinely accepted from the general public?
    b. identify the areas where insurance product or annuity sales activities occur?
    c. clearly delineate and distinguish insurance and annuity sales areas from the areas where the bank's retail deposit-taking activities occur?

Qualifications and Licensing

16. Does the state member bank permit any person to sell, or offer for sale, any insurance product or annuity in any part of its office, or on its behalf, only if the person is at all times appropriately qualified and licensed under applicable state insurance licensing standards for the specific products being sold or recommended?

Hiring, Training, and Supervision

17. Have background investigations of prospective employees that will sell insurance products or annuities been completed?
18. When a candidate for employment has previous insurance experience, has a review to determine whether the individual has been the subject of any disciplinary actions by state insurance regulators been completed?
19. Do all insurance or annuity sales personnel, or third-party sales personnel conducting sales activities at or on behalf of the state member bank, receive appropriate training and continue to meet licensing requirements?
20. Does training address policies and procedures for sales of insurance and annuity products, and does it cover personnel making referrals to a licensed insurance producer?
21. Does training ensure that personnel making referrals about insurance products or annuities are properly handling all inquiries so as not to be deemed to be acting as unlicensed insurance agents or registered (or equivalently trained) securities sales representatives (for insurance products that are also securities) if they are not qualified?
22. When insurance products or annuities are sold by the state member bank or third parties at an office of, or on behalf of, the organization, does the institution have policies and procedures to designate, by title or name, the individuals responsible for supervising insurance sales activities, as well as the referral activities of bank employees not authorized to sell these products?
23. Does the bank designate supervisory personnel responsible for monitoring compliance with any third-party agreement, as well as with the CPSI regulation?

Referrals

24. Are fees paid to nonlicensed personnel who are making referrals to qualified insurance or annuity salespersons limited to a one-time, nominal fee of a fixed dollar amount for each referral, and is the fee unrelated to whether the referral results in a sales transaction?

Third-Party Agreements

25. Does the state member bank's management conduct a comprehensive review of a third party before entering into any arrangement to conduct insurance or annuity sales activities through the third party?
26. Does the review include an assessment of the third party's financial condition, management experience, reputation, and ability to fulfill its contractual obligations to the bank, including compliance with applicable consumer protection laws and regulation?
27. Does the board of directors or a designated committee thereof approve any agreement with the third party?
28. Does the agreement outline the duties and responsibilities of each party; describe the third-party activities permitted on the institution's premises; address the sharing or use of confidential customer information; and define the terms for use of the bank's office space, equipment, and personnel?
29. Does the third-party agreement specify that the third party will comply with all applicable laws and regulations and will conduct its activities in a manner consistent with the CPSI regulation, if applicable?
30. Does the agreement authorize the bank to monitor a third party's compliance with the agreement, as well as to have access to third-party records considered necessary to evaluate compliance?
31. Does the agreement provide for indemnification of the institution by the third party for any losses caused by the conduct of the third party's employees in connection with its insurance or annuity sales activities?
32. If an arrangement includes dual employees, does the agreement provide for written employment contracts that specify the duties of these employees and their compensation arrangements?
33. If the state member bank contracts with a functionally regulated third party, does the bank obtain, as appropriate, any relevant regulatory reports of examination of the third party?
34. How does the state member bank ensure that a third party selling insurance or annuity products at or on behalf of the bank complies with all applicable regulations, including the CPSI regulation?
35. How does the state member bank ensure that any third party or dual employee selling insurance or annuity products at or on behalf of the bank is appropriately trained to comply with the minimum disclosures and other requirements of the Board's CPSI regulation and applicable state regulations?
36. Does the bank obtain and review copies of third-party training and compliance materials to monitor the third party's performance regarding its disclosure and training obligations?

Consumer Complaints

37. Does the state member bank have policies and procedures for handling customer complaints related to insurance and annuity sales?
38. Does the customer complaint process provide for the recording and tracking of all complaints?
39. Does the state member bank require periodic reviews of complaints by compliance personnel? Is a review by the state member bank's board and senior management required for significant compliance issues that may pose risk to the state member bank?

The examination of bank-related organizations must be of sufficient scope to determine a bank's compliance with laws and to evaluate its investments through an appraisal of related organizations' assets, earnings, and management. In addition, the examination must fully disclose the nature of the relationships between the bank and its related organizations, as well as the effects of these relationships on the operations and safety and soundness of the bank.

Various laws, rulings, and regulations have encouraged banks to expand their services by forming or acquiring related organizations. Examples include—

- permission for a member bank to purchase for its own account shares of a corporation that performs, at locations at which the bank is authorized to engage in business, functions that the bank is empowered to perform directly;
- authorization by specific laws to invest in various statutory subsidiaries; and
- permission by Federal Reserve regulations to invest in Edge Act and agreement corporations.

A bank also may be controlled by an individual or company that controls other bank or nonbank entities. No matter what the legal organization is between a bank and a related organization, a sound financial and satisfactory management relationship between both groups is essential to the bank's operation. Related organizations may assume several forms, as described later in this section.

SECTION 23A OF THE FEDERAL RESERVE ACT

Section 23A of the Federal Reserve Act (FRA) (12 USC 371c) is the primary statute governing transactions with affiliates. Section 23A (1) designates the types of companies that are affiliates of a bank; (2) specifies the types of transactions covered by the statute; (3) sets the quantitative limitations on a bank's covered transactions with any single affiliate, and with all affiliates combined; and (4) sets forth collateral requirements for certain bank transactions with affiliates.(See also sections 2080.1 and 2080.3.)

In addition to the statutory provisions of section 23A, the Board approved on November 27, 2002, the issuance of Regulation W. Regulation W, effective April 1, 2003, implements comprehensively section 23A and section 23B of the Federal Reserve Act. To facilitate compliance with these statutes, the rule[1] provides several exemptions and combines the statutory restrictions on transactions between a member bank and its affiliates with numerous Board interpretations and exemptions that were previously issued.

Quantitative Limits

Section 23A(a)(1)(A) states that a member bank[1a] "may engage in a covered transaction with an affiliate only if . . . in the case of any affiliate," the aggregate amount of covered transactions of the bank would not exceed 10 percent of the capital stock and surplus of the bank. The rule's interpretation of the 10 percent limit is consistent with the statutory language. Section 223.11 of the rule clarified that a bank that has crossed the 10 percent threshold with one affiliate may still conduct additional covered transactions with other affiliates, if transactions with all affiliates would not exceed 20 percent of the bank's capital stock and surplus.[1b] Sections 223.11 and 223.12 of the regulation set forth these quantitative limits. The rule's quantitative limits prohibit a member bank from engaging in a *new* covered transaction with that affiliate if the bank would be in excess of the 10 percent threshold with that affiliate or if the level of covered transactions with all its affiliates exceeded the 20 percent threshold. The rule generally does not require a member bank to unwind existing

1. In this section of the manual, Regulation W will henceforth be referred to as the "rule" or by reference to a specific section number of the rule.

1a. "Member bank" is defined in section 223.3(w) to mean "any national bank, state bank, banking association, or trust company that is a member of the Federal Reserve System." The rule also states that most subsidiaries of a member bank are to be treated as part of the member bank itself for purposes of sections 23A and 23B. The only subsidiaries of a member bank that are excluded from this treatment are financial subsidiaries, insured depository institution subsidiaries, and certain joint venture subsidiaries—companies that are generally deemed affiliates of the member bank under the regulation. This treatment of subsidiaries reflects the fact that the statute typically does not distinguish between a member bank and its subsidiaries, and all the significant restrictions of the statute apply to actions taken by a member bank "and its subsidiaries."

1b. 12 USC 371c(a)(1).

covered transactions if the bank exceeds the 10 percent or 20 percent limit because its capital declined or a preexisting covered transaction increased in value.

The Board strongly encourages member banks with covered transactions in excess of the 10 percent threshold with any affiliate to reduce those transactions before expanding the scope or extent of the bank's relationships with other affiliates. Section 223.11 of the rule also clarifies that transactions between a bank and a financial subsidiary of the bank are not subject to the 10 percent limit of section 23A.

Capital Stock and Surplus

Under section 23A, the quantitative limits on covered transactions are based on the ''capital stock and surplus'' of the member bank. Section 223.3(d) of the rule defines capital stock and surplus to be the sum of the member bank's tier 1 capital and tier 2 capital and the balance of the bank's allowance for loan and lease losses not included in its tier 2 capital plus the amount of any investment in a financial subsidiary that counts as a covered transaction that is required to be deducted from the bank's regulatory capital. Examiners can determine the amount of the quantitative limits based on the bank's most recent consolidated Report of Condition and Income (the call report).

Affiliates

Section 23A defines affiliates to include—

- any company that *controls* the member bank and any other company that is controlled by the company that controls the member bank;
- a bank subsidiary of the member bank;
- any company—
  - — that is controlled directly or indirectly, by a trust or otherwise, by or for the benefit of shareholders who beneficially or otherwise control, directly or indirectly, by trust or otherwise, the member bank or any company that controls the member bank; or
  - — in which a majority of its directors or trustees constitute a majority of the persons holding any such office with the member bank or any company that controls the member bank;
- any company, including a real estate investment trust, that is sponsored and advised on a contractual basis by the member bank or any subsidiary or affiliate of the member bank;
- any investment company with respect to which a member bank or any affiliate thereof is an investment adviser as defined in section 2(a)(20) of the Investment Company Act of 1940; and
- any company that the Board determines by regulation or order to have a relationship with the member bank or any subsidiary or affiliate of the member bank, such that covered transactions by the member bank or its subsidiary with that company may be affected by the relationship, to the detriment of the member bank or its subsidiary.

The following are *not* considered to be affiliates of a bank:

- a nonbank subsidiary of that bank, unless a determination is made not to exclude such a subsidiary
- a company engaged solely in holding that bank's premises
- a company engaged solely in conducting a safe deposit business
- a company engaged solely in holding obligations of the United States or its agencies or obligations fully guaranteed by the United States or its agencies as to principal and interest
- a company in which control arises from the exercise of rights arising out of a bona fide debt previously contracted (for a limited period of time)

Definition of Affiliates by Type of Entity

Investment funds advised by the member bank or an affiliate of the member bank. As stated previously, section 23A includes as an affiliate any company that is sponsored and advised on a contractual basis by the member bank or any of its affiliates[1c] as well as any investment company for which the member bank or its affiliate serves as an investment adviser, as defined in the Investment Company Act of 1940 (the 1940 act).[1d] In Regulation W, the Board used its

1c. 12 USC 371c(b)(1)(D)(i).
1d. 12 USC 371c(b)(1)(D)(ii).

statutory authority to define as an affiliate any investment fund—even if not an investment company for purposes of the 1940 act—for which the member bank or an affiliate of the bank serves as an investment adviser, if the bank or an affiliate of the bank owns or controls more than 5 percent of any class of voting securities or similar interests of the fund.

Most investment funds that are advised by a member bank (or an affiliate of a member bank) are affiliates of the bank under section 23A because the funds either are investment companies under the 1940 act or are sponsored by the member bank (or an affiliate of the member bank). The member bank or its affiliate, in some instances, however, may advise but not sponsor an investment fund that is not an investment company under the 1940 act.[1e] The advisory relationship of a member bank or affiliate with an investment fund presents the same potential for conflicts of interest regardless of whether the fund is an investment company under the 1940 act.[1f] An investment fund typically escapes from the definition of investment company under the 1940 act because it (1) sells interests only to a limited number of investors or only to sophisticated investors or (2) invests primarily in financial instruments that are not securities.[1g] Section 223.2(a)(6) treats any investment fund as an affiliate if the bank or an affiliate of the bank serves as an investment adviser to the fund and owns more than 5 percent of the shares of the fund.

Financial subsidiaries. In 1999, the Gramm-Leach-Bliley Act (the GLB Act) authorized banks to own ''financial subsidiaries'' that engage in activities not permissible for the parent bank to conduct directly, such as underwriting and dealing in bank-ineligible securities. The GLB Act amended section 23A to define a financial subsidiary of a bank as an affiliate of the bank and thus subjected transactions between the bank and a financial subsidiary to the limitations of sections 23A and 23B.

Section 23A defines a financial subsidiary as a subsidiary of any bank (state or national) that is engaged in an activity that is not permissible for *national* banks to engage in directly (other than a subsidiary that federal law specifically authorizes national banks to own or control). Specifically, a ''financial subsidiary'' is defined as ''any company that is a subsidiary of a bank that would be a financial subsidiary of a national bank under section 5136A of the Revised Statutes of the United States.'' (See 12 USC 371c(e)(1).) Section 5136A, in turn, defines a financial subsidiary as any company that is controlled by one or more insured depository institutions, *other than* (1) a subsidiary that engages solely in activities that national banks are permitted to engage in directly or (2) a subsidiary that national banks are specifically authorized to control by the express terms of a federal statute (other than section 5136A), such as an Edge Act corporation or a small business investment company (SBIC). (See 12 USC 24a(g)(3).) Section 5136A also generally prohibits a financial subsidiary of a national bank from engaging in insurance underwriting, real estate investment and development, or merchant banking activities. (See 12 USC 24a(a)(2).) The rule defines a financial subsidiary of a bank, exempts certain companies from the definition, and sets forth special valuation and other rules for financial subsidiaries. (See sections 223.2(a)(8), 223.3(p), and 223.32 of the rule.)

Partnerships. Banks fund legitimate commercial and community development transactions through partnerships. Partnerships for which a member bank serves as a general partner are defined in Regulation W's section 223.2(a), which also lists the entities that generally are affiliates.

Regulation W also defines an affiliate of a member bank as any partnership if the member bank or an affiliate of the bank causes any officer or employee of the bank or affiliate to serve as a general partner of the partnership (unless the partnership is an operating subsidiary of the bank, as discussed above). The rule considers a partnership an affiliate of the member bank if the bank or an affiliate of the bank causes any *director* of the bank or affiliate to serve as a general partner of the partnership (unless the partnership is an operating subsidiary of the

1e. 12 USC 371c(b)(1)(E).

1f. A member bank may face greater risk from the conflicts of interest arising from its relationships with an investment fund that is not registered as an investment company under the 1940 act because the 1940 act restricts transactions between a registered investment company and entities affiliated with the company's investment adviser. (See 15 USC 80a-17.)

1g. The term ''investment company'' in the 1940 act does not include a company that is owned by qualified persons or by no more than 100 persons, provided that the company does not engage in a public offering of its securities. (See 15 USC 80a-3(c)(1) and (7).) The term also generally does not include investment funds that are engaged primarily in investing in financial instruments other than securities. (See 15 USC 80a-3(a)(1).)

bank). Also, if a company, such as a bank holding company, controls more than 25 percent of the equity through a partnership, that company is an affiliate under Regulation W.

Subsidiaries of affiliates. Regulation W's definition of an affiliate includes any company controlled by an investment fund that is an affiliate of the member bank. (See section 223.2(a)(11).) It accords affiliate status to any company controlled by an investment fund affiliate of a member bank. More broadly, the rule deems a subsidiary of an affiliate as an affiliate of the member bank. Subsidiaries of interlocking directorate affiliates (section 223.2(a)(4)) and sponsored and advised affiliates (section 223.2(a)(5)) also are treated as affiliates of the member bank. The control relationship between such statutory affiliates and their subsidiaries may affect covered transactions between the member bank and such subsidiaries to the detriment of the bank.

Companies designated by the appropriate federal banking agency. Under section 223.2(a)(12), the Board or the appropriate federal banking agency for the relevant depository institution (under authority delegated by the Board) can determine that any company that has certain relationships with a member bank or an affiliate of the bank is itself an affiliate of the bank. The Board and the federal banking agencies can thus protect depository institutions in their transactions with associated companies. A depository institution may petition the Board for review of any such affiliate determination made by the institution's appropriate federal banking agency under the general procedures established by the Board for review of actions taken under delegated authority.[1h]

Joint venture companies. Under the terms of section 23A, subsidiaries of a member bank generally are not treated as affiliates of the bank.[1i] The statute contains two specific exceptions to this general rule: ''financial subsidiaries'' of a member bank and ''bank'' subsidiaries of a member bank are treated as affiliates of the parent bank. The statute provides that the Board may determine that other subsidiaries of a member bank should be treated as affiliates in appropriate circumstances.[1j]

Under section 223.2(b)(1)(iii) of the rule, certain joint venture subsidiary companies of a member bank are treated as an affiliate. A subsidiary of a member bank is treated as an affiliate if one or more affiliates of the bank, or *one or more controlling shareholders of the bank*, directly *control* the joint venture. For example, if a bank controls 30 percent of a company and an affiliate controls 70 percent of Company A, then Company A is an affiliate. This expansion also covers situations in which a controlling natural-person shareholder or group of controlling natural-person shareholders of the member bank (who, as natural persons, are not themselves section 23A affiliates of the bank) exercise direct control over the joint venture company.

The rule's treatment of certain bank-affiliate joint ventures as affiliates does not apply to joint ventures between a member bank and any affiliated insured depository institutions. For example, if two affiliated member banks each own 50 percent of the voting common stock of a company, the company would continue to qualify as a subsidiary and not an affiliate of each bank (despite the fact that an affiliate of each bank owned more than 25 percent of a class of voting securities of the company). The Board has retained its authority to treat such joint ventures as affiliates under section 23A on a case-by-case basis.

Employee benefit plans. Many employee stock option plans, trusts, or similar entities that exist to benefit shareholders, members, officers, directors, or employees of a member bank or its affiliates (''ESOPs'') are treated as affiliates of the bank for purposes of sections 23A and 23B. The ESOP's share ownership or the interlocking management between the ESOP and its associated member bank (or BHC), in many cases, exceeds the statutory thresholds for determining that a company is an affiliate. For example, if an ESOP controls more than 25 percent of the voting shares of the bank or bank holding company, the ESOP is an affiliate. (Under sec-

1h. See 12 CFR 265.3.

1i. See 12 USC 371c(b)(1)(A) and (b)(2)(A). Section 23A defines a subsidiary of a specified company as a company that is controlled by the specified company. Under the statute, a company controls another company if the first company owns or controls 25 percent or more of a class of voting securities of the other company, controls the election of a majority of the directors of the other company, or exercises a controlling influence over the policies of the other company (12 USC 371c(b)(3) and (4).)

1j. 12 USC 371c(b)(2)(A).

tion 223.2(b)(1)(iv), an ESOP of a member bank or an affiliate of the bank cannot itself avoid classification as an affiliate of the bank by also qualifying as a subsidiary of the bank. The relationship between a member bank and its or its affiliate's ESOP generally warrants coverage by sections 23A and 23B.)

Determination of Control

The definition of ''control'' with respect to affiliates is the same as that used in the Bank Holding Company Act (the BHC Act), that is, a company or shareholder shall be deemed to have control over another company if—

- such company or shareholder, directly or indirectly, or acting through one or more other persons, owns, controls, or has power to vote 25 percent or more of any class of voting securities of the other company;
- such company or shareholder controls in any manner the election of a majority of the directors or trustees of the other company; or
- the Board determines, after notice and opportunity for hearing, that such company or shareholder, directly or indirectly, exercises a controlling influence over the management or policies of the other company.

However, no company shall be deemed to own or control another company by virtue of its ownership or control of shares in a fiduciary capacity except (1) a company that is controlled, directly or indirectly, by a trust for the benefit of shareholders who beneficially or otherwise control, directly or indirectly, a member bank, or (2) if the company owning or controlling such shares is a business trust.

Pursuant to the merchant banking provisions in section 4(k)(4)(H) or (I) of the BHC Act and in the Board's Regulation Y, a financial holding company (FHC) shall be presumed to control another company if the FHC directly or indirectly owns or controls 15 percent of the equity capital of the other company unless the FHC provides information acceptable to the Board demonstrating that the FHC does not control the other company.

Section 23A provides that a company or shareholder shall be deemed to have control over another company if, among other things, such company or shareholder controls in any manner the election of a majority of the ''directors or trustees'' of the other company.[1k] The rule, under section 223.3(g), expands the control definition of section 23A by providing, as in Regulation Y, that control also exists when a company or shareholder controls the election of a majority of the ''general partners (or individuals exercising similar functions)'' of another company. A company or shareholder would be deemed to control another company (including a partnership, limited-liability company, or other similar organization) under section 23A if the company or shareholder controls the election of a majority of the principal policymakers of such other company.

Under the rule, three additional presumptions of control are provided, similar to the presumptions contained in Regulation Y. First, a company will be deemed to control securities, assets, or other ownership interests controlled by any subsidiary of the company.[1*l*] Second, a company that controls instruments (including options and warrants) that are convertible or exercisable, at the option of the holder or owner, into securities, will be deemed to control the securities.[1m] Third, a rebuttable presumption provides that a company or shareholder that owns or controls 25 percent or more of the equity capital of another company controls the other company, unless the company or shareholder demonstrates otherwise to the Board based on the facts and circumstances of the particular case. (See section 223.3(g).)

Covered Transactions

The restrictions of section 23A do not apply to every transaction between a member bank and its affiliates. The section only applies to ''covered transactions'' between a member bank and its affiliates.[1n] The FRA defines five types of covered transactions:

- a loan or extension of credit to an affiliate
- a purchase of or an investment in securities issued by an affiliate

1k. 12 USC 371c(b)(3)(A)(ii).

1*l*. See 12 CFR 225.2(e)(2)(i).

1m. See 12 CFR 225.31(d)(1)(i). The rule refers more generically to convertible ''instruments.'' It clarifies that the convertibility presumption applies regardless of whether the right to convert resides in a financial instrument that technically qualifies as a ''security'' under section 23A or the federal securities laws.

1n. 12 USC 371c(b)(7).

- a purchase of assets from an affiliate, including assets subject to an agreement to repurchase from the affiliate, except for purchases of real and personal property as may be specifically exempted by the Board by order or regulation
- the acceptance of securities issued by an affiliate as collateral for a loan to any person or company (such an acceptance is prohibited if a loan is to an affiliate)
- the issuance of a guarantee, acceptance, or letter of credit, including an endorsement or standby letter of credit, on behalf of an affiliate

Covered transactions must be made on terms and conditions that are consistent with safe and sound banking practices.

Among the transactions that generally are not subject to section 23A are dividends paid by a member bank to its holding company, sales of assets by a member bank to an affiliate for cash, an affiliate's purchase of securities issued by a member bank, and many service contracts between a member bank and an affiliate. Certain classes of transactions between a member bank and an affiliate are discussed below as to whether they are covered transactions for purposes of section 23A. (See section 223.3(h).)

Confirmation of a Letter of Credit Issued by an Affiliate

Section 23A includes as a covered transaction the issuance by a member bank of a letter of credit on behalf of an affiliate, including the confirmation of a letter of credit issued by an affiliate as a covered transaction. (See section 223.3(h)(5).) When a bank confirms a letter of credit, it assumes the risk of the underlying transaction to the same extent as if it had issued the letter of credit.[1o] Accordingly, a confirmation of a letter of credit issued by an affiliate is treated in the same fashion as an issuance of a letter of credit on behalf of an affiliate.

Credit Enhancements Supporting a Securities Underwriting

The definition of guarantee in section 23A would not include a member bank's issuance of a guarantee in support of securities issued by a third party and underwritten by a securities affiliate of the bank.[2] Such a credit enhancement would not be issued "on behalf of" the affiliate. Although the guarantee does provide some benefit to the affiliate (by facilitating the underwriting), this benefit is indirect. The proceeds of the guarantee would not be transferred to the affiliate for purposes of the attribution rule of section 23A.[2a] Section 23B would apply to the transaction and, where an affiliate was issuer as well as underwriter, the transaction would be covered by section 23A because the credit enhancement would be on behalf of the affiliate.

Cross-Guarantee Agreements and Cross-Affiliate Netting Arrangements

A cross-guarantee agreement among a member bank, an affiliate, and a nonaffiliate in which the nonaffiliate may use the bank's assets to satisfy the obligations of a defaulting affiliate is a guarantee for purposes of section 23A. The cross-guarantee arrangements among member banks and their affiliates are subject to the quantitative limits and collateral requirements of section 23A. (See section 223.3(h)(5).)

As for cross-affiliate netting arrangements (CANAs), such arrangements involve a member bank, one or more affiliates of the bank, and one or more nonaffiliates of the bank, where a nonaffiliate is permitted to deduct obligations of an affiliate of the bank to the nonaffiliate when settling the nonaffiliate's obligations to the bank. These arrangements also would include agreements in which a member bank is required or permitted to add the obligations of an affiliate of the bank to a nonaffiliate when determining the bank's obligations to the nonaffiliate.

These types of CANAs expose a member bank to the credit risk of its affiliates because the bank may become liable for the obligations of its affiliates. Because the exposure of a member bank to an affiliate in such an arrangement resembles closely the exposure of a member bank when it issues a guarantee on behalf of an affiliate, the rule explicitly includes such arrangements in the definition of covered transaction. Accordingly, the quantitative limits of section 23A would prohibit a member bank from entering into such a CANA to the extent that the

1o. See UCC 5-107(2).

2. See 62 *Fed. Reg.* 45295 (August 27, 1997).

2a. See 12 USC 371c(a)(2).

netting arrangement does not cap the potential exposure of the bank to the participating affiliate (or affiliates).

Keepwell Agreements

In a keepwell agreement between a member bank and an affiliate, the bank typically commits to maintain the capital levels or solvency of the affiliate. The credit risk incurred by the member bank in entering into such a keepwell agreement is similar to the credit risk incurred by a member bank in connection with issuing a guarantee on behalf of an affiliate. As a consequence, keepwell agreements generally should be treated as guarantees for purposes of section 23A and, if unlimited in amount, would be prohibited by the quantitative limits of section 23A.

Extension of Credit

Section 23A includes a ''loan or extension of credit'' to an affiliate as a covered transaction, but does not define these terms. Section 223.3(o) of the rule defines ''extension of credit'' to an affiliate to mean the making or renewal of a loan to an affiliate, the granting of a line of credit to an affiliate, or the extending of credit to an affiliate in any manner whatsoever, including on an intraday basis. A nonexhaustive list of transactions is provided that the Board deems to be extensions of credit to an affiliate:

- an advance to an affiliate by means of an overdraft, cash item, or otherwise
- a sale of federal funds to an affiliate
- a lease that is the functional equivalent of an extension of credit to an affiliate[2b]
- an acquisition by purchase, discount, exchange, or otherwise of a note or other obligation, including commercial paper or other debt securities, of an affiliate
- any increase in the amount of, extension of the maturity of, or adjustment to the interest-rate term or other material term of, an extension of credit to an affiliate[2c]
- any other similar transaction as a result of which an affiliate becomes obligated to pay money (or its equivalent) to a member bank[2d]

A member bank's purchase of a debt security issued by an affiliate is an extension of credit by the bank to the affiliate for purposes of section 23A under the rule. A member bank that buys debt securities issued by an affiliate has made an extension of credit to an affiliate under section 23A and must collateralize the transaction in accordance with the collateral requirements of section 23A. An exemption from the collateral requirements is provided for situations in which a member bank purchases an affiliate's debt securities from a third party in a bona fide secondary-market transaction.

Prohibition on the Purchase of Low-Quality Assets

Section 23A includes a general prohibition on the purchase by a member bank of a low-quality asset from an affiliate.[2e] Section 23A defines a low-quality asset to include (1) an asset classified as ''substandard,'' ''doubtful,'' or ''loss,'' or treated as ''other loans specially mentioned,'' in the most recent report of examination or inspection by a federal or state supervisory agency (a ''classified asset''), (2) an asset in nonaccrual status, (3) an asset on which payments are more than 30 days past due, or (4) an asset whose terms have been renegotiated or compromised due to the deteriorating financial condition of the obligor.[2f] Any asset meeting one of the above four criteria, including securities and real property, is a low-quality asset.[2g] Regulation W

2b. The Board would consider a full-payout, net lease permissible for a national bank under 12 USC 24 (seventh) and 12 CFR 23 to be the functional equivalent of an extension of credit.

2c. A floating-rate loan does not become a new covered transaction whenever there is a change in the relevant index (for example, LIBOR or the member bank's prime rate) from which the loan's interest rate is calculated. If the member bank and the borrower, however, amend the loan agreement to change the interest-rate term from ''LIBOR plus 100 basis points'' to ''LIBOR plus 150 basis points,'' the parties have engaged in a new covered transaction.

2d. The definition of extension of credit would cover, among other things, situations in which an affiliate fails to pay on a timely basis for services rendered to the affiliate by the member bank.

2e. See 12 USC 371c(a)(3). Section 23A does not prohibit an affiliate from donating a low-quality asset to a member bank, so long as the bank provides no consideration for the asset.

2f. 12 USC 371c(b)(10).

2g. The federal banking agencies generally consider non-investment-grade securities to be classified assets. See, for example, the Uniform Agreement on the Classification of Assets and Appraisal of Securities Held by Banks (May 7, expands the definition of low-quality assets in several respects. (See 12 CFR 223.3(v).)

First, an asset identified by examiners as an ''other transfer risk problem'' (OTRP) is a low-quality asset. Such assets represent credits to countries that are not complying with their external debt-service obligations but are taking positive steps to restore debt service through economic adjustment measures, generally as part of an International Monetary Fund program. Although OTRP assets are not considered classified assets, examiners are to consider these assets in their assessment of a bank's asset quality and capital adequacy.[2h]

Second, the rule considers a financial institution's use of its own internal asset-classification systems. The rule includes within the definition of low-quality asset not only assets classified during the last examination but also assets classified or treated as special mention under the institution's internal classification system (or assets that received an internal rating that is substantially equivalent to classified or special mention in such an internal system).

The purchase by a depository institution from an affiliate of assets that have been internally classified raises potentially significant safety-and-soundness concerns. The Board expects companies with internal rating systems to use the systems consistently over time and over similar classes of assets and will view as an evasion of section 23A any company's deferral or alteration of an asset's rating to facilitate sale of the asset to an affiliated institution.

Finally, the rule defines low-quality asset to include foreclosed property designated ''other real estate owned'' (OREO), until it is reviewed by an examiner and receives a favorable classification. It further defines as a low-quality asset any asset (not just real estate) that is acquired in satisfaction of a debt previously contracted (not just through foreclosure) if the asset has not yet been reviewed in an examination or inspection. Under the rule, if a particular asset is good collateral taken from a bad borrower, the asset should cease to be a low-quality asset upon examination.

Section 23A provides a limited exception to the general rule prohibiting purchase of low-quality assets if the bank performs an independent credit evaluation and commits to the purchase of the asset before the affiliate acquires the asset.[2i] Section 223.15 of the rule also provides an exception from the prohibition on the purchase by a member bank of a low-quality asset from an affiliate for certain loan renewals. The rule allows a member bank that purchased a loan participation from an affiliate to renew its participation in the loan, or provide additional funding under the existing participation, even if the underlying loan had become a low-quality asset, so long as certain criteria were met. These renewals or additional credit extensions may enable both the affiliate and the participating member bank to avoid or minimize potential losses. The exception is available only if (1) the underlying loan was not a low-quality asset at the time the member bank purchased its participation and (2) the proposed transaction would not increase the member bank's proportional share of the credit facility. The member bank must also obtain the prior approval of its entire board of directors (or its delegees) and it must give a 20 days' post-consummation notice to its appropriate federal banking agency. A member bank is permitted to increase its proportionate share in a restructured loan by 5 percent (or by a higher percentage with the prior approval of the bank's appropriate federal banking agency). The scope of the exemption includes renewals of participations in loans originated by any affiliate of the member bank (not just affiliated depository institutions).

Attribution Rule

The ''attribution rule,'' found in section 223.16, prevents a member bank from evading its restrictions by using intermediaries, and it limits the exposure that a member bank has to customers of affiliates of the bank. Any covered transaction by a member bank or its subsidiary with any person is deemed to be a transaction with an affiliate of the bank if any of the proceeds of the transaction are used for the benefit of, or are transferred to, the affiliate. For example, a member bank's loan to a customer for the purpose of purchasing securities from the inventory of a broker-dealer affiliate of the bank would be a covered transaction under section 23A.

1979) and also table 3 in section 2020.1 of this manual. Assets identified by examiners through the Shared National Credit and International Country Exposure Review Committee processes also should be considered classified assets for purposes of section 23A.

2h. See sections 7040.1 and 7040.3.

2i. 12 USC 371c(a)(3).

Credit Transactions with an Affiliate

Valuation of Credit Transactions with an Affiliate

A credit transaction between a member bank and an affiliate initially must be valued at the amount of funds provided by the member bank to, or on behalf of, the affiliate plus any additional amount that the bank could be required to provide to, or on behalf of, the affiliate. The section 23A value of a credit transaction between a member bank and an affiliate is the *greater* of (1) the principal amount of the credit transaction; (2) the amount owed by the affiliate to the member bank under the credit transaction; or (3) the sum of (a) the amount provided to, or on behalf of, the affiliate in the transaction and (b) any additional amount that the member bank could be required to provide to, or on behalf of, the affiliate under the terms of the transaction.

The first prong of the rule's valuation formula for credit transactions (''the principal amount of the credit transaction'') would likely determine the valuation of a transaction in which a member bank purchased a zero-coupon note issued by an affiliate. A member bank should value such an extension of credit at the principal, or face, amount of the note (that is, at the amount that the affiliate ultimately must pay to the bank) rather than at the amount of funds initially advanced by the bank. For example, assume a member bank purchased from an affiliate for $50 a 10-year zero-coupon note issued by the affiliate with a face amount of $100. The rule's valuation formula requires the member bank to value this transaction at $100.

The second prong of the rule's valuation formula for credit transactions (''the amount owed by the affiliate'') likely would determine the valuation of a transaction in which an affiliate fails to pay a member bank when due a fee for services rendered by the bank to the affiliate. This prong of the valuation formula does not include within section 23A's quantitative limits items such as accrued interest not yet due on a member bank's loan to an affiliate or the credit exposure of a member bank to an affiliate on a derivative transaction that is not the functional equivalent of a credit transaction (unless and until the affiliate defaults in making a required payment to the bank on a settlement date).

Member banks will be able to determine the section 23A value for most credit transactions under the third prong of the rule's valuation formula. Under this prong, for example, a $100 term loan is a $100 covered transaction, a $300 revolving credit facility is a $300 covered transaction (regardless of how much of the facility the affiliate has drawn down), and a guarantee backstopping a $500 debt issuance of the affiliate is a $500 covered transaction.

Under section 23A and the rule, a member bank has made an extension of credit to an affiliate if the bank purchases from a third party a loan previously made to an affiliate of the bank. A different valuation formula is provided for these indirect credit transactions: The member bank must value the transaction at the price paid by the bank for the loan plus any additional amount that the bank could be required to provide to, or on behalf of, the affiliate under the terms of the credit agreement.

For example, if a member bank pays a third party $90 for a $100 term loan that the third party previously made to an affiliate of the bank (because, for example, the loan was at a fixed rate and has declined in value because of a rise in the general level of interest rates), the covered transaction amount is $90 rather than $100. The lower covered-transaction amount reflects the fact that the member bank's maximum loss on the transaction is $90 rather than the original principal amount of the loan. For another example, if a member bank pays a third party $70 for a $100 line of credit to an affiliate, of which $70 had been drawn down by the affiliate, the covered-transaction amount would be $100 (the $70 purchase price paid by the bank for the credit plus the remaining $30 that the bank could be required to lend under the credit line).

In another example, a member bank makes a term loan to an affiliate that has a principal amount of $100. The affiliate pays $2 in up-front fees to the member bank, and the affiliate receives net loan proceeds of $98. The member bank must initially value the covered transaction at $100.

Although the rule considers a member bank's purchase of, or investment in, a debt security issued by an affiliate as an extension of credit to an affiliate, these transactions are not valued like other extensions of credit. See section 223.23 for the valuation rules for purchases of, and investments in, the debt securities of an affiliate.

Timing of a Credit Transaction with an Affiliate

A member bank has entered into a credit transaction with an affiliate at *the time during the day* that the bank becomes legally obligated to make the extension of credit to, or issue the guarantee, acceptance, or letter of credit on behalf of, the affiliate. A covered transaction occurs at the moment that the member bank executes a legally valid, binding, and enforceable credit agreement or guarantee and does not occur only when a member bank funds a credit facility or makes payment on a guarantee. Consistent with section 23A, the rule only requires a member bank to compute compliance with its quantitative limits when the bank is about to engage in a new covered transaction. The rule does not require a member bank to compute compliance with the rule's quantitative limits on a continuous basis. See section 223.21(b)(1) of the rule.

The burden of the timing rule is significantly mitigated by the exemption for intraday extensions of credit found in section 223.42(*l*). The intraday credit exemption generally applies only to extensions of credit that a member bank expects to be repaid, sold, or terminated by the end of its U.S. business day. The rule generally requires a member bank to ensure its intraday compliance with section 23A when making a loan to an affiliate during the day, which the bank expects to remain a loan outstanding and on its books overnight.

Asset Purchases from an Affiliate

Regulation W provides that a purchase of assets by a member bank from an affiliate initially must be valued at the total amount of consideration given by the bank in exchange for the asset. (See section 223.22.) This consideration can take any form and includes an assumption of liabilities by the member bank. Asset purchases are a covered transaction for a member bank for as long as the bank holds the asset. The value of the covered transaction after the purchase may be reduced to reflect amortization or depreciation of the asset, to the extent that such reductions are consistent with GAAP and are reflected on the bank's financial statements.

Certain asset purchases by a member bank from an affiliate *are not* valued in accordance with the general asset-purchase valuation formula. First, if the member bank buys from one affiliate a loan to a second affiliate, the bank must value the transaction as a credit transaction with the second affiliate under section 223.21. Second, if the member bank buys from one affiliate a security issued by a second affiliate, the bank must value the transaction as an investment in securities issued by the second affiliate under section 223.23. Third, if the member bank acquires an affiliate that becomes an operating subsidiary of the bank after the acquisition, the bank must value the transaction under section 223.31.

A special valuation rule applies to a member bank's purchase of a line of credit or loan commitment from an affiliate. A member bank initially must value such asset purchases at the purchase price paid by the bank for the asset plus any additional amounts that the bank is obligated to provide under the credit facility.[2j] This special valuation rule ensures that there are limits on the amount of risk a company can shift to an affiliated bank.

In contrast with credit transactions, an asset purchase from a nonaffiliate that later becomes an affiliate generally does not become a covered transaction for the purchasing member bank. If a member bank purchases assets from a nonaffiliate in contemplation of the nonaffiliate's becoming an affiliate of the bank, however, the asset purchase becomes a covered transaction at the time the nonaffiliate becomes an affiliate. In addition, the member bank must ensure that the aggregate amount of the bank's covered transactions (including any such asset purchase from the nonaffiliate) would not exceed the quantitative limits of section 23A at the time the nonaffiliate becomes an affiliate.

The following examples are provided to assist member banks in valuing purchases of assets from an affiliate. A member bank's receipt of an encumbered asset from an affiliate ceases to be a covered transaction when, for example, the bank sells the asset.

- *Cash purchase of assets.* A member bank purchases a pool of loans from an affiliate for $10 million. The member bank initially must value the covered transaction at $10 million.

2j. A member bank would not be required to include unfunded, but committed, amounts in the value of the covered transaction if (1) the credit facility being transferred from the affiliate to the bank is unconditionally cancelable (without cause) at any time by the bank and (2) the bank makes a separate credit decision before each drawing under the facility.

Going forward, if the borrowers repay $6 million of the principal amount of the loans, the member bank may value the covered transaction at $4 million.

- *Purchase of assets through an assumption of liabilities.* An affiliate of a member bank contributes real property with a fair market value of $200,000 to the member bank. The member bank pays the affiliate no cash for the property, but assumes a $50,000 mortgage on the property. The member bank has engaged in a covered transaction with the affiliate and initially must value the transaction at $50,000. Going forward, if the member bank retains the real property but pays off the mortgage, the member bank must continue to value the covered transaction at $50,000. If the member bank, however, sells the real property, the transaction ceases to be a covered transaction at the time of the sale (regardless of the status of the mortgage).

Purchases of and Investments in Securities Issued by an Affiliate

Section 23A includes as a covered transaction a member bank's purchase of, or investment in, securities issued by an affiliate. Section 223.23 of the rule requires a member bank to value a purchase of, or investment in, securities issued by an affiliate (other than a financial subsidiary of the bank) at the *greater* of the bank's purchase price or carrying value of the securities. A member bank that paid no consideration in exchange for affiliate securities has to value the covered transaction at no less than the bank's carrying value of the securities.[2k] In addition, if the member bank's carrying value of the affiliate securities increased or decreased after the bank's initial investment (due to profits or losses at the affiliate), the amount of the bank's covered transaction would increase or decrease to reflect the bank's changing financial exposure to the affiliate. However, the amount of the bank covered transaction cannot decline below the amount paid by the bank for the securities.

Several important considerations support the general carrying-value approach of this valuation rule. First, the approach is consistent with GAAP, which would require a bank to reflect its investment in securities issued by an affiliate at carrying value throughout the life of the investment, even if the bank paid no consideration for the securities.

Second, the approach is supported by the terms of the statute, which defines both a ‘‘purchase of *and* an ‘‘investment in’’ securities issued by an affiliate as a covered transaction. The statute's ‘‘investment in’’ language indicates that Congress was concerned with a member bank's continuing exposure to an affiliate through an ongoing investment in the affiliate's securities.

Third, GLB Act amendments to section 23A support the approach. The GLB Act defines a financial subsidiary of a bank as an affiliate of the bank, but specifically provides that the section 23A value of a bank's investment in securities issued by a financial subsidiary does *not* include retained earnings of the subsidiary. The negative implication from this provision is that the section 23A value of a bank's investment in *other* affiliates *includes* the affiliates' retained earnings, which would be reflected in the bank's carrying value of the investment under the rule.

Finally, the carrying-value approach is consistent with the purposes of section 23A—limiting the financial exposure of banks to their affiliates and promoting safety and soundness. The valuation rule requires a member bank to revalue upwards the amount of an investment in affiliate securities only when the bank's exposure to the affiliate increases (as reflected on the bank's financial statements) and the bank's capital increases to reflect the higher value of the investment. In these circumstances, the valuation rule merely reflects the member bank's greater financial exposure to the affiliate and enhances safety and soundness by reducing the bank's ability to engage in additional transactions with an affiliate as the bank's exposure to that affiliate increases.

The valuation rule also provides that the covered-transaction amount of a member bank's investment in affiliate securities can be no less than the purchase price paid by the bank for the securities, even if the carrying value of the securities declines below the purchase price. Although this aspect of the valuation rule is not consistent with GAAP, using the member bank's purchase price for the securities as a floor for valuing the covered transaction is appropriate. First, it ensures that the amount of the covered transaction never falls below the amount of

2k. Carrying value refers to the amount at which the securities are carried on the GAAP financial statements of the member bank.

funds actually transferred by the member bank to the affiliate in connection with the investment. In addition, the purchase-price floor limits the ability of a member bank to provide additional funding to an affiliate as the affiliate approaches insolvency. If investments in securities issued by an affiliate were valued strictly at carrying value, then the member bank could lend more funds to the affiliate as the affiliate's financial condition worsened. As the affiliate declined, the member bank's carrying value of the affiliate's securities would decline, the section 23A value of the bank's investment likely would decline, and, consequently, the bank would be able to provide additional funding to the affiliate under section 23A. This type of increasing support for an affiliate in distress is what section 23A was intended to restrict.

The examples provided below are designed to assist member banks in valuing purchases of, and investments in, securities issued by an affiliate.

- *Purchase of the debt securities of an affiliate.* The parent holding company of a member bank owns 100 percent of the shares of a mortgage company. The member bank purchases debt securities issued by the mortgage company for $600. The initial carrying value of the securities is $600. The member bank initially must value the investment at $600.
- *Purchase of the shares of an affiliate.* The parent holding company of a member bank owns 51 percent of the shares of a mortgage company. The member bank purchases an additional 30 percent of the shares of the mortgage company from a third party for $100. The initial carrying value of the shares is $100. The member bank initially must value the investment at $100. Going forward, if the member bank's carrying value of the shares declines to $40, the member bank must continue to value the investment at $100.
- *Contribution of the shares of an affiliate.* The parent holding company of a member bank owns 100 percent of the shares of a mortgage company and contributes 30 percent of the shares to the member bank. The member bank gives no consideration in exchange for the shares. If the initial carrying value of the shares is $300, then the member bank initially must value the investment at $300. Going forward, if the member bank's carrying value of the shares increases to $500, the member bank must value the investment at $500.

Securities Issued by an Affiliate as Collateral

General Valuation Rule (Section 223.24(a) and (b))

Section 23A defines as a covered transaction a member bank's acceptance of securities issued by an affiliate as collateral for a loan or extension of credit to any person or company.[2l] This type of covered transaction has two classes: one in which the only collateral for the loan is affiliate securities and another in which the loan is secured by a combination of affiliate securities and other collateral.

Under the rule, if the credit extension is secured exclusively by affiliate securities, then the transaction is valued at the full amount of the extension of credit. This approach reflects the difficulty of measuring the actual value of typically untraded and illiquid affiliate securities and conservatively assumes that the value of the securities is equal to the full value of the loan that the securities collateralize. An exception is provided to the general rule when the affiliate securities held as collateral have a ready market (as defined by section 223.42 of the rule). In that case, the transaction may be valued at the fair market value of the affiliate securities. The exception grants relief in those circumstances when the value of the affiliate securities is independently verifiable by reference to transactions occurring in a liquid market.[2m]

Covered transactions of the second class, in which the credit extension is secured by affiliate securities and other collateral, are valued at the *lesser* of (1) the total value of the extension of credit minus the fair market value of the other collateral or (2) the fair market value of the

2*l*. See 12 USC 371c(b)(7)(D). This covered transaction only arises when the member bank's loan is to a nonaffiliate. Under section 23A, the securities issued by an affiliate are not acceptable collateral for a loan or extension of credit to any affiliate. (See 12 USC 371c(c)(4).) If the proceeds of a loan that is secured by an affiliate's securities are transferred to an affiliate by the unaffiliated borrower (for example, to purchase assets or securities from the inventory of an affiliate), the loan should be treated as a loan to the affiliate. The loan must then be secured with collateral in an amount and of a type that meets the requirements of section 23A for loans by a member bank to an affiliate.

2m. In either case, the transaction must comply with section 23B; that is, the member bank must obtain the same amount of affiliate securities as collateral on the credit extension that the bank would obtain if the collateral were not affiliate securities.

affiliate securities (if the securities have a ready market). The rule's ready-market requirement applies regardless of the amount of affiliate collateral.[2n]

Exemption for Shares Issued by an Affiliated Mutual Fund

Section 223.24(c) of the rule provides an exemption for extensions of credit by a member bank that are secured by shares of an affiliated mutual fund. The rule effects the exemption by providing that an affiliated mutual fund's shares that meet the above-mentioned criteria do not count as affiliate-issued securities for purposes of the valuation rule for extensions of credit secured by affiliate-issued securities. To qualify for the exemption, the transaction must meet several conditions. First, to ensure that the affiliate collateral is liquid and trades at a fair price, the affiliated mutual fund must be an open-end investment company that is registered with the SEC under the 1940 act. Second, to ensure that the member bank can easily establish and monitor the value of the affiliate collateral, the affiliated mutual fund's shares serving as collateral for the extension of credit must have a publicly available market price. Third, to reduce the member bank's incentives to use these extensions of credit as a mechanism to support the affiliated mutual fund, the member bank and its affiliates must not own more than 5 percent of the fund's shares (excluding certain shares held in a fiduciary capacity). Finally, the proceeds of the extension of credit must not be used to purchase the affiliated mutual fund's shares serving as collateral or otherwise used to benefit an affiliate. In such circumstances, the member bank's extension of credit would be covered by section 23A's attribution rule. For example, a member bank proposes to lend $100 to a nonaffiliate secured exclusively by eligible affiliated mutual fund securities. The member bank knows that the nonaffiliate intends to use all the loan proceeds to purchase the eligible affiliated mutual fund securities that would serve as collateral for the loan. Under the attribution rule in section 223.16, the member bank must treat the loan to the nonaffiliate as a loan to an affiliate, and because securities issued by an affiliate are ineligible collateral under section 223.14, the loan would not be in compliance with section 223.14.

Merger and Acquisition Transactions Between a Member Bank and an Affiliate

Under section 223.31 (a)–(c) of the rule, there are several methods by which a member bank acquires an affiliate. The first method is when a member bank directly purchases or otherwise acquires the affiliate's assets and assumes the affiliate's liabilities. In this case, the transaction is treated as a purchase of assets, and the covered-transaction amount is equal to the amount of any separate consideration paid by the member bank for the affiliate's assets (if any) plus the amount of any liabilities assumed by the bank in the transaction.

The second method is when a member bank acquires an affiliate by merger. Because a merger with an affiliate generally results in the member bank's acquiring all the assets of the affiliate and assuming all the liabilities of the affiliate, this transaction is effectively equivalent to the purchase and assumption transaction described in the previous paragraph. Accordingly, the merger transaction also is treated as a purchase of assets, and the covered-transaction amount is equal to the amount of any separate consideration paid by the member bank for the affiliate's assets (if any) plus the amount of any liabilities assumed by the bank in the transaction.[2o] Another illustrative structure, whereby the bank acquires an affiliate, involves the contribution or sale of a controlling block of an affiliate's shares to a member bank. For example, the parent holding company of a member bank contributes between 25 percent and 100 percent of the voting shares of a mortgage company to the member bank. The parent holding company retains no shares of the mortgage company. The member bank gives no consideration in exchange for the transferred shares. The mortgage company has total assets of $300,000 and total liabilities of $100,000. The mortgage company's assets do not include any loans to an

2n. Under the rule, a member bank may use the higher of the two valuation options for these transactions if, for example, the bank does not have the procedures and systems in place to verify the fair market value of affiliate securities.

2o. As noted, section 223.3(dd) of the rule makes explicit the Board's view that these merger transactions generally involve the purchase of assets by a member bank from an affiliate.

affiliate of the member bank or any other asset that would represent a separate covered transaction for the member bank upon consummation of the share transfer. As a result of the transaction, the mortgage company becomes an operating subsidiary of the member bank. The transaction is treated as a purchase of the assets of the mortgage company by the member bank from an affiliate under paragraph (a) of section 223.31. The member bank initially must value the transaction at $100,000, the total amount of the liabilities of the mortgage company. Going forward, if the member bank pays off the liabilities, the member bank must continue to value the covered transaction at $100,000. However, if the member bank sells $15,000 of the transferred assets of the mortgage company or if $15,000 of the transferred assets amortize, the member bank may value the covered transaction at $85,000.

As for the third type of transaction, the rule provides that the acquisition by a member bank of a company that was an affiliate of the bank before the acquisition is treated as a purchase of assets from an affiliate if (1) as a result of the transaction, the company becomes an operating subsidiary of the bank and (2) the company has liabilities, or the bank gives cash or any other consideration in exchange for the securities. The rule also provides that these transactions must be valued initially at the sum of (1) the total amount of consideration given by the member bank in exchange for the securities and (2) the total liabilities of the company whose securities have been acquired by the member bank. In effect, the rule requires member banks to treat such share donations and purchases in the same manner as if the member bank had purchased the assets of the transferred company at a purchase price equal to the liabilities of the transferred company (plus any separate consideration paid by the bank for the shares). (See 12 CFR 223.31.)

The assets and liabilities of an operating subsidiary of a member bank are treated in the rule as assets and liabilities of the bank itself for purposes of section 23A.[3] The rule only imposes asset-purchase treatment on affiliate share transfers when the company whose shares are being transferred to the member bank was an affiliate of the bank before the transfer. If the transferred company was not an affiliate before the transfer, it would not be appropriate to treat the share transfer as a purchase of assets *from an affiliate.* Similarly, the rule only requires asset-purchase treatment for affiliate share transfers when the transferred company becomes a subsidiary and not an affiliate of the member bank through the transfer.

If a bank purchases, or receives a donation, of a partial interest in an affiliate, that transaction is treated as a purchase of, or investment in securities issued by an affiliate. This type of transaction is valued according to the purchase price or GAAP carrying value. (See 12 CFR 223.23.)

Step-Transaction Exemption (Section 223.31(d) and (e))

Under section 223.31(d) of the rule, an exemption is provided for certain step transactions that are treated as asset purchases under section 223.31(a) when a BHC acquires the stock of an unaffiliated company and, immediately after consummation of the acquisition, transfers the shares of the acquired company to the holding company's subsidiary member bank. For example, a bank holding company acquires 100 percent of the shares of an unaffiliated leasing company. At that time, the subsidiary member bank of the holding company notifies its appropriate federal banking agency and the Board of its intent to acquire the leasing company from its holding company. On the day after consummation of the acquisition, the holding company transfers all of the shares of the leasing company to the member bank. No material change in the business or financial condition of the leasing company occurs between the time of the holding company's acquisition and the member bank's acquisition. The leasing company has liabilities. The leasing company becomes an operating subsidiary of the member bank at the time of the transfer. This transfer by the holding company to the member bank, although deemed an asset purchase by the member bank from an affiliate under paragraph (a) of section 223.31, would qualify for the exemption in paragraph (d) of section 223.31.

3. Because a member bank usually can merge a subsidiary into itself, transferring all the shares of an affiliate to a member bank often is functionally equivalent to a transaction in which the bank directly acquires the assets and assumes the liabilities of the affiliate. In a direct acquisition of assets and assumption of liabilities, the covered-transaction amount would be equal to the total amount of liabilities assumed by the member bank.

The rule exempts these ‘‘step’’ transactions under certain conditions. First, the member bank must acquire the target company immediately after the company became an affiliate (by being acquired by the bank’s holding company, for example). The member bank must acquire the entire ownership position in the target company that its holding company acquired. Also, there must be no material change in the business or financial condition of the target company during the time between when the company becomes an affiliate of the member bank and when the bank is in receipt of the company. Finally, the entire transaction must comply with the market-terms requirement of section 23B, and the bank must notify its appropriate federal banking agency and the Board, at or before the time that the target company becomes an affiliate of the bank, of its intent ultimately to acquire the target company.

Regulation W requires that the bank consummate the step transaction immediately to ensure the quality and fairness of the transaction. To the extent that the member bank acquires the target company some time after the company becomes an affiliate, the transaction looks less like a single transaction in which the bank acquires the target company and more like two separate transactions, the latter of which involves the bank acquiring assets from an affiliate. The Board recognized, however, that banking organizations may need a reasonable amount of time to address legal, tax, and business issues relating to an acquisition. Regulation W thus permits member banks to avail themselves of the step-transaction exemption if the bank acquires the target company within three months after the target company becomes an affiliate so long as the appropriate federal banking agency for the bank has approved the longer time period.

The 100 percent ownership requirement (that the member bank must acquire the entire ownership position in the target company that its holding company acquired) prevents a holding company from keeping the good subsidiaries of the target company and transferring its bad subsidiaries to the holding company’s subsidiary member bank. If a banking organization fails to meet the terms of the step-transaction exemption, the organization may be able to satisfy the conditions of the rule’s internal-corporate-reorganization exemption or may be able to obtain a case-by-case exemption from the Board.

Financial Subsidiaries

Section 23A Statutory Provisions for Financial Subsidiaries

Section 23A has several special provisions that apply to covered transactions between a bank and its financial subsidiary. Section 23A defines a ‘‘financial subsidiary’’ as any company that is a subsidiary of a bank that would be a financial subsidiary of a national bank under section 5136A of the Revised Statutes of the United States.[3a] Section 5136A, in turn, defines a financial subsidiary of a national bank as any company that is controlled by one or more insured depository institutions, other than (1) a subsidiary that engages solely in activities that national banks are permitted to engage in directly (and subject to the same terms and conditions that apply to national banks) or (2) a national bank is specifically authorized by the express terms of a federal statute (other than section 5136A), such as an Edge Act corporation or an SBIC.[3b] Section 5136A also prohibits a financial subsidiary of a national bank from engaging in insurance underwriting, real estate investment and development, or merchant banking activities.[3c]

Under section 23A, the section’s 10 percent quantitative limit does not apply to covered transactions between a bank and any individual financial subsidiary of the bank. Accordingly, a bank may engage in covered transactions with any individual financial subsidiary up to 20 percent of the bank’s capital stock and surplus. A bank’s covered transactions with its financial subsidiaries, however, are subject to a statutory 20 percent quantitative limit. Thus, a bank may not engage in a covered transaction with any affiliate (including a financial subsidiary) if the bank’s aggregate amount of covered transactions with all affiliates (including financial subsidiaries) would exceed 20 percent of the bank’s capital stock and surplus.

Because financial subsidiaries of a bank are considered affiliates of the bank for purposes of section 23A, purchases of and investments in the securities of a financial subsidiary are covered transactions under the statute and count against the bank’s quantitative limit. A bank’s investment in its financial subsidiary, for pur-

3a. 12 USC 24a(g)(3).
3b. 12 USC 24a(a)(2).
3c. 12 USC 371c(e)(1).

poses of section 23A, shall not include the retained earnings of the financial subsidiary.

Section 23A generally applies only to transactions between (1) a bank and an affiliate of the bank and (2) a bank and a third party in which some benefit from either type of transaction accrues to an affiliate of the bank. The statute generally does not apply to transactions between two affiliates. Section 23A establishes two special anti-evasion rules, however, that govern transactions between a financial subsidiary of a bank and another affiliate of the bank. First, the FRA provides that any purchase of or investment in the securities of a bank's financial subsidiary by an affiliate of the bank will be deemed to be a purchase of, or investment in, such securities by the bank itself. Second, the GLB Act authorizes the Board to deem a loan or other extensions of credit made by a bank's affiliate to any financial subsidiary of a bank to be an extension of credit by the bank to the financial subsidiary, if the Board determines that such action is necessary or appropriate to prevent evasion.

Regulation W Provisions for Financial Subsidiaries

Regulation W includes, in section 223.32, several special rules that apply to transactions with financial subsidiaries.

Applicability of the 10 percent quantitative limit to transactions with a financial subsidiary. First, section 223.32(a) of the rule provides that the 10 percent quantitative limit in section 23A does not apply with respect to covered transactions between a member bank and any individual financial subsidiary of the bank. A member bank's aggregate amount of covered transactions with any individual financial subsidiary of the bank may exceed 10 percent of the bank's capital stock and surplus.[3d] A member bank's covered transactions with its financial subsidiaries, however, are subject to the 20 percent quantitative limit in section 23A. Thus, a member bank may not engage in a covered transaction with any affiliate (including a financial subsidiary) if the bank's aggregate amount of covered transactions with all affiliates (including financial subsidiaries) would exceed 20 percent of the bank's capital stock and surplus.

The Board notes that the exemption from the 10 percent limit for investments by a member bank in its own financial subsidiary does not apply to investments by a member bank in the financial subsidiary of an affiliated depository institution. Although the financial subsidiary of an affiliated depository institution is an affiliate of the member bank for purposes of sections 23A and 23B, the GLB Act states that only ''covered transactions between a bank and any individual financial subsidiary *of the bank*'' are not subject to the 10 percent limit in section 23A.[3e] A member bank may not engage in a covered transaction with the financial subsidiary of an affiliated depository institution if the aggregate amount of the member bank's covered transactions with that financial subsidiary would exceed 10 percent of the bank's capital stock and surplus.

Valuation of investments in securities issued by a financial subsidiary. Because financial subsidiaries of a member bank are considered affiliates of the bank for purposes of section 23A, a member bank's purchases of and investments in the securities of its financial subsidiary are covered transactions under the statute. The GLB Act further provides that a member bank's investment in its own financial subsidiary, for purposes of section 23A, shall not include the retained earnings of the financial subsidiary.[3f] In light of this statutory provision, the rule's section 223.32(b) contains a special valuation rule for investments by a member bank in the securities of its own financial subsidiary.[3g] Such investments must be valued at the greater of (1) the price paid by the member bank for the securities or (2) the carrying value of the securities on the financial statements of the member bank (determined in accordance with GAAP but without reflecting the bank's pro rata share of any earnings retained or losses incurred by the financial subsidiary after the bank's acquisition of the securities).[3h]

3d. Section 223.11 also indicates that covered transactions between a member bank and its financial subsidiary are exempt from the 10 percent limit.

3e. See 12 USC 371c(e)(3)(A).

3f. GLB Act section 121(b)(1) (12 USC 371c(e)(3)(B)).

3g. The rule's special valuation formula for investments by a member bank in its own financial subsidiary does not apply to investments by a member bank in a financial subsidiary of an affiliated depository institution. Such investments must be valued using the general valuation formula set forth in section 223.23 for investments in securities issued by an affiliate and, further, may trigger the anti-evasion rule contained in section 223.32(c)(1) of the rule.

3h. The rule also makes clear that if a financial subsidiary

This valuation rule differs from the general valuation rule for investments in securities issued by an affiliate only in that the financial subsidiary rule requires, consistent with the GLB Act, that the carrying value of the investment be computed without consideration of the retained earnings or losses of the financial subsidiary since the time of the member bank's investment. As a result of this rule, the covered-transaction amount for a member bank's investment in securities issued by its financial subsidiary generally would not increase after the investment was made except if the member bank made an additional capital contribution to the subsidiary or purchased additional securities of the subsidiary.

The following examples were designed to assist member banks in valuing investments in securities issued by a financial subsidiary of the member bank. Each example involves a securities underwriter that becomes a financial subsidiary of the member bank after the transactions described below.

- *Initial valuation.*
  - *Direct acquisition by a member bank.* A member bank pays $500 to acquire 100 percent of the shares of a securities underwriter. The initial carrying value of the shares on the member bank's parent-only GAAP financial statements is $500. The member bank initially must value the investment at $500.
  - *Contribution of a financial subsidiary to a member bank.* The parent holding company of a member bank acquires 100 percent of the shares of a securities underwriter in a transaction valued at $500 and immediately contributes the shares to the member bank. The member bank gives no consideration in exchange for the shares. The member bank initially must value the investment at the carrying value of the shares on the member bank's parent-only GAAP financial statements. Under GAAP, the member bank's initial carrying value of the shares would be $500.
- *Carrying value not adjusted for earnings and losses of the financial subsidiary.* A member bank and its parent holding company engage in a transaction whereby the member bank acquires 100 percent of the shares of a securities underwriter in a transaction valued at $500. The member bank initially values the investment at $500. In the following year, the securities underwriter earns $25 in profit, which is added to its retained earnings. The member bank's carrying value of the shares of the underwriter is not adjusted for purposes of this part, and the member bank must continue to value the investment at $500. If, however, the member bank contributes $100 of additional capital to the securities underwriter, the member bank must value the aggregate investment at $600.

is consolidated with its parent member bank under GAAP, the carrying value of the bank's investment in the financial subsidiary shall be determined based on parent-only financial statements of the bank.

Anti-evasion rules as they pertain to financial subsidiaries. Section 23A generally applies only to transactions between a member bank and an affiliate of the bank and transactions between a member bank and a third party when some benefit of the transaction accrues to an affiliate of the bank. The statute generally does not apply to transactions between two affiliates. The GLB Act establishes two special anti-evasion rules, however, that govern transactions between a financial subsidiary of a member bank and another affiliate of the bank.[3i] First, the GLB Act provides that any purchase of, or investment in, securities issued by a member bank's financial subsidiary by an affiliate of the bank will be deemed to be a purchase of, or investment in, such securities by the bank itself. Second, the GLB Act authorizes the Board to deem an extension of credit made by a member bank's affiliate to any financial subsidiary of the bank to be an extension of credit by the bank to the financial subsidiary, if the Board determines that such action is necessary or appropriate to prevent evasions of the Federal Reserve Act or the GLB Act. Section 223.32(c) of the rule incorporates both of these provisions.

The Board exercised its authority under the second anti-evasion rule by stating that an extension of credit to a financial subsidiary of a member bank by an affiliate of the bank would be treated as an extension of credit by the bank itself to the financial subsidiary if the extension of credit is treated as regulatory capital of the financial subsidiary. An example of the kind of credit extension covered by this provision would be a subordinated loan to a financial subsidiary that is a securities broker-dealer where the loan is treated as capital of the subsidiary under the

3i. GLB Act section 121(b)(1) (12 USC 371c(e)(4)).

SEC's net capital rules. Treating such an extension of credit as a covered transaction is appropriate because the extension of credit by the affiliate has a similar effect on the subsidiary's regulatory capital as an equity investment by the affiliate, which is treated as a covered transaction by the terms of the GLB Act (as described above). The rule generally does not prevent a BHC or other affiliate of a member bank from providing financial support to a financial subsidiary of the bank in the form of a senior or secured loan.

Derivative Transactions

Derivative transactions between a bank and its affiliates generally arise either from the risk-management needs of the bank or the affiliate. Transactions arising from the bank's needs typically arise when a bank enters into a swap or other derivative contract with a customer but chooses not to hedge directly the market risk generated by the derivative contract or is unable to hedge the risk directly because the bank is not authorized to hold the hedging asset. In order to manage the market risk, the bank may have an affiliate acquire the hedging asset. The bank would then do a ''bridging'' derivative transaction between itself and the affiliate maintaining the hedge.

Other derivative transactions between a bank and its affiliate are affiliate-driven. A bank's affiliate may enter into an interest-rate or foreign-exchange derivative with the bank in order to accomplish the asset-liability management goals of the affiliate. For example, a BHC may hold a substantial amount of floating-rate assets but issue fixed-rate debt securities to obtain cheaper funding. The BHC may then enter into a fixed-to-floating interest-rate swap with its subsidiary bank to reduce the holding company's interest-rate risk.

Banks and their affiliates that seek to enter into derivative transactions for hedging (or risk-taking) purposes could enter into the desired derivatives with unaffiliated companies. Banks and their affiliates often choose to use each other as their derivative counterparties, however, in order to maximize the profits of and manage risks within the consolidated financial group.

Regulation W does not require most derivative transactions to meet the quantitative and collateral requirements of section 23A. Instead, the rule requires the member bank to establish and maintain policies and procedures designed to manage the credit exposure arising from the derivative. These policies and procedures require, at a minimum, that the bank monitor and control its exposure to its affiliates by imposing appropriate credit controls and collateral requirements.

Regulation W requires member banks to comply strictly with section 23B in their derivative transactions with affiliates. In this regard, section 23B requires a member bank to treat an affiliate no better than a *similarly situated* nonaffiliate. Section 23B generally does not allow a member bank to use with an affiliate the terms and conditions it uses with its most creditworthy unaffiliated customer unless the bank can demonstrate that the affiliate is of comparable creditworthiness as the bank's most creditworthy unaffiliated customer. Instead, section 23B requires that an affiliate be treated comparably (with respect to terms, conditions, and credit limits) to the majority of third-party customers engaged in the same business, and having comparable credit quality and size as the affiliate. Because a bank generally has the strongest credit rating within a holding company, the Board generally would not expect an affiliate to obtain better terms and conditions from a member bank than the member bank receives from its major unaffiliated counterparties. In addition, market terms for derivatives among major financial institutions generally include daily marks to market and two-way collateralization above a relatively small exposure threshold.

Covering Derivatives That Are the Functional Equivalent of a Guarantee

Although most derivatives are not treated as covered transactions, section 223.33 of the rule provides that credit derivatives between a member bank and a nonaffiliate in which the bank protects the nonaffiliate from a default on, or a decline in the value of, an obligation of an affiliate of the bank are covered transactions under section 23A. Such derivative transactions are viewed as guarantees by a member bank on behalf of an affiliate (and, hence, are covered transactions) under section 23A.

The rule provides that these credit derivatives are covered transactions under section 23A and gives several examples.[3j] A member bank is not

3j. In most instances, the covered-transaction amount for such a credit derivative would be the notional principal amount of the derivative.

allowed to reduce its covered-transaction amount for these derivatives to reflect hedging positions established by the bank with third parties. A credit derivative is treated as a covered transaction only to the extent that the derivative provides credit protection with respect to obligations of an affiliate of the member bank.

Collateral

There are collateral requirements for certain transactions with affiliates. Each loan or extension of credit to an affiliate or guarantee, acceptance, or letter of credit issued on behalf of an affiliate[3k] (herein referred to as credit transactions) by a member bank or its subsidiary must be secured at the time of the transaction by collateral. The required collateral, based on its fair market value, varies according to a percentage of the credit extended,[3l] depending on the type of collateral used to secure the transaction.[3m] The specific collateral requirements are—

- 100 percent of the amount of the credit extended if the collateral is composed of (1) obligations of the United States or its agencies; (2) obligations fully guaranteed by the United States or its agencies as to principal and interest; (3) notes, drafts, bills of exchange, or banker's acceptances that are eligible for rediscount or purchase by a Federal Reserve Bank; or (4) a segregated, earmarked deposit account with the member bank;
- 110 percent of the amount of the credit extended if the collateral is composed of obligations of any state or political subdivision of any state;
- 120 percent of the amount of the credit extended if the collateral is composed of other debt instruments, including receivables; or
- 130 percent of the amount of the credit extended if the collateral is composed of stock, leases, or other real or personal property.

For example, a member bank makes a $1,000 loan to an affiliate. The affiliate posts as collateral for the loan $500 in U.S. Treasury securities, $480 in corporate debt securities, and $130 in real estate. The loan satisfies the collateral requirements of this section because $500 of the loan is 100 percent secured by obligations of the United States, $400 of the loan is 120 percent secured by debt instruments, and $100 of the loan is 130 percent secured by real estate. The statute prohibits a member bank from counting a low-quality asset toward section 23A's collateral requirements for credit transactions with affiliates.[3n] A member bank must maintain a perfected security interest at all times in the collateral that secures the credit transaction.

3k. 12 USC 371c(b)(7).

3*l*. "Credit extended" means the loan or extension of credit, guarantee, acceptance, or letter of credit.

3m. 12 USC 371c(c)(1).

Collateral Requirements in Regulation W

The collateral requirements for credit transactions are found in section 223.14 of the rule. Section 223.14(a) requires that a bank meet the collateral requirements only at the inception of a credit transaction with an affiliate.

Deposit account collateral. Under section 23A, a member bank may satisfy the collateral requirements of the statute by securing a credit transaction with an affiliate with a "segregated, earmarked deposit account" maintained with the bank in an amount equal to 100 percent of the credit extended.[3o] Member banks may secure covered transactions with omnibus deposit accounts so long as the member bank takes steps to ensure that the omnibus deposit accounts fully secure the relevant covered transactions. Such steps might include substantial overcollateralization or the use of subaccounts or other recordkeeping devices to match deposits with covered transactions. To obtain full credit for any deposit accounts taken as section 23A collateral, member banks must ensure that they have a perfected, first-priority security interest in the accounts. (See section 223.14(b)(1)(i)(D).)

Ineligible collateral. The purpose of section 23A's collateral requirements is to ensure that member banks that engage in credit transactions with affiliates have legal recourse, in the event of affiliate default, to tangible assets with a value at least equal to the amount of the credit extended. The statute recognizes that certain types of assets are not appropriate to serve as collateral for credit transactions with an affiliate.

3n. 12 USC 371c(c)(3).

3o. 12 USC 371c(c)(1)(A)(iv).

In particular, the statute provides that low-quality assets and securities issued by an affiliate are not eligible collateral for such covered transactions.[3p]

Under section 223.14(c) of the rule, intangible assets are not deemed acceptable to meet the collateral requirements imposed by section 23A.[4] Intangible assets, including servicing assets, are particularly hard to value, and a member bank may have significant difficulty in collecting and selling such assets in a reasonable period of time.

Section 23A(c) requires that credit transactions with an affiliate be "secured" by collateral. A credit transaction between a member bank and an affiliate supported only by a guarantee or letter of credit from a third party does not meet the statutory requirement that the credit transaction be secured by collateral. Guarantees and letters of credit often are subject to material adverse change clauses and other covenants that allow the issuer of the guarantee or letter of credit to deny coverage. Letters of credit and guarantees are not balance-sheet assets under GAAP and, accordingly, would not constitute "real or personal property" under section 23A. There is a particularly significant risk that a member bank may have difficulty collecting on a guarantee or letter of credit provided by a nonaffiliate on behalf of an affiliate of the bank. Accordingly, guarantees and letters of credit are not acceptable section 23A collateral.[4a]

As noted above, section 23A prohibits a member bank from accepting securities issued by an affiliate as collateral for an extension of credit to any affiliate. The rule clarifies that securities issued by the member bank itself also are not eligible collateral to secure a credit transaction with an affiliate. Equity securities issued by a lending member bank, and debt securities issued by a lending member bank that count as regulatory capital of the bank, are not eligible collateral under section 23A. If a member bank were forced to foreclose on a credit transaction with an affiliate secured by such securities, the bank may be unwilling to liquidate the collateral promptly to recover on the credit transaction because the sale might depress the price of the bank's outstanding securities or result in a change in control of the bank. In addition, to the extent that a member bank is unable or unwilling to sell such securities acquired through foreclosure, the transaction would likely result in a reduction in the bank's capital, thereby offsetting any potential benefit provided by the collateral.

Perfection and priority. Under section 223.14(d) of the rule, a member bank's security interest in any collateral required by section 23A must be perfected in accordance with applicable law to ensure that a member bank has good access to the assets serving as collateral for its credit transactions with affiliates. This requirement ensures that the member bank has the legal right to realize on the collateral in the case of default, including a default resulting from the affiliate's insolvency or liquidation. A member bank also is required to either obtain a first-priority security interest in the required collateral or deduct from the amount of collateral obtained by the bank the lesser of (1) the amount of any security interests in the collateral that are senior to that obtained by the bank or (2) the amount of any credits secured by the collateral that are senior to that of the bank. For example, if a member bank lends $100 to an affiliate and takes as collateral a second lien on a parcel of real estate worth $200, the arrangement would only satisfy the collateral requirements of section 23A if the affiliate owed the holder of the first lien $70 or less (a credit transaction secured by real estate must be secured at 130 percent of the amount of the transaction).

The rule includes the following example of how to compute the section 23A collateral value of a junior lien: A member bank makes a $2,000 loan to an affiliate. The affiliate grants the member bank a second-priority security interest in a piece of real estate valued at $3,000. Another institution that previously lent $1,000 to the affiliate has a first-priority security interest in the entire parcel of real estate. This transaction is not in compliance with the collateral requirements of this section. Because of the existence of the prior third-party lien on the real estate, the effective value of the real estate collateral for the member bank for purposes of this section is only $2,000—$600 less than the amount of real estate collateral required by this section for the transaction ($2,000 × 130 percent = $2,600).

3p. 12 USC 371c(c)(3) and (4).

4. The rule does not confine the definition of intangible assets by reference to GAAP.

4a. The rule also provides that instruments "similar" to guarantees and letters of credit are ineligible collateral. For example, in the Board's view, a member bank cannot satisfy section 23A's collateral requirements by purchasing credit protection in the form of a credit-default swap referencing the affiliate's obligation.

Unused portion of an extension of credit. Section 23A requires that the ''amount'' of an extension of credit be secured by the statutorily prescribed levels of collateral. In general, if a member bank provides a line of credit to an affiliate, it must secure the full amount of the line of credit throughout the life of the credit. Section 223.14(f)(2) of the rule provides an exemption to the collateral requirements of section 23A for the unused portion of an extension of credit to an affiliate so long as the member bank does not have any legal obligation to advance additional funds under the credit facility until the affiliate has posted the amount of collateral required by the statute with respect to the entire used portion of the extension of credit.[4b] In such credit arrangements, securing the unused portion of the credit line is unnecessary from a safety-and-soundness perspective because the affiliate cannot require the member bank to advance additional funds without posting the additional collateral required by section 23A. If a member bank voluntarily advances additional funds under such a credit arrangement without obtaining the additional collateral required under section 23A to secure the entire used amount (despite its lack of a legal obligation to make such an advance), the Board views this action as a violation of the collateral requirements of the statute. Even if the line of credit does not need to be secured, the entire amount of the line counts against the bank's quantitative limit.

Purchasing affiliate debt securities in the secondary market. A member bank's investment in the debt securities issued by an affiliate is an extension of credit by the bank to the affiliate and thus is subject to section 23A's collateral requirements. Section 223.14(f)(3) of the rule provides an exemption that permits member banks in certain circumstances to purchase debt securities issued by an affiliate without satisfying the collateral requirements of section 23A. The exemption is available where a member bank purchases an affiliate's debt securities from a third party in a bona fide secondary-market transaction. When a member bank buys an affiliate's debt securities in a bona fide secondary-market transaction, the risk that the purchase is designed to shore up an ailing affiliate is reduced.

4b. This does not apply to guarantees, acceptances, and letters of credit issued on behalf of an affiliate. These instruments must be fully collateralized at inception.

Any purchase of affiliate debt securities that qualifies for this exemption would still remain subject to the quantitative limits of section 23A and the market-terms requirement of section 23B. In analyzing a member bank's good faith under this exemption transaction, examiners should look at the time elapsed between the original issuance of the affiliate's debt securities and the bank's purchase, the existence of any relevant agreements or relationships between the bank and the third-party seller of the affiliate's debt securities, any history of bank financing of the affiliate, and any other relevant information.

Credit transactions with nonaffiliates that become affiliates. Banks sometimes lend money to, or issue guarantees on behalf of, unaffiliated companies that later become affiliates of the bank. Section 223.21(b)(2) provides transition rules that exempt credit transactions from the collateral requirements in situations in which the member bank entered into the transactions with the nonaffiliate at least one year before the nonaffiliate became an affiliate of the bank.

For example, a member bank with capital stock and surplus of $1,000 and no outstanding covered transactions makes a $120 unsecured loan to a nonaffiliate. The member bank does not make the loan in contemplation of the nonaffiliate becoming an affiliate. Nine months later, the member bank's holding company purchases all the stock of the nonaffiliate, thereby making the nonaffiliate an affiliate of the member bank. The member bank is not in violation of the quantitative limits of the rule's section 223.11 or 223.12 at the time of the stock acquisition. The member bank is, however, prohibited from engaging in any additional covered transactions with the new affiliate at least until such time as the value of the loan transaction falls below 10 percent of the member bank's capital stock and surplus. In addition, the member bank must bring the loan into compliance with the collateral requirements of section 223.14 promptly after the stock acquisition.

Exemptions from Section 23A

Section 23A authorizes the Board to grant exemptions from the statute's restrictions if such exemptions are ''in the public interest and consistent with the purposes of this section'' (12

USC 371c(f)(2)). The Board has approved a number of exemptions over the past several years, most of which involve corporate reorganizations.

Section 23A exempts several types of transactions from the statute's quantitative and collateral requirements and exempts other types of transactions from the statute's quantitative, collateral, and low-quality-asset requirements.[4c] Regulation W, subpart E, sets forth the statutory exemptions, clarifies certain of these exemptions, and exempts a number of additional types of transactions

The Board reserves the right to revoke or modify any additional exemption granted by the Board in Regulation W, if the Board finds that the exemption is resulting in unsafe or unsound banking practices. The Board also reserves the right to terminate the eligibility of a particular member bank to use any such exemption if the bank's use of the exemption is resulting in unsafe or unsound banking practices.

Covered Transactions Exempt from the Quantitative Limits and Collateral Requirements

Under the rule's section 223.41, the quantitative limits (sections 223.11 and 223.12) and the collateral requirements (section 223.14) do not apply to the following transactions. The transactions are, however, subject to the safety-and-soundness requirement (section 223.13) and the prohibition on the purchase of a low-quality asset (section 223.15).

- *Parent institution/subsidiary institution transactions.* Transactions with a depository institution if the member bank controls 80 percent or more of the voting securities of the depository institution or the depository institution controls 80 percent or more of the voting securities of the member bank.
- *Purchase of loans on a nonrecourse basis from an affiliated depository institution.*

Sister-bank exemption (section 223.41(b)). Regulation W exempts transactions with a federally insured depository institution if the same company controls 80 percent or more of the voting securities of the member bank and the depository institution. In addition, the statute provides that covered transactions between sister banks must be consistent with safe and sound banking practices.[4d]

The sister-bank exemption generally applies only to transactions between insured depository institutions.[4e] The rule's definition of affiliate excludes uninsured depository institution subsidiaries of a member bank. Covered transactions between a member bank and a parent uninsured depository institution or a commonly controlled uninsured depository institution, under the rule, generally would be subject to section 23A whereas covered transactions between a member bank and a subsidiary uninsured depository institution would not be subject to section 23A.[4f]

The sister-bank exemption, by its terms, only exempts transactions by a member bank with a sister-bank affiliate; hence, the sister-bank exemption cannot exempt a member bank's extension of credit to an affiliate that is not a sister bank (even if the extension of credit was purchased from a sister bank). For example, a member bank purchases from Sister-Bank Affiliate A a loan to Affiliate B in a purchase that qualifies for the sister-bank exemption in section 23A. The member bank's asset purchase from Sister-Bank Affiliate A would be an exempt covered transaction under section 223.41(b), but the member bank also would have acquired an extension of credit to Affiliate B, which would be a covered transaction between the member bank and Affiliate B under section 223.3(h)(1) that does not qualify for the sister-bank exemption.

Internal corporate reorganizations. Section 223.41(d) of the rule provides an exemption for asset purchases by a bank from an affiliate that are part of a one-time internal corporate reorganization of a banking organization.[4g] The exemption includes purchases of assets in connection with a transfer of securities issued by an

4c. 12 USC 371c(d).

4d. 12 USC 371c(a)(4).

4e. A member bank and its operating subsidiaries are considered a single unit for purposes of section 23A. Under the statute and the regulation, transactions between a member bank (or its operating subsidiary) and the operating subsidiary of a sister insured depository institution generally qualify for the sister-bank exemption.

4f. The sister-bank exemption in section 23A does not allow a member bank to avoid any restrictions on sister-bank transactions that may apply to the bank under the prompt-corrective-action framework set forth in section 38 of the FDI Act (12 USC. 1831o) and regulations adopted thereunder by the bank's appropriate federal banking agency.

4g. See 1998 *Fed. Res. Bull.* 985 and 1013–14.

affiliate to a member bank, as described in section 223.31(a).

Under this exemption, a member bank would be permitted to purchase assets (other than low-quality assets) from an affiliate (including in connection with an affiliate share transfer that section 223.31 of the rule treats as a purchase of assets) exempt from the quantitative limits of section 23A if the following conditions are met.

First, the asset purchase must be part of an internal corporate reorganization of a holding company that involves the transfer of all or substantially all of the shares or assets of an affiliate or of a division or department of an affiliate.[4h] The asset purchase must not be part of a series of periodic, ordinary-course asset transfers from an affiliate to a member bank. Second, the member bank's holding company must provide the Board with contemporaneous notice of the transaction and must commit to the Board to make the bank whole, for a period of two years, for any transferred assets that become low-quality assets.[4i] Third, a majority of the member bank's directors must review and approve the transaction before consummation. Fourth, the section 23A value of the covered transaction must be less than 10 percent of the member bank's capital stock and surplus (or up to 25 percent of the bank's capital stock and surplus with the prior approval of the bank's appropriate federal banking agency). Fifth, the member bank's holding company and all its subsidiary depository institutions must be well capitalized and well managed and must remain well capitalized upon consummation of the transaction.

Covered Transactions Exempt from the Quantitative Limits, Collateral Requirements, and Low-Quality-Asset Prohibition

The quantitative limits (sections 223.11 and 223.12), the collateral requirements (section 223.14), and the prohibition on the purchase of a low-quality asset (section 223.15) do not apply to the following exempted transactions. (See section 223.42.) The transactions are, however, subject to the safety-and-soundness requirement (section 223.13). Detailed conditions or restrictions pertaining to these exemptions are discussed after this list.

- making correspondent banking deposits in an affiliated depository institution (as defined in section 3 of the FDI Act (12 USC 1813) or an affiliated foreign bank that represent an ongoing, working balance maintained in the ordinary course of correspondent business
- giving immediate credit to an affiliate for uncollected items received in the ordinary course of business
- transactions secured by cash or U. S. government securities
- purchasing securities of a servicing affiliate
- purchasing certain liquid assets
- purchasing certain marketable securities
- purchasing certain municipal securities
- purchasing from an affiliate an extension of credit subject to a repurchase agreement that was originated by a member bank and sold to the affiliate subject to a repurchase agreement or with recourse
- asset purchases from an affiliate by a newly formed member bank, if the appropriate federal banking agency for the member bank has approved the asset purchase in writing in connection with the review of the formation of the member bank
- transactions approved under the Bank Merger Act that involve federally insured depository institutions in U.S. branches and agencies of a foreign bank
- purchasing, on a nonrecourse basis, an extension of credit from an affiliate
- intraday extensions of credit
- riskless-principal transactions

Correspondent banking. Section 23A exempts from its quantitative limits and collateral requirements any deposit by a member bank in an affiliated bank or affiliated foreign bank that is made in the ordinary course of correspondent business, subject to any restrictions that the Board may impose.[4j] Section 223.42(a) of the rule further provides that such deposits must represent ongoing, working balances maintained by the member bank in the ordinary course of

4h. The notice also must describe the primary business activities of the affiliate whose shares or assets are being transferred to the member bank and must indicate the anticipated date of the reorganization.

4i. The holding company can meet this criteria by either repurchasing the assets at book value plus any write-down that has been taken or by making a quarterly cash contribution to the bank equal to the book value plus any write-downs that have been taken by the bank.

4j. 12 USC 371c(d)(2).

conducting the correspondent business.[4k] Although not required by section 23A or the Home Owners' Loan Act (HOLA), the rule also provides that correspondent deposits in an affiliated insured savings association are exempt if they otherwise meet the requirements of the exemption.

Secured credit transactions. Section 23A and section 223.42(c) of the rule exempt any credit transaction by a member bank with an affiliate that is "fully secured" by U.S. government obligations or by a "segregated, earmarked" deposit account.[4*l*] A deposit account meets the "segregated, earmarked" requirement only if the account exists for the sole purpose of securing credit transactions between the member bank and its affiliates and is so identified. Under section 23A, if U.S. government obligations or deposit accounts are sufficient to *fully* secure a credit transaction, then the transaction is completely exempt. If, however, the U.S. government obligations or deposit accounts represent less than full security for the credit transaction, then the amount of U.S. government obligations or deposits counts toward the collateral requirements of section 23A, but no part of the transaction is exempt from the statute's quantitative limits.

An additional exemption provided in the rule is consistent with the (d)(4) exemption in section 23A. A credit transaction with an affiliate will be exempt "to the extent that the transaction is and remains secured" by appropriate (d)(4) collateral. If a member bank makes a $100 nonamortizing term loan to an affiliate that is secured by $50 of U.S. Treasury securities and $75 of real estate, the value of the covered transaction will be $50. If the market value of the U.S. Treasury securities falls to $45 during the life of the loan, the value of the covered transaction would increase to $55. The Board expects member banks that use this expanded (d)(4) exemption to review the market value of their U.S. government obligations collateral regularly to ensure compliance with the exemption.

Purchases of assets with readily identifiable market quotes. Section 23A(d)(6) exempts the purchase of assets by a member bank from an affiliate if the assets have a "readily identifiable and publicly available market quotation" and are purchased at their current market quotation.[4m] The rule (section 223.42(e)) limits the availability of this exemption (the (d)(6) exemption) to purchases of assets with market prices that are recorded in widely disseminated publications that are readily available to the general public, such as newspapers with a national circulation. Because as a general matter only exchange-traded assets are recorded in such publications, this test has ensured that the qualifying assets are traded actively enough to have a true "market quotation" and that examiners can verify that the assets are purchased at their current market quotation. The rule applies if the asset is purchased at *or below* the asset's current market quotation.[5]

If a member bank purchases from one affiliate securities issued by another affiliate, the bank has engaged in two types of covered transactions. Under the rule, although the (d)(6) exemption may exempt the one-time asset purchase from the first affiliate, it would not exempt the ongoing investment in securities issued by the second affiliate.

The (d)(6) exemption may apply to a purchase of assets that are not traded on an exchange. In particular, purchases of foreign exchange, gold, and silver, and purchases of over-the-counter (OTC) securities and derivative contracts whose prices are recorded in widely disseminated publications, may qualify for the (d)(6) exemption.

Purchases of securities with a ready market from a securities affiliate. Section 223.42(f) of the rule expands the statutory (d)(6) exemption to allow a member bank to purchase securities from an affiliate based on price quotes obtained from certain electronic screens so long as, among other things, (1) the selling affiliate is a broker-dealer registered with the SEC, (2) the securities are traded in a ready market and eligible for purchase by state member banks, (3) the securities are not purchased within 30 days of an underwriting (if an affiliate of the bank is an

4k. Unlike the sister-bank exemption, the exemption for correspondent banking deposits applies to deposits placed by a member bank in an *uninsured* depository institution or foreign bank.

4*l*. 12 USC 371c(d)(4).

4m. 12 USC 371c(d)(6).

5. The rule provides that a U.S. government obligation is an eligible (d)(6) asset only if the obligation's price is quoted routinely in a widely disseminated publication that is readily available to the general public. Although all U.S. government obligations have low credit risk, not all U.S. government obligations trade in liquid markets at publicly available market quotations.

underwriter of the securities), and (4) the securities are not issued by an affiliate.

- *Broker-dealer requirement and securities purchases from foreign broker-dealers.* As stated above, the selling affiliate must be a registered broker-dealer. Broker-dealers that are registered with the SEC are subject to supervision and examination by the SEC and are required by SEC regulations to keep and maintain detailed records concerning each securities transaction conducted by the broker-dealer. In addition, SEC-registered broker-dealers have experience in determining whether a security has a ''ready market'' under SEC regulations. The rule does not expand the exemption to include securities purchases from foreign broker-dealers. The rule explicitly provides, however, that a member bank may request that the Board exempt securities purchases from a particular foreign broker-dealer, and the Board would consider these requests on a case-by-case basis in light of all the facts and circumstances.
- *Securities eligible for purchase by a state member bank.* The exemption requires that the bank's purchase of securities be eligible for purchase by a state member bank. The Board determined that a member bank may purchase equity securities from an affiliate under the (d)(6) exemption, if the purchase is made to hedge the bank's permissible customer-driven equity derivative transaction (and the purchase meets all the other requirements of the exemption).
- *No purchases within 30 days of an underwriting.* The (d)(6) rule generally prohibits a member bank from using the (d)(6) exemption to purchase securities during an underwriting, or within 30 days of an underwriting, if an affiliate of the bank is an underwriter of the securities. This provision applies unless the security is purchased as part of an issue of obligations of, or obligations fully guaranteed as to principal and interest by, the United States or its agencies. The rule includes the 30-day requirement because of the uncertain and volatile market values of securities during and shortly after an underwriting period and because of the conflicts of interest that may arise during and after an underwriting period, especially if an affiliate has difficulty selling its allotment.
- *No securities issued by an affiliate.* If a member bank purchases from one affiliate securities issued by another affiliate, it would not exempt the investment in securities issued by the second affiliate, even though the (d)(6) exemption may exempt the asset purchase from the first affiliate. The transaction would be treated as a purchase of, or an investment in, securities issued by an affiliate.
- *Price-verification methods.* The (d)(6) exemption applies only in situations in which the member bank is able to obtain price quotes on the purchased securities from an unaffiliated electronic, real-time pricing service. The Board reaffirms its position that it would not be appropriate to use independent dealer quotations to establish a market price for a security under the new (d)(6) exemption. A security that is not quoted routinely in a widely disseminated news source or a third-party electronic financial network may not trade in a sufficiently liquid market to justify allowing a member bank to purchase unlimited amounts of the security from an affiliate.
- *Record retention.* The rule expressly includes a two-year record-retention and supporting information requirement that is sufficient to enable the appropriate federal banking agencies to ensure that the member bank is in compliance with the terms of the (d)(6) exemption.

Purchasing municipal securities. Section 223.42(g) of the rule exempts a member bank's purchase of municipal securities from an affiliate if the purchase meets certain requirements.[5a] First, the member bank must purchase the municipal securities from a broker-dealer affiliate that is registered with the SEC. Second, the municipal securities must be eligible for purchase by a state member bank, and the member bank must report the transaction as a securities purchase in its call report. Third, the municipal securities must either be rated by a nationally recognized statistical rating organization or must be part of an issue of securities that does not exceed $25 million in size. Finally, the price for the securities purchased must be (1) quoted routinely on an unaffiliated electronic service that provides indicative data from real-time financial networks; (2) verified by reference to

5a. Municipal securities are defined by reference to section 3(a)(29) of the Securities Exchange Act. It defines municipal securities as direct obligations of, or obligations guaranteed as to principal or interest by, a state or agency, instrumentality, or political subdivision thereof, and certain tax-exempt industrial development bonds. (See 17 USC 78c(a)(29).)

two or more actual independent dealer quotes on the securities to be purchased or securities that are comparable to the securities to be purchased; or (3) in the case of securities purchased during the underwriting period, verified by reference to the price indicated in the syndicate manager's written summary of the underwriting.[5b] Under any of the three pricing options, the member bank must purchase the municipal securities at or below the quoted or verified price.

Purchases of assets by newly formed banks. Section 223.42(i) of the rule exempts a purchase of assets by a newly chartered member bank from an affiliate if the appropriate federal banking agency for the bank has approved the purchase. This exemption allows companies to charter a new bank and to transfer assets to the bank free of the quantitative limits and low-quality-asset prohibition of section 23A.

Transactions approved under the Bank Merger Act. The Bank Merger Act exemption applies to transactions between a member bank and an insured depository institution affiliate. Section 223.42(j) exempts transactions between insured depository institutions that are approved pursuant to the Bank Merger Act. The rule makes the Bank Merger Act exemption available for merger and other related transactions between a member bank and a U.S. branch or agency of an affiliated foreign bank, if the transaction has been approved by the responsible federal banking agency pursuant to the Bank Merger Act, and should help ensure that such transactions do not pose significant risks to the member bank. There is no regulatory exemption for merger transactions between a national bank and its nonbank affiliate. Any member bank merging or consolidating with a nonbank affiliate may be able to take advantage of the regulatory exemption for internal-reorganization transactions contained in section 223.41(d) of the rule.

Purchases of extensions of credit—the purchase exemption.

- The purchase of an extension of credit on a nonrecourse basis from an affiliate is exempt from section 23A's quantitative limits provided that—
  - — the extension of credit is originated by the affiliate;
  - — the member bank makes an independent evaluation of the creditworthiness of the borrower before the affiliate makes or commits to make the extension of credit; and
  - — the member bank does not make a blanket advance commitment to purchase extensions of credit from the affiliate. (See section 223.42(k) of the rule.)

  The rule also includes a 50 percent limit on the amount of loans a bank may purchase from an affiliate under the purchase exemption. When a member bank purchases more than half of the extensions of credit originated by an affiliate, the purchases represent the principal ongoing funding mechanism for the affiliate. The member bank's status as the predominant source of financing for the affiliate calls into question the availability of alternative funding sources for the affiliate, places significant pressure on the bank to continue to support the affiliate through asset purchases, and reduces the bank's ability to make independent credit decisions with respect to the asset purchases.
- *"Substantial, ongoing funding" test.* The rule allows the appropriate federal banking agency for a member bank to reduce the 50 percent threshold prospectively, on a case-by-case basis, in those situations in which the agency believes that the bank's asset purchases from an affiliate under the exemption may cause harm to the bank.
- *Independent credit review by the bank.* To qualify for the purchase exemption under section 223.42(k), a member bank must independently review the creditworthiness of each obligor before committing to purchase each loan. Under established Federal Reserve guidance, a state member bank is required to have clearly defined policies and procedures to ensure that it performs its own due diligence in analyzing the credit and other risks inherent in a proposed transaction.[5c] This function is not delegable to any third party, including affiliates of the member bank or government-sponsored enterprises. Accordingly, to qualify for this exemption, the member bank, independently and using its own credit policies

5b. Under the Municipal Securities Rulemaking Board's Rule G-11, the syndicate manager for a municipal bond underwriting is required to send a written summary to all members of the syndicate. The summary discloses the aggregate par values and prices of bonds sold from the syndicate account.

5c. See, for example, SR-97-21.

and procedures, must itself review and approve each extension of credit before giving a purchase commitment to its affiliate.

- *Purchase of loans from an affiliate must be without recourse.* In connection with a bank's purchase of loans from an affiliate, the affiliate cannot retain recourse on the loans. The rule (section 223.42(k)) specifies that the exemption does not apply in situations where the affiliate retains recourse on the loans purchased by the member bank. The rule also specifies that the purchase exemption only applies in situations where the member bank purchases loans from an affiliate that were originated by the affiliate. The exemption cannot be used by a member bank to purchase loans from an affiliate that the affiliate purchased from another lender. The exemption is designed to facilitate a member bank's using its affiliate as an origination agent, not to permit a member bank to take off an affiliate's books loans that the affiliate purchased from a third party.

Intraday extensions of credit. Section 223.42(*l*) of the rule provides that intraday credit extensions by a member bank to an affiliate are section 23A covered transactions but exempts all such intraday credit extensions from the quantitative and collateral requirements of section 23A if the member bank (1) maintains policies and procedures for the management of intraday credit exposure and (2) has no reason to believe that any affiliate receiving intraday credit would have difficulty repaying the credit in accordance with its terms. The establishment of policies and procedures are for—

- monitoring and controlling the credit exposure arising at any one time from the member bank's intraday extensions of credit to each affiliate and all affiliates in the aggregate and
- ensuring that any intraday extensions of credit by the member bank to an affiliate comply with the market-terms requirement of section 223.51 of the rule.

Standard under which the board may grant additional exemptions. Section 223.43 of the rule provides that exemption requests should (1) describe in detail the transaction or relationship for which the member bank seeks exemption, (2) explain why the Board should exempt the transaction or relationship, and (3) explain how the exemption would be in the public interest and consistent with the purposes of section 23A.

Exemptions from the Attribution Rule of Section 23A

The attribution rule of section 23A provides that "a transaction by a member bank with any person shall be deemed a transaction with an affiliate to the extent that the proceeds of the transaction are used for the benefit of, or transferred to, that affiliate" (12 USC 371c(a)(2)). One respective interpretation and three exemptions are discussed below.

Loans to a nonaffiliate that purchases securities or other assets through a depository institution affiliate agent or broker. The Board issued an interpretation on an insured depository institution's loan to a nonaffiliate that purchases assets through an institution's affiliate that is acting as agent. This interpretation confirms that section 23A of the FRA does not apply to extensions of credit an insured depository institution grants to customers that use the loan proceeds to purchase a security or other asset through an affiliate of the depository institution, so long as (1) the affiliate is acting exclusively as an agent or broker in the transaction and (2) the affiliate retains no portion of the loan proceeds as a fee or commission for its services.

Under this interpretation, the Board concluded that when the affiliated agent or broker retains a portion of the loan proceeds as a fee or commission, the portion of the loan not retained by the affiliate as a fee or commission would still be outside the coverage of section 23A. On the other hand, the portion of the loan retained by the affiliate as a fee or commission would be subject to section 23A because it represents proceeds of a loan by a depository institution to a third party that are transferred to, and used for the benefit of, an affiliate of the institution. The Board, however, granted an exemption from section 23A for that portion of a loan to a third party that an affiliate retains as a market-rate brokerage or agency fee.

The interpretation would not apply if the securities or other assets purchased by the third-party borrower through the affiliate of the depository institution were issued or underwritten by, or sold from the inventory of, another affiliate of the depository institution. In that case, the proceeds of the loan from the depository institution would be transferred to, and used for the benefit of, the affiliate that issued, underwrote, or sold the assets on a principal basis to the third party.

The above-mentioned transactions are subject to the market-terms requirement of section 23B, which applies to ''any transaction in which an affiliate acts as an agent or broker or receives a fee for its services to the bank or any other person'' (12 USC 371c-1(a)(2)(D)). A market-rate brokerage commission or agency fee refers to a fee or commission that is no greater than that prevailing at the same time for comparable agency transactions the affiliate enters into with persons who are neither affiliates nor borrowers from an affiliated depository institution. (See Regulation W at 12 CFR 223.16(b).)

Exemption—Loans to a nonaffiliate that purchases securities from a depository institution securities affiliate that acts as a riskless principal. The Board has granted an exemption from section 23A of the FRA for extensions of credit by an insured depository institution to customers who use the loan proceeds to purchase a security that is issued by a third party via a broker-dealer affiliate of the institution that acts as riskless principal. The exemption for riskless-principal transactions would not apply if the broker-dealer affiliate sold to the third-party borrower securities that were issued or underwritten by, or sold out of the inventory of, an affiliate of the depository institution. Riskless-principal trades, although the functional equivalent of securities brokerage transactions, involve the purchase of a security by the depository institution's broker-dealer affiliate. Accordingly, the broker-dealer retains the loan proceeds at least for some moment in time.

There is negligible risk that loans a depository institution makes to borrowers to engage in riskless-principal trades through a broker-dealer affiliate of the depository institution would be used to fund the broker-dealer. For this reason, the Board adopted an exemption from section 23A to cover riskless-principal securities transactions engaged in by depository institution borrowers through broker-dealer affiliates of the depository institution. This exemption is applicable even if the broker-dealer retains a portion of the loan proceeds as a market-rate markup for executing the riskless-principal securities trade. (See Regulation W at 12 CFR 223.16(c)(1).)

Exemption—Loan to a nonaffiliate pursuant to a preexisting line of credit and the proceeds are used to purchase securities from the institution's broker-dealer affiliate. The Board approved an exemption from section 23A for loans by an insured depository institution to a nonaffiliate pursuant to a preexisting line of credit, in which the loan proceeds are used to purchase securities from a broker-dealer affiliate. In more detail, the Board exempted extensions of credit by an insured depository institution to its customers that use the credit to purchase securities from a registered broker-dealer affiliate of the institution, so long as the extension of credit is made pursuant to, and consistent with any conditions imposed in, a preexisting line of credit. This line of credit should not have been established in expectation of a securities purchase from or through an affiliate of the institution. The preexisting requirement is an important safeguard to ensure that the depository institution did not extend credit for the purpose of inducing a borrower to purchase securities from or issued by an affiliate. The preexisting line of credit exemption may not be used in circumstances in which the line has merely been preapproved. (See Regulation W at 12 CFR 223.16(c)(3).)

Exemption—Credit card transactions. An exemption is provided from section 23A's attribution rule for general-purpose credit card transactions that meet certain criteria. (See section 223.16(c)(4).) The rule defines a general-purpose credit card as a credit card issued by a member bank that is widely accepted by merchants that are not affiliates of the bank (such as a Visa card or Mastercard) if less than 25 percent of the aggregate amount of purchases with the card are purchases from an affiliate of the bank. Extensions of credit to unaffiliated borrowers pursuant to special-purpose credit cards (that is, credit cards that may only be used or are substantially used to buy goods from an affiliate of the member bank) are subject to the rule.

The credit card exemption includes several alternatives. First, several different methods are provided for a member bank to demonstrate that its credit card meets the 25 percent test. If a member bank has no commercial affiliates (other than those permitted for an FHC under section 4 of the BHC Act), the bank would be deemed to satisfy the 25 percent test if the bank has no reason to believe that it would fail the test. (A member bank could use this method of complying with the 25 percent test even if, for example, the bank's FHC controls, under section 4(a)(2), 4(c)(2), or 4(k)(4)(H) of the BHC Act, several companies engaged in nonfinancial activities.) Such a member bank would not be obligated to establish systems to verify strict, ongoing compliance with the 25 percent test. Most BHCs and FHCs should meet this test. If a member bank has commercial affiliates (beyond those permitted for an FHC under section 4 of the BHC Act), the bank would be deemed to satisfy the 25 percent test if—

- the bank establishes systems to verify compliance with the 25 percent test on an ongoing basis and periodically validates its compliance with the test, or
- the bank presents information to the Board demonstrating that its card would comply with the 25 percent test. (One way that a member bank could demonstrate that its card would comply with the 25 percent test would be to show that the total sales of the bank's affiliates are less than 25 percent of the total purchases by cardholders.)

Second, for those member banks that fall out of compliance with the 25 percent test, there is a three-month grace period to return to compliance before extensions of credit under the card become covered transactions. Third, member banks that are required to validate their ongoing compliance with the 25 percent test have a fixed method, time frames, and examples for computing compliance.

Example of calculating compliance with the 25 percent test. A member bank seeks to qualify a credit card as a general-purpose credit card under section 223.16, paragraph (c)(4)(ii)(A), of the rule. The member bank assesses its compliance under paragraph (c)(4)(iii) of this section on the 15th day of every month (for the preceding 12 calendar months). The credit card qualifies as a general-purpose credit card for at least three consecutive months. On June 15, 2005, however, the member bank determines that, for the 12-calendar-month period from June 1, 2004, through May 31, 2005, 27 percent of the total value of products and services purchased with the card by all cardholders were purchases of products and services from an affiliate of the member bank. Unless the credit card returns to compliance with the 25 percent limit by the 12-calendar-month period ending August 31, 2005, the card will cease to qualify as a general-purpose credit card as of September 1, 2005. Any outstanding extensions of credit under the credit card that were used to purchase products or services from an affiliate of the member bank would become covered transactions at such time.

SECTION 23B OF THE FEDERAL RESERVE ACT

Regulation W, subpart F, sets forth the principal restrictions of section 23B. These include (1) a requirement that most transactions between a member bank and its affiliates be on terms and circumstances that are substantially the same as those prevailing at the time for comparable transactions with nonaffiliates; (2) a restriction on a member bank's purchase as fiduciary of assets from an affiliate unless certain criteria are met; (3) a restriction on a member bank's purchase, during the existence of an underwriting syndicate, of any security if a principal underwriter of the security is an affiliate; and (4) a prohibition on publishing an advertisement or entering into an agreement stating that a member bank will be responsible for the obligations of its affiliates. For the most part, subpart F restates the operative provisions of section 23B. The following transactions with affiliates are subject to restrictions:

- any covered transaction with an affiliate
- the sale of securities or other assets to an affiliate, including assets subject to repurchase
- the payment of money or the furnishing of services to an affiliate under contract, lease, or otherwise
- any transaction in which an affiliate acts as an agent or broker or receives a fee for its services to the bank or to any other person
- any transaction or series of transactions with a third party—
  - — if an affiliate has a financial interest in the third party or
  - — if an affiliate is a participant in this transaction or series of transactions

Any transaction by a member bank or its subsidiary with any person is deemed to be a transaction with an affiliate of the bank if any of the proceeds of the transaction are used for the benefit of, or are transferred to, the affiliate. A member bank and its subsidiaries may engage in the transactions covered by section 23B of the FRA only on terms and under circumstances, including credit standards, that are substantially the same, or at least as favorable to the bank or its subsidiary, as those prevailing at the time for comparable transactions with, or that in good faith would be offered to, nonaffiliate companies.

Section 23B also restricts the following transactions with affiliates:

- A member bank or its subsidiary cannot purchase as fiduciary any securities or other assets from any affiliate unless the purchase is permitted—
  - under the terms of the instrument creating the fiduciary relationship,
  - by court order, or
  - by the law of the jurisdiction governing the fiduciary relationship.
- A member bank or its subsidiary, whether acting as principal or fiduciary, cannot knowingly purchase or acquire, during the existence of any underwriting or selling syndicate, any security if a principal underwriter of that security is an affiliate of the bank. This limitation applies unless the purchase or acquisition of the security has been approved before it is initially offered for sale to the public by a majority of the directors of the bank. The purchase should be based on a determination that it is a sound investment for the bank irrespective of the fact that an affiliate of the bank is a principal underwriter of the securities.

Transactions Exempt from Section 23B

The market-terms requirement of section 23B applies to, among other transactions, any ‘‘covered transaction’’ between a member bank and an affiliate.[5d] Section 23B(d)(3) makes clear that the term ‘‘covered transaction’’ in section 23B has the same meaning as the term ‘‘covered transaction’’ in section 23A, but does not include any transaction that is exempt under section 23A(d)—for example, transactions between sister banks, transactions fully secured by a deposit account or U.S. government obligations, and purchases of assets from an affiliate at a readily identifiable and publicly available market quotation.[5e] Consistent with the statute, Regulation W’s section 223.52(a)(1) exempts from section 23B any transaction that is exempt under section 23A(d).[5f]

The rule also excludes from section 23B any covered transaction that is exempt from section 23A under section 223.42(i) or (j) (that is, asset purchases by a newly formed member bank and transactions approved under the Bank Merger Act). The Board excluded from section 23B this additional set of transactions because, in each case, the appropriate federal banking agency for the member bank involved in the transaction should ensure that the terms of the transaction are not unfavorable to the bank.

Purchases of Securities for Which an Affiliate Is the Principal Underwriter

The GLB Act amended section 23B to permit a member bank to purchase securities during an underwriting conducted by an affiliate if the following two conditions are met. First, a majority of the directors of the member bank (with no distinction drawn between inside and outside directors) must approve the securities purchase before the securities are initially offered to the public. Second, such approval must be based on a determination that the purchase would be a sound investment for the member bank regardless of the fact that an affiliate of the bank is a principal underwriter of the securities.[5g] Section 223.53(b) includes this standard and clarifies that if a member bank proposes to make such a securities purchase in a fiduciary capacity, then the directors of the bank must base their approval on a determination that the purchase is a sound investment for the person on whose behalf the bank is acting as fiduciary.

A member bank may satisfy this director-approval requirement by obtaining specific prior director approval of each securities acquisition otherwise prohibited by section 23B(b)(1)(B). The rule clarifies, however, that a member bank also satisfies this director-approval requirement if a majority of the directors of the bank approves appropriate standards for the bank’s acquisition of securities otherwise prohibited by section 23B(b)(1)(B) and each such acquisition meets the standards adopted by the directors. In addition, a majority of the member bank’s directors

5d. 12 USC 371c-1(a)(2)(A).
5e. 12 USC 371c-1(d)(3).

5f. Regulation W will again be subsequently referred to as the ‘‘rule’’ or by its specified section-numbered discussion of section 23B provisions.
5g. GLB Act, section 738 (12 USC 371c-1(b)(2)).

must periodically review such acquisitions to ensure that they meet the standards and must periodically review the standards to ensure they meet the ''sound investment'' criterion of section 23B(b)(2). The appropriate period of time between reviews would vary depending on the scope and nature of the member bank's program, but such reviews should be conducted by the directors at least annually. Before the passage of the GLB Act, Board staff informally allowed member banks, based on the legislative history of section 23B, to meet the director-approval requirement in this fashion, and there is no indication that Congress in the GLB Act intended to alter the procedures that a member bank could use to obtain the requisite director approval.[5h] The rule codifies staff's preexisting approach to the director-approval requirement.[5i]

Definition of Affiliate Under Section 23B

Section 23B states that the term ''affiliate'' under section 23B has the meaning given to such term in section 23A except that the term ''affiliate'' under section 23B does not include a ''bank,'' as defined in section 23A.[5j] In the case of the sister-bank exemption, the rule's section 223.2(c) clarifies that the only companies that qualify for the ''bank'' exception to section 23B's definition of affiliate are insured depository institutions.

Advertising Restriction

In section 23B(c), the ''advertising restriction'' prohibits a member bank from publishing any advertisement or entering into any agreement stating or suggesting that the bank shall in any way be responsible for the obligations of its affiliates unless the transaction satisfies the quantitative and collateral restrictions of section 23A.[5k] The rule clarifies that section 23B(c) does not prohibit a member bank from making reference to such a guarantee, acceptance, or letter of credit in a prospectus or other disclosure document, for example, if otherwise required by law.

OPERATIONS SUBSIDIARIES

The Board has authorized member banks to establish and own operations subsidiaries. ''Operations subsidiaries'' are organizations that are, in effect, designed to serve as separately incorporated departments of a bank.

Member Bank Purchases of Stock of Operations Subsidiaries

The Board concluded in 1968 that ''. . . a member bank may purchase for its own account shares of a corporation to perform, at locations at which the bank is authorized to engage in business, functions that the bank is empowered to perform directly'' (12 CFR 250.141(i)). The Board reasoned that this authority could reasonably be interpreted as within a bank's incidental powers to ''organize its operations in the manner that it believes best facilitates the performance thereof,'' and that the subsidiary essentially constitutes a separately incorporated division or department of the bank.

No specific rule requires a state member bank to give the Board prior notice of, or to acquire the Board's approval for, the acquisition of an operations subsidiary to engage in activities that the bank itself may lawfully perform. However, section 208.3(d)(2) of Regulation H (12 CFR 208.3(d)(2)) prohibits a state member bank from causing or permitting a change in the general character of its business or in the scope of its corporate powers approved at the time of admission to membership, except with the permission of the Board.

Transactions Between a Member State Bank and Its Operations Subsidiary

The Board noted in 1970 that ''[S]ince an

5h. The conference report accompanying the Competitive Equality Banking Act of 1987 stated that the prior-approval requirement of section 23B(b) could be met ''by the establishment in advance of specific standards by the outside directors for such acquisitions. If the outside directors establish such standards, they must regularly review acquisitions to assure that the standards have been followed, and they must periodically review the standards to assure that they continue to be appropriate in light of market and other conditions.'' See *H.R. Conf. Rep. No. 100-261* at 133 (1987).

5i. The rule also provides, consistent with existing Board interpretations, that a U.S. branch, agency, or commercial lending company of a foreign bank may comply with this requirement by obtaining the required approvals and reviews from either a majority of the directors or a majority of the senior executive officers of the foreign bank.

5j. 12 USC 371c-1(d)(1).

5k. 12 USC 371c-1(c).

operations subsidiary is in effect a part of, and subject to the same restrictions as, its parent bank, there is no reason to limit transactions between the bank and such subsidiary any more than transactions between departments of a bank.'' The Board concluded that ''a credit transaction by a member State bank with its operations subsidiary . . . is not a 'loan or . . . extension of credit' of the kind intended to be restricted and regulated by section 23A and is, therefore, outside the purview of that section'' (12 CFR 223.2(b)(1)–(2)).

Operations Subsidiary Not Wholly Owned

The previously mentioned 1968 interpretation only expressly authorized state member banks to establish wholly owned operations subsidiaries, in that a wholly owned subsidiary of a bank is functionally indistinguishable from a division or department of the bank. In enacting the GLB Act, Congress recognized the authority of national and state member banks to own and control an operations subsidiary. The GLB Act recognized traditional operations subsidiaries by distinguishing them from financial subsidiaries. A financial subsidiary is defined so as not to include a company engaged solely in activities that a parent bank may perform, subject to the limitations that govern the conduct of these activities.

The GLB Act also does not appear to require that a state member bank own 100 percent of an operations subsidiary or a financial subsidiary. The GLB Act defines the term ‘‘subsidiary’’ by reference to the BHC Act. Under the BHC Act, a company is a ‘‘subsidiary’’ of a bank holding company if the BHC (1) owns or controls 25 percent or more of the company's voting shares, or (2) controls the election of a majority of the company's directors.[6]

The Board thus believes that, as a result of the GLB Act and consistent with section 5136 of the Revised Statutes (12 USC 24 (seventh)) and the Board's 1968 interpretation, a state member bank may acquire shares of a company that is not wholly owned and that (1) on consummation of the acquisition would be a subsidiary of the bank within the meaning of the BHC Act, and (2) engages only in activities in which the parent bank may engage, at locations at which the bank may engage in the activities, subject to the same limitations as if the bank were engaging in the activities directly.

FINANCIAL SUBSIDIARIES

Qualifying state member banks may control or hold an interest in a ‘‘financial subsidiary.’’ A financial subsidiary is any company that is controlled by one or more insured depository institutions and engages in activities that are financial in nature or incidental to a financial activity. A financial subsidiary does not include (1) a subsidiary that the state member bank is specifically authorized to hold by the express terms of federal law (other than by section 9 of the FRA), such as an Edge Act subsidiary held under section 25 of the FRA, or (2) a subsidiary that engages only in activities that the parent bank could conduct directly and that are conducted on the same terms and conditions that govern the conduct of the activity by the state member bank. A financial subsidiary is authorized for national banks by section 5136A of the Revised Statutes (12 USC 24a) and for state banks by section 46 of the Federal Deposit Insurance Act (FDI Act) (12 USC 1831w). To implement the authorization for state member banks, a new subpart G was added to Regulation H (12 CFR 208.71 et seq.).

Investing in or Controlling a Financial Subsidiary

Under the GLB Act, a state member bank may control, or hold an interest in, a financial subsidiary only if—

- the state member bank and each of its depository institution affiliates is well capitalized and well managed;[7]
- the aggregate consolidated total assets of all the bank's financial subsidiaries do not exceed the lesser of 45 percent of the consolidated total assets of the bank or $50 billion;[8]
- the state member bank is one of the 100 largest insured banks and meets the following debt-rating or alternative debt-rating requirements:
  — for the 50 largest insured banks, the bank must have at least one issue of outstanding eligible debt that is currently rated in one of the three highest investment-grade rating categories by a nationally recognized statistical rating organization;[9]

6. See 12 USC 1841(d). A company also is considered a subsidiary of a bank holding company if the Board determines, after notice and opportunity for a hearing, that the bank holding company directly or indirectly exercises a controlling influence over the managment or policies of the company.

7. An institution is ‘‘well capitalized’’ if it meets or exceeds the capital levels designated by the institution's appropriate federal banking agency (section 38 of the FDI Act (12 USC 1831o)). A depository institution will be deemed ‘‘well managed’’ by references to specific examination ratings, or if its federal banking agency determines that the managerial resources are satisfactory, or if it has not been examined.

8. This dollar amount will be adjusted based on an indexing mechanism that is established jointly by the Federal Reserve Board and the Secretary of the Treasury.

9. ‘‘Eligible debt’’ refers to unsecured debt that has an initial maturity of more than 360 days. The debt must be issued and outstanding, may not be supported by any form of credit enhancement, and may not be held in whole or any

— for the second 50 largest insured banks, the bank must meet the issuer-credit-rating requirement for the 50 largest insured banks or the bank must meet the alternative criteria established jointly by regulation by the Secretary of the Treasury and the Federal Reserve[10]

(the debt-rating and alternative criteria are not applicable if the bank's financial subsidiaries engage in any newly authorized financial activities solely as agent and not as principal); and

- the state member bank obtains the Federal Reserve's approval to engage in the activities of the financial subsidiary (using the notice procedures in section 208.76 of Regulation H). The state member bank also must obtain any necessary approvals from its state supervisory authority.

Issuer-Credit-Rating Requirement

The issuer-credit-rating requirement of the rule (12 CFR 208.71) requires a long-term issuer credit rating from a nationally recognized statistical rating organization that is within the three highest investment-grade rating categories used by the organization. An ''issuer credit rating'' is one that assesses the bank's overall capacity and willingness to pay, on a timely basis, its unsecured financial obligations. An issuer credit rating differs from a debt rating in that it does not assess the bank's ability or willingness to make payments on any individual class or issue of debt, nor does it reflect payment priority or payment preferences among financial obligations.

For this rule, the issuer credit rating must be assigned to the national or state member bank that controls or holds an interest in a financial subsidiary. Issuer credit ratings that are assigned to a subsidiary or affiliate of the parent bank, such as a subsidiary engaged in derivatives activities, do not meet the rule's requirements. Rating organizations may issue long-term or short-term issuer credit ratings for the same bank and separate ratings for dollar-denominated and foreign-currency-denominated obligations. Only long-term issuer ratings for dollar-denominated obligations satisfy the requirements of the rule. A ''long-term credit rating'' means a written opinion that is issued by a nationally recognized statistical rating organization regarding the bank's overall capacity and willingness to pay on a timely basis its unsecured, dollar-denominated financial obligations maturing in no less than one year.

The Secretary of the Treasury and the Federal Reserve have determined that certain types of ratings assigned by the rating agencies indicated in table 1 currently meet the requirements of the rule, provided that the ratings assess the parent bank's ability and willingness to meet its financial obligations denominated in U.S. dollars.

Standard and Poor's may modify its AA or A ratings to include a plus (+) or minus (-) sign to show relative standing within these rating categories. Any rating from A minus to AAA would satisfy the long-term issuer-credit-rating requirement; an A minus would constitute the lowest acceptable rating in the case of Standard & Poor's and Fitch. Moody's top three investment-grade categories for long-term issuer credit ratings are Aaa, Aa, or A, with Aaa denoting the highest rating. Moody's applies numerical modifiers of 1, 2, and 3 in the Aa and A rating

significant part by affiliates or insiders of the bank or by any other person acting on behalf of or with funds from the bank or an affiliate.

10. The size of an insured bank is determined based on the consolidated total assets of the bank as of the end of each calendar year.

Table 1—Acceptable Rating Organizations and Ratings

Rating Organization	*Type of Rating*	*Rating*
Standard & Poor's	Issuer credit rating (including a counterparty credit rating)	AAA, AA, or A
Moody's	Issuer credit rating	Aaa, Aa, or A
Fitch	International credit rating	AAA, AA, or A

categories, with 3 denoting the lowest end of the letter-rating modifiers. Any rating from A-3 to Aaa would satisfy the long-term issuer-credit-rating requirement; a rating of A-3 would be the lowest acceptable rating in the case of Moody's.

Prudential Standards

A state member bank that owns a financial subsidiary must comply with certain prudential safeguards. These standards pertain to the bank's capital requirements and its establishment of policies and procedures arising from financial subsidiary ownership.

As for the capital requirements, the state member bank must ''deconsolidate'' the assets and liabilities of all of its financial subsidiaries from those of the bank. Although the GLB Act requires a bank to deconsolidate the assets and liabilities of any financial subsidiary for regulatory capital purposes, a financial subsidiary remains a subsidiary of a state member bank. The Board will continue to review the operations and financial and managerial resources of the bank on a consolidated basis as part of the supervisory process. The Board may take appropriate supervisory action if it believes that the bank does not have the appropriate financial and managerial resources (including capital resources and risk-management controls) to conduct its direct or indirect activities in a safe and sound manner.

In addition to the deconsolidation described above, the bank must also deduct a specified percentage of the aggregate amount of the equity investment (including retained earnings) (''the aggregate amount'') in all financial subsidiaries from the bank's capital and assets. Therefore, the bank must deduct—

- 50 percent of the aggregate amount from both the bank's tier 1 capital and its tier 2 capital for purposes of determining its risk-based capital ratios;
- 50 percent of the aggregate amount from the bank's tier 1 capital for purposes of determining its leverage ratios; and
- 100 percent of the aggregate amount from its tangible equity for purposes of determining its tangible equity capital ratio. It must also deduct 100 percent of the aggregate amount from the bank's risk-weighted assets, average total assets, and total assets when determining its risk-based, leverage, and tangible capital ratios.

The bank must meet all capital requirements—including the ''well-capitalized'' requirement (Regulation H, section 208.71) and the capital levels established by the Board under section 38 of the FDI Act—after the adjustments described above.

The member bank must also establish and maintain policies and procedures to manage the financial and operational risks associated with its ownership of a financial subsidiary. These procedures must identify and manage financial and operational risks with the bank and its financial subsidiaries. They must adequately protect the bank from such risks and preserve the bank's separate corporate identity and the limited liability of the bank and its financial subsidiaries. In addition, a financial subsidiary of a state member bank is considered a nonsubsidiary affiliate of the bank for purposes of sections 23A and 23B of the FRA and a subsidiary of the BHC (and not a subsidiary of a bank) for the purposes of the anti-tying prohibitions of the Bank Holding Company Act Amendments of 1970.

Permissible Activities for a Financial Subsidiary

A financial subsidiary can engage in three types of permissible activities:

1. Those activities that are determined to be financial in nature or incidental to financial activities under section 4(k)(4) of the BHC Act. These permissible activities include—
   - general insurance agency activities in any location and travel agency activities;
   - underwriting, dealing in, and making a market in all types of securities; and
   - any activity that the Federal Reserve determined by regulation or order to be closely related to banking or managing or controlling banks so as to be a proper incident thereto and that was in effect on the effective date of the GLB Act. (See section 225.86 of the Board's Regulation Y (12 CFR 225.86).)
2. Activities that the Secretary of the Treasury, in consultation with the Board, determines to

be financial in nature or incidental to financial activities and permissible for financial subsidiaries of national banks pursuant to section 5136A(b) of the Revised Statutes of the United States (12 USC 24a(b)).
3. Activities that the state member bank is permitted to engage in directly, subject to the same terms and conditions that govern the conduct of the activity by the state member bank (12 USC 24a(a)(2)(A)(ii)).

Impermissible Activities for a Financial Subsidiary

A financial subsidiary *may not* engage as principal in insurance underwriting (except to the extent permitted for national banks by the Comptroller of the Currency as of January 1, 1999, and not subsequently overturned in certain grandfathered titile insurance activities), providing or issuing annuities, real estate investment or development (except as expressly authorized by law), and merchant banking and insurance company investment activities.

Federal Reserve Approval Requirements

Federal Reserve approval of a financial subsidiary involves a streamlined notice procedure. A state member bank must file a notice with the appropriate Reserve Bank before acquiring control of, or an interest in, a financial subsidiary, or before engaging in an additional financial activity through an existing financial subsidiary. No notice is required for a financial subsidiary to engage in an additional activity that the parent state member bank could conduct directly. The notice must include basic information on the financial subsidiary and its existing and proposed activities. In the case of an acquisition, the notice should include a description of the transaction through which the bank proposes to acquire control of or an interest in the financial subsidiary. The notice also must contain a certification that the state member bank and its depository institution affiliates meet the capital, management, and credit-rating requirements to own a financial subsidiary, as stated in the GLB Act and subpart G of Regulation H. If the notice is for the state member bank's initial affiliation with a company engaged in insurance activities, the notice must describe the company's insurance activities and identify the states where the company holds an insurance license. A notice will be considered approved on the fifteenth day after receipt of a complete notice by the appropriate Reserve Bank, unless before that date, the notice is approved or disapproved or the bank is notified that additional time is needed to review the submitted notice.

The GLB Act permits a state member bank to acquire an interest in or control a financial subsidiary if the bank meets the criteria and requirements set forth in the rule. The Board, however, retains its general supervisory authority for state member banks and may restrict or limit the activities of, or the acquisition or ownership of a subsidiary by, a state member bank if the Board finds that the bank does not have the appropriate financial and managerial resources to conduct the activities or to acquire or retain ownership of the company.

AGRICULTURAL CREDIT CORPORATIONS

The increasing number of agricultural credit corporations and their effect on parent banks have intensified the need for their supervision. Most agricultural credit corporations come under the direct supervision of the district Federal Intermediate Credit Bank (FICB) where the corporations discount most of their loans. However, a corporation may obtain funds exclusively in the open market and avoid FICB regulation.

EDGE ACT AND AGREEMENT CORPORATIONS

U.S.-based corporations and permissible activities for their Edge Act and agreement corporation subsidiaries are described in detail in the Board's Regulation K (12 CFR 211). Edge Act and agreement corporations provide banks with a vehicle for engaging in international banking or foreign financial operations. They also have the power, with supervisory consent, to purchase and hold the stock of foreign banks and other international financial concerns. Edge Act and agreement corporations are examined by the Federal Reserve, and their respective reports of examination should be reviewed during each examination of a parent member bank. The

Federal Reserve examination report and the amount and quality of paper held by these corporations must provide the basis for evaluating the bank's investment in them.

Transactions between the parent bank and the bank's Edge Act and agreement corporation subsidiaries are not subject to the limitations in section 23A. However, they are subject to limitation under section 25 of the FRA (12 USC 601) and under the Board's Regulation K. In addition, transactions with such bank subsidiaries and the parent bank's affiliates are aggregated with transactions by the bank and its affiliates for purposes of section 23A limitations and restrictions. Transactions between a bank and Edge Act and agreement corporation subsidiaries of the bank's holding company are also subject to section 23A.

PARALLEL-OWNED BANKING ORGANIZATIONS

A parallel-owned banking organization is created when at least one U.S. depository institution and a foreign bank[10a] are controlled, either directly or indirectly, by the same person or group of persons[10b] who are closely associated in their business dealings or otherwise acting in concert. Parallel-owned banking organizations do not include structures in which one depository institution is a subsidiary of the other, or in which the organization is controlled by a company subject to the BHC Act or the Savings and Loan Holding Company Act.[10c] The banking agencies consider whether ''control'' of a depository institution exists when a person or group of persons controls 10 percent or more of any class of the depository institution's voting shares. Parallel-owned banking organizations are established and maintained for a variety of reasons, including tax and estate planning and the potential risks associated with nationalization. While these reasons may be legitimate and not prohibited by U.S. or foreign law, the structure of such organizations creates or increases certain risks and may make it more difficult for supervisors to monitor and address those risks. On April 23, 2002, the U.S. banking agencies (the Federal Reserve System, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, and Office of Thrift Supervision) issued a joint agency statement that addresses the potential risks associated with parallel-owned banking organizations. The existence of one or more of the following factors may, depending on the circumstances, warrant additional inquiry:

- An individual or group of individuals acting in concert that controls a foreign bank also controls any class of voting shares of a U.S. depository institution, or financing for persons owning or controlling the shares is received from, or arranged by, the foreign bank, especially if the shares of the U.S. depository institution are collateral for the stock-purchase loan.
- The U.S. depository institution has adopted particular or unique policies or strategies similar to those of the foreign bank, such as common or joint marketing strategies, sharing of customer information, cross-selling of products, or linked web sites.
- An officer or director of the U.S. depository institution either (1) serves as an officer or director[10d] of a foreign bank, or (2) controls a foreign bank or is a member of a group of individuals acting in concert or with common ties that controls a foreign bank.
- The name of the U.S. depository institution is similar to that of the foreign bank.

Parallel-owned banking organizations present supervisory risks similar to those arising from chain banking organizations in the United States. The fundamental risk presented by these organizations is that they may be acting in a de facto organizational structure that, because it is not formalized, is not subject to comprehensive consolidated supervision. Therefore, relationships between the U.S. depository institution and other affiliates may be harder to understand and monitor. To reduce these risks, the U.S. banking

10a. References to ''foreign bank'' or ''foreign parallel bank'' also include a holding company of the foreign bank and any U.S. or foreign affiliates of the foreign bank. References to ''U.S. depository institution'' do not include a U.S. depository institution that is controlled by a foreign bank.

10b. The term ''persons'' includes both business entities and natural persons, which may or may not be U.S. citizens.

10c. A bank holding company or savings and loan holding company, however, may be a component of a parallel-owned banking organization. This situation may arise when a bank holding company or savings and loan holding company controls the U.S. depository institution, and the holding company, in turn, is controlled by a person or group of persons who also controls a foreign bank.

10d. The sharing of a director, by itself, is unlikely to indicate common control of the U.S. and foreign depository institutions.

agencies (1) work with appropriate non-U.S. supervisors to better understand and monitor the activities of the foreign affiliates and owners; (2) share information, as appropriate, with foreign and domestic bank supervisory agencies; and (3) impose special conditions or obtain special commitments or representations related to an application or an enforcement or other supervisory action, when warranted.

Parallel-owned banking organizations may foster additional management and supervisory risks:

- Officers and directors of the U.S. depository institution may be unable or unwilling to exercise independent control to ensure that transactions with the foreign parallel bank or affiliates are legitimate and comply with applicable laws and regulations. As a result, the U.S. depository institution may be the conduit or participant in a transaction that violates U.S. law or the laws of a foreign country, or that is designed to prefer a foreign bank or nonbank entity in the group, to the detriment of the U.S. depository institution.
- Money-laundering concerns may be heightened due to the potential lack of arm's-length transactions between the U.S. depository institution and the foreign parallel bank. Specifically, the flow of funds through wires, pouch activity, and correspondent accounts may be subject to less internal scrutiny by the U.S. depository institution than usually is warranted. This risk is greatly increased when the foreign parallel bank is located in an offshore jurisdiction or other jurisdiction that limits exchange of information through bank secrecy laws, especially if the jurisdiction has been designated as a "non-cooperating country or territory," or the jurisdiction or the foreign bank has been found to be of primary money-laundering concern under the International Money Laundering Abatement and Financial Anti-Terrorism Act of 2001.
- Securities, custodial, and trust transactions may be preferential to the extent that assets, earnings, and losses are artificially allocated among parallel banks. Similarly, low-quality assets and problem loans can be shifted among parallel banks to manipulate earnings or losses and avoid regulatory scrutiny. Also, if the foreign parallel bank were to begin experiencing financial difficulties, the foreign bank or the common owners might pressure the U.S. depository institution to provide credit support or liquidity to an affiliate in excess of the legal limits of 12 USC 371c, 371c-1.
- The home country of the foreign parallel bank may have insufficient mechanisms or authority to monitor changes in ownership or to ensure arm's-length intercompany transactions between the foreign parallel bank and other members of the group, including the U.S. depository institution, or to monitor concentrations of loans or transactions with third parties that may present safety-and-soundness concerns to the group.
- Capital may be generated artificially through the use of international stock-purchase loans. Such loans can be funded by the U.S. depository institution to the foreign affiliate or to a nonaffiliate with the purpose of supporting a loan back to the foreign affiliate and used to leverage the U.S. depository institution or vice versa. This concern is heightened for parallel-owned banking organizations if the foreign bank is not adequately supervised.
- Political, legal, or economic events in the foreign country may affect the U.S. depository institution. Events in the foreign country, such as the intervention and assumption of control of the foreign parallel bank by its supervisor, may trigger a rapid inflow or outflow of deposits at the U.S. depository institution, thereby affecting liquidity. Foreign events may increase reputational risk to the U.S. depository institution. In addition, these events may adversely affect the foreign bank owner's financial resources and decrease the ability of the foreign bank owner to provide financial support to the U.S. depository institution. Foreign law may change without the U.S. depository institution or the banking agencies becoming aware of the effect of legal changes on the parallel-owned banking organization, including the U.S. depository institution.
- Parallel-owned banking organizations may seek to avoid legal lending limits or limitations imposed by securities or commodities exchanges or clearinghouses on transactions by one counterparty, thereby unduly increasing credit risk and other risks to the banking organizations and others.

To minimize risks, the U.S. banking agencies coordinate the supervision of a parallel-owned banking organization's U.S. operations. The supervisory approach may include unannounced coordinated examinations if more than one regulator has examination authority. Such examinations may be conducted if regulators suspect irregular transactions between parallel-owned banks, such as the shifting of problem assets between the depository institutions. Factors to consider in determining whether to conduct coordinated reviews of an organization's U.S. operations include intercompany and related transactions; strategy and management of the parallel-owned banking organization; political, legal, or economic events in the foreign country; and compliance with commitments or representations made or conditions imposed in the application process or pursuant to prior supervisory action.

The U.S. depository institution's board of directors and senior management are expected to be cognizant of the risks associated with being part of a parallel-owned banking structure, especially with respect to diversion of a depository institution's resources, conflicts of interest, and affiliate transactions. The depository institution's internal policies and procedures should provide guidance on how personnel should treat affiliates. The Federal Reserve and other U.S. banking agencies will expect to have access to such policies, as well as to the results of any audits of compliance with the policies. The agencies will seek an overview of the entire organization, as well as a better understanding of how foreign bank affiliates are supervised. Authorized bank regulatory supervisory staff will work with foreign supervisors to better understand the activities of the foreign affiliates and owners. As appropriate and feasible, and in accordance with applicable law, such authorized staff will share information regarding material developments with foreign and domestic supervisory agencies that have supervisory responsibility over relevant parts of the parallel-owned banking organization.

DOMESTIC AND FOREIGN SUBSIDIARIES

Domestic subsidiaries are any majority-owned companies, other than Edge Act or agreement corporations, domiciled in the United States and its territories and possessions. Foreign subsidiaries are any majority-owned or -controlled companies domiciled in a foreign country or any Edge Act or agreement corporation. Section 211.13 of Regulation K (12 CFR 211.13) requires foreign subsidiaries to maintain effective systems of records, controls, and reports to keep bank management informed of their activities and conditions. In particular, these systems are to provide information on risk assets, exposure to market risk, liquidity management, operations, internal controls, and conformance with management policies. Reports on risk assets must be sufficient enough to allow for an appraisal of credit quality and an assessment of exposure to loss; for that purpose, they must provide full information on the condition of material borrowers. Reports on the operations and controls are to include internal and external audits of the branch or subsidiary.

On-site examinations of foreign subsidiaries are sometimes precluded because of objections voiced by foreign directors, minority shareholders, or local bank supervisors. In addition, secrecy laws in countries such as Switzerland, Singapore, Luxembourg, and the Bahamas sometimes preclude on-site examinations. When on-site examinations cannot be performed, foreign subsidiary reports submitted according to section 211.13 and reports submitted to foreign banking authorities must serve as the basis for evaluating the bank's investment.

Additionally, Regulation K allows for investments in foreign companies to be made under the general-consent provisions without prior approval of the Board. These investments can be sizeable and can pose significant risk to the banking organization. Investments in foreign subsidiaries should be reviewed for compliance with the FRA and investment limitations in Regulation K. (See Regulation K, sections 211.8 and 211.9.)

SIGNIFICANT SUBSIDIARIES

As used in the consolidation instructions for certain regulatory reports, ''significant subsidiaries'' refers to subsidiaries that meet any one of the following tests:

- a majority-owned subsidiary in which the bank's direct and indirect investment and advances represent 5 percent or more of the parent bank's equity capital accounts
- a majority-owned subsidiary whose gross operating revenues amount to 5 percent or more of the parent bank's gross operating revenues
- a majority-owned subsidiary whose ''income (loss) before income taxes and securities gains

or losses'' amounts to 5 percent or more of the parent bank's ''income (loss) before income taxes and securities gains or losses''

- a majority-owned subsidiary that is the parent of one or more subsidiaries that, when consolidated, constitute a ''significant subsidiary'' as defined above

ASSOCIATED COMPANIES

Associated companies are those in which the bank directly or indirectly owns 20 to 50 percent of the outstanding common stock, unless the bank can rebut to the Federal Reserve the presumption of exercising significant influence. However, as noted above, for purposes of section 23A, affiliation is defined by 25 percent share ownership. Because of the absence of direct or indirect control, regulators have no legal authority to conduct full examinations of this type of company. Investments in these companies are generally appraised in the same way as commercial loans, that is, by a credit analysis of the underlying financial information.

CHAIN BANKING SYSTEMS

Chain banking systems exist when an individual (or group of individuals) is a principal in two or more banking institutions, in either banks or bank holding companies or a combination of both types of institutions. In these systems, the possibility exists that problems in one or more of the entities may adversely affect the safety and soundness of the bank entities because of pressure exerted by their common principal (or principals). Examiners should determine whether the bank is a member of a chain. If so, the extent of its relationship with other links of the chain should be determined, as well as the effects these relationships have on the bank.

REAL ESTATE INVESTMENT TRUSTS AND OTHER RELATED ORGANIZATIONS

Although a bank, its parent holding company, or its nonbank affiliate may not have a direct investment in an ''other related organization,'' the bank may sponsor, advise, or influence the activities of these companies. The most notable examples are real estate investment trusts (REITs) or special-purpose vehicles (SPVs). Transactions between the bank and REITs and between other investment companies sponsored or advised by the bank are subject to the limitations in section 23A. In other cases, because of nonownership or a less-than-majority ownership, legal authority to conduct an examination does not exist.

A REIT may be considered an affiliate if it is sponsored and advised on a contractual basis by the member bank or by any subsidiary or affiliate of the member bank. In these cases, transactions between the bank and an affiliated REIT are subject to the requirements of section 23A. Because a REIT frequently carries a name that closely identifies it with its sponsoring bank or bank holding company, failure of the REIT could have an adverse impact on public confidence in the holding company and its subsidiaries.

The examiner should be aware of all significant transactions between the bank under examination and its related REIT in order to determine conflicts of interest and contingent risks. In several instances, REITs have encountered serious financial problems and have attempted to avoid failure by selling questionable assets to or swapping these assets with their bank affiliates. In other instances, because of the adversary relationship, REITs have been encouraged to purchase assets of inferior quality from their related organizations.

FINANCIAL HOLDING COMPANIES

Section 4(k) of the BHC Act authorizes affiliations among banks, securities firms, insurance firms, and other financial companies. It provides for the formation of financial holding companies (FHCs) and allows a BHC or foreign bank that qualifies as an FHC to engage in a broad range of activities that are (1) defined by the GLB Act to be financial in nature or incidental to a financial activity, or (2) determined by the Board, in consultation with the Secretary of the Treasury, to be financial in nature or incidental to a financial activity, or that are determined by the Board to be complementary to a financial activity and not to pose a substantial risk to the safety and soundness of depository institutions or the financial system generally.

Certain conditions must be met for a BHC or a foreign bank to be deemed an FHC and to engage in the expanded activities. BHCs that do not qualify as FHCs are limited to engaging in those nonbanking activities that are permissible under section 4(c)(8) of the BHC Act. Section 4(k) of the BHC Act authorizes an FHC to engage in designated financial activities, including insurance and securities underwriting and agency activities, securities underwriting, merchant banking, and insurance company portfolio investment activities.

Supervisory Oversight

The Federal Reserve has supervisory oversight authority and responsibility for BHCs that operate as FHCs and for BHCs that are not FHCs. The GLB Act sets parameters for operating relationships between the Federal Reserve and other regulators. The statute differentiates between the Federal Reserve's relations with (1) depository institution regulators and (2) functional regulators, which include insurance, securities, and commodities regulators. The Federal Reserve's relationships with functional regulators will, in practice, depend on the extent to which an FHC is engaged in functionally regulated activities; those relationships will also be influenced by existing working arrangements between the Board and the functional regulator.

The Federal Reserve's supervisory oversight role is that of an umbrella supervisor concentrating on a consolidated or group-wide analysis of an organization. Umbrella supervision is not an extension of more traditional bank-like supervision throughout an FHC. The FHC framework is consistent with and incorporates principles that are well established for BHCs. The FHC supervisory policy focuses on addressing supervisory practice for and relationships with FHCs, particularly those that are engaged in securities or insurance activities. (See SR-00-13.)

The Federal Reserve is responsible for the consolidated supervision of FHCs. The Federal Reserve thus assesses the holding company on a consolidated or group-wide basis. The objective is to ensure that the holding company does not threaten the viability of its depository institution subsidiaries. Depository institution subsidiaries of FHCs are supervised by their appropriate primary bank or thrift supervisor (federal and state). However, the GLB Act did not change the Federal Reserve's role as the federal bank holding company supervisor.

Nonbank (or nonthrift) subsidiaries engaged in securities, commodities, or insurance activities are to be supervised by their appropriate functional regulators. Examples of these functionally regulated subsidiaries include a broker, dealer, investment adviser, and investment company registered with and regulated by the Securities and Exchange Commission (SEC) (or, in the case of an investment adviser, registered with any state); an insurance company or insurance agent subject to supervision by a state insurance regulator; and a nonbank subsidiary engaged in activities regulated by the Commodity Futures Trading Commission (CFTC).

As the umbrella supervisor, the Federal Reserve will seek to determine that FHCs are operated in a safe and sound manner so that their financial condition does not threaten the viability of affiliated depository institutions. Oversight of FHCs (particularly those engaged in a broad range of financial activities) at the consolidated level is important because the risks associated with an FHC's activities can cut across legal entities and business lines. The purpose of FHC supervision is to identify and evaluate, on a consolidated or group-wide basis, the significant risks that exist in a diversified holding company to assess how these risks might affect the safety and soundness of depository institution subsidiaries.

The Federal Reserve's focus will be on the financial strength and stability of FHCs, their consolidated risk-management processes, and overall capital adequacy. The Federal Reserve will review and assess internal policies, reports, and procedures, as well as the effectiveness of the FHC consolidated risk-management process. The appropriate bank, thrift, or functional regulator will continue to have primary responsibility for evaluating risks, hedging, and risk management at the legal-entity level for the entity or entities that it supervises.

Permissible Activities

Permissible activities for FHCs include any activity that the Board determined to be closely related to banking under section 4(c)(8) of the BHC Act by regulation or order that was in effect on November 12, 1999. This includes the long-standing "laundry list" of nonbanking activities for BHCs. (See section 225.28(b) of Regulation Y.) Section 225.86(a)(2) of Regulation Y lists the nonbanking activities approved for BHCs by Board order as of November 12, 1999.[11]

Section 4(k)(4)(G) of the BHC Act also defines "financial in nature" as any activity (1) in which a BHC may engage outside the United States, and (2) that the Board has determined, by regulation or interpretations issued under section (4)(c)(13) of the BHC Act that were in effect on November 11, 1999, to be usual in conducting banking or other financial services abroad. Section 225.86(b) of Regulation Y lists three activities that the Board has found to be usual in connection with the transaction of banking or other financial operations abroad.[12] The activities are providing management consulting services; operating a travel agency; and organizing, sponsoring, and managing a mutual fund. The conduct of each activity has certain prescribed limitations. Management consulting services must be advisory and not allow the FHC to control the person to whom the services are provided. These services, however, may be offered to any person on nonfinancial matters. An FHC may also operate a travel agency in connection with financial services offered by the FHC or others. Finally, a mutual fund organized, sponsored, or managed by an FHC may not

11. Section 20 company activities are not included in this list. Section 4(k)(4)(E) of the BHC Act authorizes FHCs to engage in securities underwriting, dealing, and market-making activities in a broader form than was previously authorized by Board order.

12. See section 211.10 of Regulation K (12 CFR 211.10).

exercise managerial control over the companies in which the fund invests, and the FHC must reduce its ownership of the fund, if any, to less than 25 percent of the equity of the fund within one year of sponsoring the fund (or within such additional period as the Board permits).

The activities that a BHC is authorized to engage in outside the United States under section 211.10 of Regulation K have been either (1) authorized for FHCs in a broader form by the GLB Act (for example, underwriting, distributing, and dealing in securities and underwriting various types of insurance) or (2) authorized in the same or a broader form in Regulation Y (for example, data processing activities; real and personal property leasing; and acting as agent, broker, or adviser in leasing property). Section 4(k)(4)(G) of the BHC Act and section 225.86 of Regulation Y only authorize FHCs to engage in the activities that are listed in section 211.10 of Regulation K, as interpreted by the Board. The Board has also approved activities found in individual orders issued under section 4(c)(13) of the BHC Act. Section 4(k)(4)(G) and Regulation Y do not authorize an FHC to engage in activities that the Board authorized a BHC to provide in individual orders issued under section 4(c)(13) of the BHC Act.

The remaining activities authorized by section 4(k)(4) of the BHC Act are those that are defined to be ‘‘financial in nature’’ under section 4(k)(4)(A) through (E), (H), and (I). (See section 225.86(c) of Regulation Y.) These activities include issuing annuity products and acting as principal, agent, or broker for purposes of insuring, guaranteeing, or indemnifying against loss, harm, damage, illness, disability, or death. Permissible insurance activities as principal include reinsuring insurance products. An FHC acting under section 4(k)(4) of the BHC Act may conduct insurance activities without regard to the restrictions on the insurance activities imposed on BHCs under section 4(c)(8). (See section 3905.0 of the *Bank Holding Company Supervision Manual* for more information pertaining to the activities of FHCs.)

BANK HOLDING COMPANIES

As defined in section 2 of the BHC Act of 1956 (12 USC 1841 et seq.), a bank holding company is any company that directly or indirectly, or acting through one or more other persons, owns, controls, or has power to vote 25 percent or more of any class of voting securities of the bank or company; that controls in any manner the election of a majority of the directors or trustees of the bank or company; or that the Board determines, after notice and opportunity for hearing, directly or indirectly exercises controlling influence over the management or policies of the bank or company. A bank and its parent holding company are considered affiliates when the holding company controls the bank in a manner consistent with the definition of control in section 23A of the FRA. Section 23A exempts from the quantitative and collateral requirements of the law all transactions (except for the purchase of low-quality assets) between ‘‘sister’’ banks (banks with 80 percent or more common ownership) in a bank holding company system. A low-quality asset is any asset (1) classified ‘‘substandard,’’ ‘‘doubtful,’’ or ‘‘loss’’ or treated as ‘‘other loans especially mentioned’’ in the most recent federal or state examination report; (2) on nonaccrual status; (3) with principal or interest payments more than 30 days past due; or (4) whose terms have been renegotiated or compromised due to the deteriorated financial condition of the borrower.

Under the BHC Act, the Federal Reserve has authority to examine bank holding companies and their nonbank subsidiaries. The Federal Reserve requires periodic inspections of all bank holding companies, the frequency of which is based on the size, complexity, and condition of the organization. Often a bank holding company is inspected at the same time as the examination of its state member bank subsidiaries. In these cases, the examiner at the bank should collaborate closely with inspection personnel on those holding company issues that directly affect the condition of the bank. When the BHC inspection is not conducted simultaneously with the examination, the bank examiner should closely review the most recent report of inspection and may also need to consult the Y-series of reports regularly submitted to the Federal Reserve System by bank holding companies.

Many banks are owned by bank holding companies. To understand the effects of the holding company structure on the subsidiary bank, the examiner should evaluate the overall financial support provided by the parent company, quality of supervision and centralized functions provided, and appropriateness of intercompany transactions. Since financial and managerial issues at the bank holding company and subsidiary bank levels are so closely connected, it is strongly recommended that a holding company inspection and its respective bank examination (or examinations) be conducted at the same time. A combined examination/inspection report, as discussed in SR-94-46, is available to facilitate this coordination when the lead subsidiary is a state member bank.

Financial Support

The holding company structure can provide its subsidiary bank with strong financial support because of its greater ability to attract and shift funds to less capital-intensive areas and to enter markets in a wider geographic area than would otherwise be possible. Financial support may take the form of capital (equity or debt) or funding of loans and investments. In general, the lower the parent bank holding company's leverage, the more it is able to serve as a source of financial strength to its bank subsidiaries. This is because less cash flow will be required from the banks for debt servicing, and the parent has more borrowing capacity, which could be used to provide funds to the bank. When the financial condition of the holding company or its nonbanking subsidiaries is unsound, the operations of its subsidiary bank can be adversely affected. To service its debt or provide support to another subsidiary that is experiencing financial difficulty, the holding company may involve its bank subsidiary in the following imprudent actions:

- engaging in high-risk investments to obtain increased yields
- purchasing or swapping its high-quality assets for the parent's or other affiliate's lower-quality assets
- entering into intercompany transactions that are detrimental because of inordinately high fees or inadequate or unnecessary services
- paying excessive dividends
- making improper tax payments or unfavorably altering its tax situation

Even when the holding company's structure is financially sound, the holding company's ability to sell short- or long-term debt and to pass the proceeds down to its bank subsidiary in the form of equity capital may still present problems. That procedure is frequently referred to as "double leveraging," the amount of the equity investment in the bank subsidiary is financed by debt. Problems may arise when the holding company must service its debt out of dividends from the subsidiary, and the subsidiary, if it encounters an earnings problem or is prevented by regulatory agreement or action, may not be able to pass dividends up to its parent.

Another potential problem may develop when the holding company sells its commercial paper and funds its subsidiary's loans with those proceeds. This may cause a liquidity problem if the maturities of the commercial paper sold and loans funded are not matched appropriately and if the volume of such funding is large in relation to the subsidiary's overall operations.

On April 24, 1987, the Federal Reserve adopted a policy statement on the responsibility of bank holding companies to act as sources of financial and managerial strength to their subsidiary banks. The Board's statement reiterates a general policy that has been expressed on numerous occasions, in accordance with authority that is provided under the BHC Act and the enforcement provisions of the FDI Act.

BHC Supervision of Subsidiaries

Bank holding companies use a variety of methods to supervise their bank subsidiaries, including—

- having holding company senior officers serve as directors on the bank's board;
- establishing reporting lines from senior bank management to corporate staff;
- formulating or providing input into key policies; and
- establishing management information systems, including internal audit and loan review.

As part of the evaluation of bank management, the examiner should be aware of these various control mechanisms and determine whether they are beneficial to the bank. Examiners should keep in mind that, even in a bank holding company organization, the directors and senior management of the bank are ultimately responsible for operating it in a safe and sound manner.

In addition, many bank functions (investment management, asset/liability management, human resources, operations, internal audit, and loan review) may be performed on behalf of the bank by its parent bank holding company or by a nonbank affiliate. These functions are reviewed at inspections of the bank holding company. Examiners at the bank should be aware of the evaluation of these functions by inspection personnel, either at a concurrent inspection or in the report of a prior inspection. In addition, a review of these same issues at the level of the subsidiary bank is useful to determine compliance with corporate policies, corroborate inspection findings, and identify any inappropriate transactions that may have been overlooked in the more general, top-down review at the parent level.

EVALUATION OF INVESTMENTS IN AND LOANS TO BANK-RELATED ORGANIZATIONS

To properly evaluate affiliates and other bank-related organizations[13] relative to the overall condition of the bank, the examiner must—

- know the applicable laws and regulations that define and establish limitations with respect to investments in and extensions of credit to affiliates and
- analyze thoroughly the propriety of the related organizations' carrying value, the nature of the relationships between the bank and its related organizations, and the effect of such relationships on the affairs and soundness of the bank.

The propriety of the carrying value of a bank's investment in any related organization is determined by evaluating the balance sheet and income statement of the company in which the bank has the investment. At times, this may not seem important in relation to the overall condition of the bank because the amount invested may be small relative to the bank's capital. It may appear that a cursory appraisal of the company's assets would therefore be sufficient. However, the opposite is often true. Even though a bank's investment in a subsidiary or associated company is relatively small, the underlying legal or moral obligation may be substantial and may greatly exceed the total amount of the reported investment. If the subsidiary experiences large losses, the bank may have to recapitalize the subsidiary by injecting much more than its original investment to protect unaffiliated creditors of the subsidiary or protect its own reputation.

When examining and evaluating the bank's investment in and loans to related organizations, classified assets held by such companies should first be related to the capital structure of the company, and then be used as a basis for classifying the bank's investment in and loans to that company.

One problem that examiners may encounter when they attempt to evaluate the assets of some subsidiaries and associated companies is inadequate on-premises information. This may be especially true of foreign investments and associated companies in which the bank has less than a majority interest. In those instances, the examiner should request that adequate information be obtained during the examination and should establish agreed-on standards for that information in the future. The examiner should insist that the organization have adequate supporting information readily obtainable or available in the bank and that the information be of sufficient quality to allow for an informed evaluation of the investment. Bank management, as well as regulatory authorities, must be adequately informed of the condition of the companies in which the bank has an investment. For subsidiary companies, it is necessary that bank representatives be a party to policy decisions, have some on-premises control of the company (such as board representation), and have audit authority. In the case of an associated company, the bank should participate in company affairs to the extent practicable. Information documenting the nature, direction, and current financial status of all such companies should be maintained at the bank's head office or maintained regionally for global companies. Full audits by reputable certified public accountants are often used to provide much of this information.

For foreign subsidiaries, in addition to the audited financial information prepared for management, the bank should have on file the following:

13. Information about related organizations and interlocking directorates and officers can be obtained from the bank holding company form FR Y-6 and SEC form 10-K, if applicable, or from other required domestic and foreign regulatory reports. Further information on business interests of directors and principal officers of the bank can be obtained by reviewing information maintained by the bank in accordance with the Board's Regulation O.

- reports prepared according to the Board's Regulation K
- reports prepared for foreign regulatory authorities
- information on the country's cultural and legal influence on banking activities, current economic conditions, anticipated relaxation or strengthening of capital or exchange controls, fiscal policy, political goals, and the risk of expropriation
- adequate information to review compliance with the investment provisions of Regulation K (For each investment, information should be provided on the type of investment (equity, binding commitments, capital contributions, subordinated debt), dollar amount of the investment, percentage ownership, activities conducted by the company, legal authority for such activities, and whether the investment was made under Regulation K's general-consent, prior-notice, or specific-consent procedures. With respect to investments made under the general-consent authority, information also must be maintained that demonstrates compliance with the various limits set out in section 211.9 of Regulation K. (See Regulation K, sections 211.8 and 211.9.)

For agricultural credit corporations, the examiner-in-charge normally decides when to examine such an entity. A complete analysis of the entity's activities should always be performed if—

- the corporation is not supervised by the Federal Intermediate Credit Bank (FICB),
- the most recent FICB examination occurred over a year ago, or
- the most recent FICB examination indicates that the corporation is in less than satisfactory condition.

The extent of any analysis should be based on the examiner's assessment of the corporation's effect on the parent bank. That analysis should include, but not be limited to, a review of—

- asset quality;
- the volatility, maturity, and interest-rate sensitivity of the asset and liability structures; and
- the bank's liability for guarantees issued on behalf of the corporation.

When the same borrower is receiving funds from both the corporation and the parent bank, and the combined exposure exceeds 25 percent of total consolidated capital, the debt should be detailed on the concentration page of the examination report. The consolidation procedures listed in the instructions for the preparation of Consolidated Reports of Condition and Income should be used when consolidating the figures of the corporation with those of its parent.

INTERCOMPANY TRANSACTIONS

As with the supervision of subsidiaries, intercompany transactions should be reviewed at both the parent level during inspections and at the subsidiary-bank level during examinations. The transactions should comply with sections 23A and 23B of the FRA and should not otherwise adversely affect the financial condition of the bank.

Intercompany Tax Payments

As set forth in the policy statement regarding intercorporate income tax accounting transactions of bank holding companies and state-chartered banks that are members of the Federal Reserve System (September 20, 1978), Federal Reserve policy relative to intercompany tax payments is to treat the bank as a separate taxpayer whose tax payments to its parent should not exceed payments it would make on a separate-entity basis. Payments should not be made to the parent before the time payments are or would have been made to the Internal Revenue Service. Refunds to the bank should be timely. Individual situations may result in complicated issues, and the examiner should consult with Reserve Bank personnel before reaching conclusions concerning a particular transaction. Bank holding company inspection report comments and bank examination report comments should be consistent concerning the nature and propriety of intercompany transactions.

Management and Other Fees

Banks often obtain goods and services from the parent bank holding company or an affiliated nonbank subsidiary. These arrangements may benefit the bank, since the supplier may offer lower costs because of economies of scale, such as volume dealing. Furthermore, banks may be able to purchase a package of services that otherwise might not be available. However, because of the interrelationship between the bank and the supplier, examiners should ensure that the fees being paid represent reasonable reimbursement for goods and services received. Fees paid by the bank to the parent or nonbank affiliates should have a direct relationship to, and be based solely on, the fair value of goods and services provided and a reasonable profit. Fees should compensate the affiliated supplier only for providing goods and services that meet the legitimate needs of the bank.

Banks should retain satisfactory records that substantiate the value of goods and services received, their benefit to the bank, and their cost efficiencies. There are no other minimum requirements for records, but an examiner should be able to review the records maintained and determine that fees represent reasonable payment. In general, the supplier will decide on the amount to be charged by using one of three methods:

- reimbursement for cost of goods or services
- cost plus a reasonable profit margin
- comparative fair-market value

Any of these methods may be acceptable as long as the bank can substantiate that the fees paid are reasonable for the value received. Basing fees on costs may be the most common approach since market comparisons often are difficult to obtain. A holding company may be able to offer a number of services on a cost basis to a subsidiary bank, any one of which might be contracted elsewhere for less. However, in the aggregate, the services may be cost effective or produce economies of scale for the entire organization. Nevertheless, having one or more subsidiary banks pay excessive fees for services to subsidize other unprofitable operations is not an acceptable practice.

When the servicer incurs overhead expenses, recovery of those costs is acceptable to the extent they represent a legitimate and integral part of the service rendered. Overhead includes salaries and wages, occupancy expenses, utilities, payroll taxes, supplies, and advertising. Debt-service requirements of holding companies, shareholders, or other related organizations are not legitimate overhead expenses for a subsidiary bank.

Generally, the payment of excessive fees is considered an unsafe and unsound practice. When fees are not justified, appear excessive, do not serve legitimate needs, or are otherwise abusive, the examiner should inform the board of directors through appropriate criticism in the report of examination.

Dividends

Dividends represent a highly visible cash outflow by banks. If the dividend-payout ratio exceeds the level at which the growth of retained earnings can keep pace with the growth of assets, the bank's capital ratios will deteriorate. Examiners should evaluate the appropriateness of dividends relative to the bank's financial condition, prospects, and asset-growth forecast.

Purchases or Swaps of Assets

Asset purchases or swaps between affiliates create the potential for abuse. Regulatory concern focuses on the fairness of such asset transactions, their financial impact, and timing. Fairness and financial considerations include the quality and collectibility of such assets and liquidity effects. Asset exchanges may be a mechanism to avoid regulations designed to protect subsidiary banks from becoming overburdened with nonearning assets.

Compensating Balances

A subsidiary bank may be required to maintain excess balances at a correspondent bank that lends to other parts of the holding company organization, possibly to the detriment of the bank. The subsidiary bank may be foregoing earnings on such excess funds, which may adversely affect its financial condition.

Split-Dollar Life Insurance

Split-dollar life insurance is a type of life insurance in which the purchaser of the policy pays at least part of the insurance premiums and is entitled to only a portion of the cash surrender value, or death benefit, or both. In some circumstances, when the subsidiary bank pays all or substantially all of the insurance premiums, an unsecured extension of credit from the bank to its parent holding company generally results because the bank has paid the holding company's portion of the premium, and the bank will not be fully reimbursed until later. In other arrangements, when the parent uses the insurance policy as collateral for loans from the subsidiary bank, the loan may not meet the collateral requirements of section 23A. In addition, split-dollar arrangements may not comply with section 23B if the return to the bank is not commensurate with the size and nature of its financial commitment. Finally, split-dollar arrangements may be considered unsafe and unsound, which could be the case if the bank is paying the entire premium but is not the beneficiary, or if it receives less than the entire proceeds of the policy. (See SR-93-37.)

Other Transactions with Affiliates

Checking accounts of the parent or nonbank subsidiaries at subsidiary banks present the potential for overdrafts, which are regarded as unsecured extensions of credit to an affiliate by the subsidiary bank. In general, a subsidiary bank should be adequately compensated for its services or for the use of its facilities and personnel by other parts of the holding company organization. In addition, a subsidiary bank should not pay for expenses for which it does not receive a benefit (for example, the formation expenses of a one-bank holding company).

Situations sometimes arise in which more than one legal entity in a banking organization shares offices or staff. In certain cases, it can be hard to determine whether a legal entity is operating within the scope of its permissible activities. In addition, a counterparty may be unclear as to which legal entity an employee is representing. Finally, there may be expense-allocation problems and, thus, issues pertaining to sections 23A and 23B. Examiners should be aware of these concerns and make sure that institutions have the proper records and internal controls to ensure an adequate separation of legal entities. (See SR-95-34.)

Bank-Related Organizations

Examination Objectives

Effective date May 2001

Section 4050.2

1. To determine if policies, procedures, and internal controls for bank-related organizations are adequate.
2. To determine if bank and affiliate management are complying with the established policies.
3. To determine compliance with sections 23A and 23B of the Federal Reserve Act and other applicable laws and regulations involving intercompany and other transactions.
4. To evaluate the bank's investment in and loans to its related organizations, as well as the propriety of those carrying values.
5. To determine the relationships between the bank and its related organizations and the effects of those relationships on the operations and safety and soundness of the bank.
6. To initiate corrective action when policies, practices, procedures, or internal controls are deficient or when violations of law or regulations have been noted.

PRE-EXAMINATION ANALYSIS

During the pre-examination analysis of the bank, it should be determined which related organizations should be examined in depth. The criteria for that determination are as follows:

1. All operating subsidiaries should be examined concurrently with the regular examination of the parent bank, unless such examination is specifically waived by the Federal Reserve Bank.
2. Other subsidiaries should be examined except when relationships between the subsidiary, its parent, and other related organizations are fully disclosed by material on hand and when the subsidiary's condition or operations are determined not to be detrimental to the safety and soundness of the bank. Factors to be considered in making the determination to examine a subsidiary are as follows:
   a. the bank's percent of ownership and dollar amount of investment in the subsidiary
   b. nature of the subsidiary's business
   c. types and amounts of intercompany transactions
   d. types and amounts of participations and purchased, sold, or swapped assets between the subsidiary and the bank or other related organizations
   e. types of services performed by the subsidiary for the bank or other related organizations
   f. outstanding contingent liabilities by the bank in favor of the subsidiary
   g. the bank's potential contingent liabilities, moral or legal, as a result of litigation, claims, or assessments pending against the subsidiary
3. If practical under the circumstances, the parent holding company and nonbank affiliates should be inspected in conjunction with the examination of the lead state member bank. The decision to coordinate the timing of the bank holding company inspection and the state member bank examination should be based on the nature and extent of interaction between the bank and its parent holding company and nonbank affiliates. Factors to be considered in making the decision to coordinate the examination and inspection are as follows:
   a. dollar amount of loans or advances by the bank
   b. nature of business of the nonbank affiliates
   c. types and amount of intercompany transactions
   d. types and amounts of participations and other assets purchased, sold, or swapped
   e. types of services performed for or by the bank and fees paid or received
   f. outstanding contingent liabilities by the bank in favor of its parent or nonbank affiliates

   Factors to be considered in determining whether to examine nonbanking subsidiaries within the parent holding company under inspection are detailed in the *Bank Holding Company Supervision Manual*.

EXAMINATION PROCEDURES FOR RELATED ORGANIZATIONS

The following procedural steps should be performed in all banks that have related organizations.

1. If selected for implementation, complete or update the bank-related organizations section of the internal control questionnaire.
2. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examination procedures.
3. When appropriate, obtain the following reports or forms prepared or filed since the preceding examination:
   a. annual report on SEC Form 10-K
   b. current report on SEC Form 8-K
   c. quarterly report on SEC Form 10-Q
   d. quarterly report on Federal Reserve Form Y-8
   e. annual fiscal year-end report on Federal Reserve Form Y-6
   f. annual report to shareholders
   g. required reports under Federal Reserve Regulation K and to foreign banking authorities for foreign subsidiaries

h. subsidiary and affiliate reports prepared by examiners
i. federal reports of examination for nonbanking subsidiaries

4. Request that the bank provide a list of the names of all related organizations; the list should set forth the loans to and investments in these organizations and any management official interlocks among these organizations and the banks.
5. Circulate a list of the names of the related organizations and the loans to and investments in these organizations. This list should be circulated among the examiners assigned to each bank department. The accuracy and completeness of this information should be verified by the recipients.
6. Obtain, from the examiners assigned to other assets and other liabilities, information concerning receivables from or payables to related organizations.
7. Review the bank's files and reports obtained in step 3, and transcribe for the workpapers pertinent financial data and comments regarding related organizations.
8. Review fees paid by the bank to related organizations, bank insider–related organizations, and stockholders. Determine that the fees represent reasonable reimbursement for goods and services received by—
   a. determining the method used to compute the charge to the bank for goods or services (cost, cost plus profit, fair market value),
   b. reviewing documentation maintained by the bank to substantiate the fair value of the goods or services received, their benefit to the bank, and the cost efficiencies of the alternative selected,
   c. comparing the schedule of fees currently in effect with those in effect 12 months ago, and
   d. comparing the fees paid during the last three months with those paid for the same period one year ago.
9. On the basis of the information obtained above, review the following for each related organization:
   a. the quality of loans, investments, and future commitments to any related organization
   b. the nature and volume of transactions between the related organization and the bank and—
      - the extent of any participations and the purchase, sale, or swap of assets between the bank and the related organizations, as well as the propriety of the transactions and related considerations;
      - the fees these organizations charge the bank for services rendered and the reasonableness of those fees;
      - cash transfers to or from a related organization in connection with a consolidated income tax obligation (Amounts paid should be based on that amount due if a separate return was filed. They should be paid only at such time to reasonably permit required estimated payments or final settlements to be made to the IRS.);
      - fees received by the bank from the organization for the use of bank personnel, premises, marketing services, and equipment, and the adequacy of those fees; and
      - any agreements, guarantees, pledges, or hypothecations between the bank and any related organization, if they are properly reflected on the books of the bank, and whether there are any apparent conflicts of interest.
   c. litigation, when the related organization is a defendant in a suit and if the litigation could have an adverse effect on the bank (from SEC Form 10-K or another source)
   d. each interlocking officer and/or director relationship as reflected by the information obtained in step 4. Determine—
      - whether fees or salaries are excessive for duties performed and
      - if adequate time is devoted to management responsibilities.
10. *Section 23A of the Federal Reserve Act (12 USC 371c), Relations with Affiliates, and the Board's Regulation W.* By coordinating work with the examiners assigned to the various loan areas, determine compliance with laws and regulations pertaining to related organizations by performing the following procedures.
    a. Obtain a listing of loans to affiliates.
    b. Compare the listing with the bank's customer liability records to determine the list's accuracy and completeness.
    c. Obtain a listing of other covered transactions with affiliates (that is, purchase of securities issued by an affiliate, pur-

chase of assets, acceptance of securities issued by an affiliate as collateral for a loan to any person or company, or the issuance of a guarantee, acceptance, or letter of credit on behalf of an affiliate).

d. Conduct transaction testing of intercompany affiliate transactions[1] for compliance with the limitations of section 23A of the Federal Reserve Act and the Board's Regulation W (see SR-03-02) by—
   - reviewing—
     - the time elapsed between the original issuance of the affiliate's debt securities and the bank's purchase,
     - the existence of any relevant agreements or relationships between the bank and the third-party seller of the affiliate's debt securities,
     - any history of bank financing of the affiliate, and
     - any other relevant information;
   - documenting any violations or potential violations, and reaching an agreement with the directors and senior management to resolve violations quickly; and
   - considering the inclusion of "other transfer-risk problem" (OTRP) assets in the evaluation of asset quality and capital adequacy. (See section 7040.1 for a discussion of OTRP credits.)

e. Ensure that transactions with affiliates meet the collateral requirements of section 23A.

f. Ensure that low-quality loans have not been purchased from an affiliate.

g. Determine that all transactions with affiliates are on terms and conditions that are consistent with safe and sound banking practices.

h. *Policies and procedures.*
   - Obtain the bank's policies and procedures to determine compliance with sections 23A and 23B of the Federal Reserve Act.
   - Ensure the policies and procedures cover all relevant affiliates (e.g., financial subsidiaries and joint ventures) and transactions covered by section 23A, and verify that the bank treats "sponsored and advised" companies as affiliates ("Sponsored and advised" companies would include, at a minimum, any company that receives investment advice and administrative services on a contractual basis from a member bank, whose trustees or managers are selected by the bank, and that has a name similar to that of the bank.).
   - Ensure that the policies and procedures are comprehensive and include adequate controls—
     - to identify covered transactions and
     - to ensure that necessary steps are performed for identified transactions (e.g., the required collateralization of loans to affiliates).

i. *Covered transactions.*
   - If the controls for section 23A are considered adequate, use the list of covered transactions provided by the bank.
   - If controls are considered inadequate (for example, for transactions testing), review the bank's general ledger to identify transactions that are covered transactions.
   - Verify that covered transactions count against required limits and are collateralized when required.
   - If the bank uses an internal rating system for its assets, determine that the bank has not deferred or altered an asset's rating to facilitate sale of the asset to an affiliate.
   - Review controls for monitoring compliance with the established limits and for collateralizing required credit-extension transactions.
   - If controls are considered inadequate (for example, for transactions testing), ensure that covered transactions are properly valued.
   - Verify that identified covered transactions comply with the limits of sections 23A and 23B (If the covered transactions do not comply with the

1. Examples of affiliates include a bank holding company and its nonbank subsidiaries, companies under the member bank's control (see Regulation W, section 223.3(g)), any mutual fund advised by a member bank, merchant banking investments, a member bank or affiliate serving as a general partner in a partnership, and affiliates' subsidiaries. In addition, certain joint venture companies, ESOPs of banks and their affiliates, and special-purpose entities are affiliates if the regulatory definitions of control are met.

limits, criticize the bank for inadequate controls, and discuss what steps the bank will use to correct the violations.).
- Obtain collateral listings, and verify that necessary covered transactions are adequately collateralized:
  — Verify that the values of omnibus deposit accounts used to secure covered transactions are sufficient to fully secure the relevant covered transactions.
  — Review collateral documentation to ensure that the bank's interest is adequately perfected and prioritized (Regulation W, section 223.14(d)).

j. *Corporate lending (funding).* Ensure that there is compliance with the collateral requirements and quantitative limits:
- Obtain the bank's "trial balances" of loans.
- Check that loans to affiliates are included on the list of ''covered transactions'' and included in measurements for compliance with the quantitative limits. If some loans are not included, ascertain why.
- If an exemption is being used, verify that its application is correct.
- Verify that the loans are collateralized (using collateral listings), and review the documentation to ensure proper collateralization.

k. *Verification of exemptions.*
- For renewal of participations involving problem loans (see Regulation W, section 223.15(b)) involving nondepository affiliates, review supporting documentation to ensure that—
  — the loan was not low quality at the time the bank purchased the participation,
  — the renewal is approved at the board committee or senior management level as appropriate, and
  — the bank's share of the renewal does not exceed its original share by more than 5 percent (unless approved by an appropriate federal bank regulator) and that the bank notified the federal bank regulator within 20 days.
- For retail lending (e.g., credit cards and mortgage banking) involving the funding of loans and the purchase of loans, ensure compliance with quantitative limits (for funding and compliance with collateral requirements) as follows:
  — For credit card examinations, obtain the ''trial balances'' of the outstanding balances, and for mortgage banking exams, obtain lists of the loans sold.
  — Check that credit card amounts generated by bank affiliates and mortgage loans sold to the bank by affiliates are included on the list of covered transactions and in measurements for compliance with the quantitative limits. If they are not included, ascertain why.
  — If an exemption is being used, verify that its use is correct.
  — Verify that loans are collateralized (using collateral), and review the documentation to ensure proper collateralization.
- For the general-purpose credit card exemption (Regulation W, section 223.16(c)(4)), verify, through review of relevant documentation, that the bank can demonstrate that its credit card meets the less than 25 percent test through one of three available methods. (An exemption from the attribution rule for extensions of credit under a general-purpose credit card is defined as one on which ''less than 25 percent of the aggregate amount of purchases are purchases from a bank affiliate.'')
  — The bank has no commercial affiliates.
  — The bank establishes systems to verify compliance with the less than 25 percent test on an ongoing basis.
  — The bank presents information to the Board of Governors to demonstrate its card would comply.
- For purchases of extensions of credit—the ''250.250 exemption'' (Regulation W, section 223.42(k))—review supporting documentation to ensure that—
  — the member bank makes an independent creditworthiness evaluation before the affiliate makes or commites to make the loan,

  - the bank commits to make the loan purchase before the affiliate makes the loan,
  - the bank does not make a blanket advance commitment to purchase loans, and
  - the purchases from the affiliate by the depository institution and all depository institution affiliates in the prior 12 months represent 50 percent or less of all loans originated by the affiliate during such period.

l. If the bank is critically undercapitalized (under prompt-corrective-action rules), determine if the bank has engaged in any covered transaction, as defined in section 23A, without the prior approval of the FDIC or FRS.

m. *Internal controls.*
   - Determine the bank's methods for identifying transactions subject to sections 23A and 23B of the Federal Reserve Act. Determine if these methods adequately identify such transactions. Consider the following information:
     - internal reports (Management should document any covered transactions with affiliates.)
     - loan records
     - deposit accounts
     - accounts payable and receivable
     - board minutes
   - Determine if management understands what services its affiliates provide.
   - Determine the volume and frequency of inter-institution transactions, such as loan participations or sales, purchases or sales of other assets, bank stock loans, insider transactions, and contractual obligations for services. Review these transactions for possible noncompliance or abusive practices.
   - Review any formal or informal agreements regarding covered transactions. Determine if management adequately documents the cost, fee structure, and quality of services.
   - Determine the bank's compliance with any outstanding conditions of an approved order or commitment issued by the regulator.

n. Determine if the affiliates are in compliance with the capital requirements of their functional regulator.

o. If the bank has used the expanded (d)(4) exemption, determine that the bank regularly reviews the market value of its U.S. government obligations collateral.

p. Determine that the bank's program for monitoring and controlling the credit exposure from derivative transactions with affiliates includes, at a minimum, imposing appropriate credit limits, mark-to market requirements, and collateral requirements.

q. Determine that the limits and requirements reflect the nature, volume, and complexity of the bank's derivatives transactions.

r. Determine that the limits and requirements on credit exposures from derivative transactions have been approved by the board of directors of the bank or an appropriate board committee.

s. Determine that the bank's program for monitoring and controlling the credit exposure from intraday extensions of credit to affiliates includes, at a minimum, imposing appropriate credit limits (on a per-affiliate and aggregate basis) and collateral requirements.

t. Determine that that the limits and requirements imposed by the bank reflect the volume of intraday credit transactions and the reasons for those transactions.

u. Determine that the limits and requirements on intraday credit transactions have been approved by the board of directors of the bank or an appropriate board committee.

11. *Section 23B of the Federal Reserve Act (12 USC 371c-1), Restrictions on Transactions with Affiliates, and the Board's Regulation W.*

   a. Determine that covered transactions with affiliates comply with the restrictions in section 23B.
   b. If the bank has derivative transactions with affiliates, determine that the bank has treated the affiliate no better than a similarly situated nonaffliate.
   c. Determine that management and other fees paid by the bank have a direct relationship to the value of the actual goods and services rendered, based on reasonable costs consistent with current market values for such goods and services.
   d. Review any mortgage banking activity and servicing contracts with affiliates, if

applicable. Give particular attention to—
- the capacity in which the affiliate is acting,
- the nature of the services provided,
- the billing arrangement, frequency of billing, method of computation, and the basis for fees,
- the method of compensating the bank for balances maintained and net interest earned on warehouse loans and lines (This method should not be preferential.),
- the pricing of loan and servicing-right sales,
- advertising restrictions (for noncompliance).

12. *Regulation O (12 CFR 215), Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks.*
    a. Obtain lists of loans to executive officers and business interests of directors, executive officers, and principal shareholders from the examiner assigned to duties and responsibilities of directors.
    b. Determine the accuracy and completeness of the list as it concerns related organizations by comparing it with information obtained from management and other examiners.
    c. Investigate to determine undisclosed affiliate relationships if there are several directors or officers who have a common interest in the same entity by—
    - obtaining a listing of all directors for the entity that are suspected of maintaining an affiliate relationship,
    - reviewing authorizing signatures on corporate resolutions to borrow, and
    - reviewing signatory authorities on deposit signature cards.
13. If the bank engaged in an impermissible nonbank activity, determine that it has divested itself of that activity.
14. If the bank is a subsidiary of a holding company and the parent has sold commercial paper and funded bank loans with the proceeds, obtain or prepare the following schedules and forward them to the examiner assigned to funds management:
    a. amount and maturities of commercial paper outstanding
    b. amount and maturity of the assets the paper supports
15. If the bank is a subsidiary of a holding company and if the parent has sold long-term debt and passed the proceeds down to the bank in the form of equity, obtain or prepare the following schedules and forward them to the examiner assigned to assessment of capital adequacy:
    a. amount, maturity, and repayment terms of long-term debt sold
    b. amount of equity capital passed to bank
    c. expected minimum dividend payment required by bank to service the debt of the parent
16. From the results of previous steps and discussion with management, determine if there are any anticipated changes in the related organization–bank relationship that may possibly have adverse effects on the affairs and soundness of the bank.
17. On the basis of the above steps, determine the propriety of the carrying value and nature of the relationship between the bank and its related organizations and the effect of that relationship on the affairs and soundness of the bank.
18. If, in the performance of the above procedures, the full nature and extent of interaction between the bank and its related organizations cannot be determined, consider the necessity of an in-depth examination of related organizations. Perform appropriate procedures in step 19, and develop additional specific procedures based on the type and scope of activities being conducted.
19. The following procedures should be considered when an in-depth examination of a bank's nonbank subsidiaries is deemed appropriate:
    a. Review and analyze the liability structure of the nonbank subsidiaries.
    - Review and appraise any funding agreements with the parent bank.
    - Review all arrangements whereby the bank purchases assets, pursuant to 12 CFR 223.42(k).
    - Review and appraise any funding agreements with (including guarantees) and debt instruments issued to outside creditors.
    - Review agreements with third parties involving the outright purchase of assets to determine liability for the repurchase of assets or any other contingent liabilities.

    b. Analyze cash flow, earnings, and tax policies of the nonbank subsidiaries. Prepare cash-flow statements for the previous three fiscal years and compare current year-to-date with previous year-to-date.

c. Review and evaluate capital adequacy by—
   - relating the consolidated classified assets of the subsidiaries against the consolidated net worth, or by relating classifieds proportionately to the parent's investment in and advances to each subsidiary;
   - commenting on the overall capital structure of both the parent bank and specific nonbank subsidiaries, as warranted; and
   - discussing the adequacy of capital with management, and noting management's future plans to raise capital.

d. Review and evaluate management and control policies by—
   - reviewing board meeting minutes of the parent corporation, and assessing director interest in and awareness of subsidiaries;
   - reviewing and evaluating corporate management's internal audit procedures for those policies;
   - reviewing ''management letters'' from certified public accountants about those internal controls; and
   - reviewing shareholder records, noting significant concentrations, and, when officers or directors are involved, noting any undue influence with regard to policies, practices, and procedures.

e. Review management's future operating plan for the subsidiary company.
   - Analyze the subsidiary's earnings and capital projections for one and five years.
   - Obtain underlying assumptions for—
     — return on assets,
     — dividend retention rate,
     — asset growth rate, and
     — capital growth rate.
   - Compare projections against past operating performance, and comment on the plan.

20. Discuss findings and conclusions reached in the examination of any nonbank subsidiary with the management of that entity. Prepare comments for the examination report.

21. Prepare, in appropriate report form, and discuss with appropriate bank management the following:
    a. the adequacy of written policies on related organizations
    b. the manner in which bank officers are operating in conformance with established policy
    c. violations of law or regulations
    d. the impropriety of any transaction between the related organization and the bank
    e. loans to or investments in related organizations that the examiner questions for any reason, such as their quality, carrying value, or ultimate collection
    f. litigation, commitments, contingent liabilities, or current or anticipated changes between the bank and its related organizations that may have adverse effects on the affairs and soundness of the bank
    g. interlocking officer or director relationships that are detrimental to the bank under examination or to any of its related organizations
    h. any other information that will communicate the condition of the related organization and the nature and effect of the relationship between the related organization and the bank under examination
    i. recommended corrective action when policies, practices, or procedures are deficient

22. Consolidate information in the operating subsidiary report (or reports) for inclusion in the report of examination.

23. Consolidate financial information and any other comments concerning related organizations for inclusion, when appropriate, in the report of examination.

24. If material changes have occurred in related organizations since the most recent examination of the bank, and if the changes may have a substantial impact on the bank, this information should be communicated by separate memorandum to the Federal Reserve Bank.

25. Update the workpapers with any information that will facilitate future examinations.

Review the bank's internal controls, policies, practices, and procedures concerning related organizations. The bank's system should be documented completely and concisely and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used, and other pertinent information.

POLICIES AND OBJECTIVES

1. Does the bank have written guidelines for the expansion of services through the formation or acquisition of related organizations?
2. Are established objectives and policies adhered to?
   a. Is there an overall lending policy that would bring banking- and nonbanking-related organizations under a common set of controls?
   b. Are bank officials an integral part of subsidiary or related-company management?
   c. Can operating procedures be monitored from available internal or external audit reports?
3. Are periodic independent reviews performed to assess bank management's objectives and policies on the current status of their association with the related organizations?
4. Does bank management have an active role in the related organizations' audit committees, or does management retain the right to examine the companies' records, including the right to receive third-party letters from the external auditors?
5. Are policies and procedures such that the effect on the bank's liquidity is monitored when commercial paper or other proceeds are used to fund bank loans?

RECORDS

1. Are records maintained for the companies in which the bank has a capital investment, including foreign companies, so that a determination can be made of the extent of bank control, quality of assets, profitability of the company, legality of operations, and compliance with the investment limitations of Regulation K? (See Regulation K, sections 211.8 and 211.9.)
2. Does the bank maintain current records on the form and status of each related organization (such a list should include name, location, nature of business, manner of affiliation, relationship with bank, amount of loans, investments in and other extensions of credit, security pledged, obligations of any affiliate that is used as collateral security for advances made to others, commitments, and litigation)?
3. Does the bank maintain a copy of all internal or external audit reports, including management letters and responses, of the subsidiary or related company?
4. In the case of registered bank holding companies and nonbank affiliates arising through the holding company relationship, are copies of the Federal Reserve's inspection reports and forms 10-Q, 10-K, 8-K, Y-6, and Y-8 available for review?
5. In the case of Edge Act and agreement corporations and foreign subsidiaries, are copies of Federal Reserve examination reports and foreign regulatory reports available for review?
6. Do credit files of foreign subsidiaries include information regarding a particular country's cultural and legal influences on banking activities, current economic conditions, anticipated relaxation or strengthening of capital or exchange controls, fiscal policy, political goals, and risk of expropriation?
7. Are adequate records maintained to determine compliance with the investment provisions of Regulation K, including information on the type of investment (equity, binding commitments, capital contributions, subordinated debt), the dollar amount of the investment, the percentage ownership, the activities conducted by the company, the legal authority for such activities, and whether the investment was made under Regulation K's general-consent, prior-notice, or specific-consent procedures? (See Regulation K, sections 211.8 and 211.9.)
8. Is the carrying value of all subsidiaries and related companies accounted for on the equity basis and adjusted, at least quarterly,

to reflect the reporting bank's cumulative share of the company's earnings or losses?

9. Is an objective review performed of the benefits or quality of assets received relative to the cost incurred?
10. Are money transfers between the bank and any related organization adequately documented to justify the equity of the transaction?

CONCLUSION

1. Is the foregoing information considered an adequate basis for evaluating internal controls, that is, there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.

2. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

INTRODUCTION

Banking organizations increasingly rely on information technology (IT) to conduct their operations and manage risks. The use of IT can have important implications for a banking organization's financial condition, risk profile, and operating performance and should be incorporated into the safety-and-soundness assessment of each organization. As a result, all safety-and-soundness examinations (or examination cycles) of banking organizations conducted by the Federal Reserve should include an assessment and evaluation of IT risks and risk management. Further information about banks' IT activities and examination methodology can be found in the *FFIEC Information Systems Examination Handbook* (the *IS Handbook*) and in supervisory guidance issued by the Federal Reserve and the other federal banking agencies.

ASSESSING INFORMATION TECHNOLOGY IN THE RISK-FOCUSED SUPERVISORY FRAMEWORK

The risk-focused supervisory process is evolving to adapt to the changing role of IT in banking organizations, with greater emphasis on an assessment of IT's effect on an organization's safety and soundness. Accordingly, examiners should explicitly consider IT when developing risk assessments and supervisory plans. Examiners should use appropriate judgment in determining the level of review, given the characteristics, size, and business activities of the organization. Moreover, to determine the scope of supervisory activities, close coordination is needed between general safety-and-soundness examiners and IT specialists during the risk-assessment and planning phase, as well as during on-site examinations. Given the variability of IT environments, the level of technical expertise needed for a particular examination will vary across institutions and should be identified during the planning phase of the examination. In general, examiners should accomplish the following goals during a risk-focused examination:

- Develop a broad understanding of the organization's approach to and strategy and structure for IT activities within and across business lines. Determine also the role and importance of IT to the organization and any unique characteristics or issues.
- Incorporate an analysis of IT activities into risk assessments, supervisory plans, and scope memoranda. An organization's IT systems should be considered in relation to the size, activities, and complexity of the organization, as well as the degree of reliance on these systems across particular business lines. Although IT concerns would clearly affect an institution's operational risk profile, IT also can affect other business risks (i.e., credit, market, liquidity, legal, and reputational risk) depending upon the specific circumstances and should be incorporated into these assessments as appropriate.
- Assess the organization's critical systems, that is, those that support its major business activities, and the degree of reliance those activities have on IT systems. The level of review should be sufficient to determine that the systems are delivering the services necessary for the organization to conduct its business in a safe and sound manner.
- Determine whether the board of directors and senior management are adequately identifying, measuring, monitoring, and controlling the significant risks associated with IT for the overall organization and its major business activities.

STANDARDS FOR SAFEGUARDING CUSTOMER INFORMATION

The federal banking agencies jointly issued guidelines establishing standards for safeguarding customer information (the standards), which became effective July 1, 2001.[1] The guidelines implement sections 501 and 505 of the Gramm-Leach-Bliley Act (15 USC 6801 and 6805). The GLB Act requires the agencies to establish financial-institution standards for administrative, technical, and physical safeguards for customer records and information. (See SR-01-15.)

1. See 66 *Fed. Reg.* 8616–8641 (February 1, 2001); Regulation H, 12 CFR 208, appendix D-2; Regulation K, 12 CFR 211.9 and 211.24; and Regulation Y, 12 CFR 225, appendix F.

Under the standards, institutions must establish an effective *written* information security program to assess and control risks to customer information. An institution's information security program should be appropriate to its size and complexity and to the nature and scope of its operations. The board of directors should oversee the institution's development, implementation, and maintenance of the information security program and also approve written information security policies and programs.

The information security program should include administrative, technical, and physical safeguards appropriate to the size and complexity of the bank and the nature and scope of its activities. The program should be designed to ensure the security and confidentiality of customer information,[2] protect against anticipated threats or hazards to the security or integrity of such information, and protect against unauthorized access to or use of such information that could result in substantial harm or inconvenience to any customer.[3] Each institution must assess risks to customer information and implement appropriate policies, procedures, training, and testing to manage and control these risks. Institutions must also report annually to the board of directors or a committee of the board of directors.

The standards outline specific security measures that banking organizations should consider in implementing a security program based on the size and complexity of their operations. Training and testing are also critical components of an effective information security program. Financial institutions are required to oversee their service-provider arrangements in order to protect the security of customer information maintained or processed by service providers.

The Federal Reserve recognizes that banking organizations are highly sensitive to the importance of safeguarding customer information and the need to maintain effective information security programs. Existing examination procedures and supervisory processes already address information security. As a result, most banking organizations may not need to implement any new controls and procedures.

Examiners should assess compliance with the standards during each safety-and-soundness examination, which may include targeted reviews of information technology. Ongoing compliance with the standards should be monitored as needed during the risk-focused examination process. Material instances of noncompliance should be noted in the examination report.

The standards apply to customer information maintained by or on behalf of state member banks and bank holding companies and the nonbank subsidiaries of each. The standards do not apply to brokers, dealers, investment companies, and investment advisers, or to persons providing insurance under the applicable state insurance authority of the state in which the person is domiciled.[4] An institution or banking organization is not required to implement a *uniform* information security program. For example, a bank holding company may include subsidiaries within the scope of its information security program, or the subsidiaries may implement separate information security programs. The institution or bank holding company is expected, however, to coordinate all the elements of its information security program.

Institutions must exercise due diligence when selecting service providers, including reviewing the service provider's information security program or the measures the service provider uses to protect the institution's customer information.[5] In addition, contracts entered into after March 5, 2001, must require that the service provider implement appropriate measures designed to meet the objectives of the standards. By July 1, 2003, all contracts are subject to this requirement. Institutions also must conduct ongoing oversight to confirm that the service provider maintains appropriate security measures. An institution's methods for overseeing its service-provider arrangements may differ depending on the type of services or service provider or the level of risk. For example, if a service provider is subject to regulations or a

2. "Customer information" is defined to include any record, whether in paper, electronic, or other form, containing nonpublic personal information of a customer.

3. A "customer" is defined in the same manner as in Regulation P: a consumer who has established a continuing relationship with an institution under which the institution provides one or more financial products or services to the consumer to be used primarily for personal, family, or household purposes. The definition of customer does not include a business, nor does it include a consumer who has not established an ongoing relationship with the financial institution.

4. The appropriate federal agency or state insurance authority regulates these entities under sections 501 and 505 of the GLB Act.

5. A "service provider" is deemed to be a person or entity that maintains, processes, or is otherwise permitted access to customer information through its provision of services directly to the bank.

code of conduct that imposes a duty to protect customer information consistent with the objectives of the standards, the institution may consider that duty in exercising its due diligence and oversight of the service provider. In situations where a service provider hires a subservicer (or subcontractor), the subservicer would not be considered a ‘‘service provider’’ under the guidelines.

EXAMINATION FREQUENCY AND SCOPE

All safety-and-soundness examinations (or examination cycles) of banking organizations conducted by the Federal Reserve should include an assessment and evaluation of IT risks and risk management. The scope of the IT assessment should generally be sufficient to assign a composite rating under the Uniform Rating System for Information Technology (URSIT). URSIT component ratings may be updated at the examiner's discretion based on the scope of the assessment. The scope would normally be based on factors such as—

- implementation of new systems or technologies since the last examination;
- significant changes in operations, such as mergers or systems conversions;
- new or modified outsourcing relationships for critical operations;
- targeted examinations of business lines whose internal controls or risk-management systems depend heavily on IT; and
- other potential problems or concerns that may have arisen since the last examination, or the need to follow up on previous examination or audit issues.

Institutions that outsource core processing functions, although not traditionally subject to IT examinations, are exposed to IT-related risks. For these institutions, some or all components of the URSIT rating may not be meaningful. In these cases, the assessment of IT activities may be incorporated directly into the safety-and soundness rating for the institution, rather than through the assignment of an URSIT rating. The scope of the IT assessment for such institutions should evaluate the adequacy of the institution's oversight of service providers for critical processing activities and should incorporate the results of any relevant supervisory reviews of these service providers. The assessment should also include reviews of any significant in-house activities, such as management information systems and local networks, and the implementation of new technologies, such as Internet banking. As noted above, the assessment of IT should be reflected in the overall safety-and-soundness examination report and in the appropriate components of the safety-and-soundness examination rating assigned to the institution, as well as in the associated risk-profile analysis. (See SR-00-3.)

Targeted IT examinations may be conducted more frequently if deemed necessary by the Reserve Bank. A composite URSIT rating should be assigned for targeted reviews when possible. In addition, institutions for which supervisory concerns have been raised (normally those rated URSIT 3, 4, or 5) should be subject to more frequent IT reviews, until such time as the Reserve Bank is satisfied that the deficiencies have been corrected.

RISK ELEMENTS

To provide a common terminology and consistent approach for evaluating the adequacy of an organization's IT, five IT elements are defined below. These elements may be used to evaluate the IT processes at the functional business level or for the organization as a whole and to determine the impact on the business risks outlined in SR-95-51, as well as their impact on the IT rating (URSIT) discussed below. (See SR-98-9.)

1. *Management processes.* Management processes encompass planning, investment, development, execution, and staffing of IT from a corporate-wide and business-specific perspective. Management processes over IT are effective when they are adequately and appropriately aligned with and support the organization's mission and business objectives. Management processes include strategic planning; budgeting; management and reporting hierarchy; management succession; and a regular, independent review function. Examiners should determine if the IT strategy for the business activity or organization is consistent with the organization's mission and business objectives and whether the IT

function has effective management processes to execute that strategy.

2. *Architecture.* Architecture refers to the underlying design of an automated information system and its individual components. The underlying design encompasses both physical and logical architecture, including operating environments, as well as the organization of data. The individual components refer to network communications, hardware, and software, which includes operating systems, communications software, database-management systems, programming languages, and desktop software. Effective architecture meets current and long-term organizational objectives, addresses capacity requirements to ensure that systems allow users to easily enter data at both normal and peak processing times, and provides satisfactory solutions to problems that arise when information is stored and processed in two or more systems that cannot be connected electronically. When assessing the adequacy of IT architecture, examiners should consider the ability of the current infrastructure to meet operating objectives, including the effective integration of systems and sources of data.
3. *Integrity.* Integrity refers to the reliability, accuracy, and completeness of information

delivered to the end-user. Integrity risk could arise from insufficient controls over systems or data, which could adversely affect critical financial and customer information. Examiners should review and consider whether the organization relies upon information-system audits or independent reviews of applications to ensure the integrity of its systems. Examiners should review the reliability, accuracy, and completeness of information delivered in key business lines.

4. *Security.* Security risk is the risk of unauthorized disclosure or destruction of critical or sensitive information. To mitigate this risk, physical access and logical controls are generally provided to achieve a level of protection commensurate with the value of the information. Security risk is managed effectively when controls prevent unauthorized access, modification, destruction, or disclosure of sensitive information during creation, transmission, processing, maintenance, or storage. Examiners should ensure that operating procedures and controls are commensurate with the potential for and risks associated with security breaches, which may be either physical or electronic, inadvertent or intentional, internal or external.
5. *Availability.* Availability refers to the timely delivery of information and processes to end-users in support of business and decision-making processes and customer services. In assessing the management of availability risk, examiners should consider the capability of IT functions to provide information to the end-users from either primary or secondary sources, as well as the ability of back-up systems, presented in contingency plans, to mitigate business disruption. Contingency plans should set out a process for an organization to restore or replace its information-processing resources; reconstruct its information assets; and resume its business activity from disruption caused by human error or intervention, natural disaster, or infrastructure failure (including loss of utilities and communication lines and operational failure of hardware, software, and network communications).

UNIFORM RATING SYSTEM FOR INFORMATION TECHNOLOGY

The Uniform Rating System for Information Technology (URSIT) is an interagency examination rating system adopted by the Federal Financial Institutions Examination Council (FFIEC) agencies to evaluate IT activities of financial institutions. The rating system includes component- and composite-rating descriptions and the explicit identification of risks and assessment factors that examiners consider in assigning component ratings. This rating system helps examiners assess risk and compile examination findings. However, the rating system should not drive the scope of an examination. In particular, not all assessment factors or component rating areas are required to be assessed at each examination. Examiners should use the rating system to help evaluate the entity's overall risk exposure and risk-management performance, and determine the degree of supervisory attention believed necessary to ensure that weaknesses are addressed and that risk is properly managed. See SR-99-8.

The URSIT rating framework is based on a risk evaluation of four general areas: audit, management, development and acquisition, and support and delivery. These components are used to assess the overall IT functions within an organization and arrive at a composite URSIT rating. Examiners evaluate the areas identified within each component to assess the institution's ability to identify, measure, monitor, and control IT risks.

In adopting the URSIT rating system, the FFIEC recognized that management practices vary considerably among financial institutions depending on their size and sophistication, the nature and complexity of their business activities, and their risk profile. For less complex information systems environments, detailed or highly formalized systems and controls are not required to receive the higher composite and component ratings.

URSIT Composite-Rating Definitions

Financial institutions rated URSIT composite 1 exhibit strong performance in every respect and generally have components rated 1 or 2. Weaknesses in IT functions are minor and are easily corrected during the normal course of business. Risk-management processes provide a comprehensive program to identify and monitor risk relative to the size, complexity, and risk profile of the entity. Strategic plans are well defined and fully integrated throughout the organization. This allows management to quickly adapt to the changing market, business, and technology needs of the entity. Management identifies weaknesses promptly and takes appropriate corrective action to resolve audit and regulatory concerns.

Financial institutions rated URSIT composite 2 exhibit safe and sound performance but may demonstrate modest weaknesses in operating performance, monitoring, management processes, or system development. Generally, senior management corrects weaknesses in the normal course of business. Risk-management processes adequately identify and monitor risk relative to the size, complexity, and risk profile of the entity. Strategic plans are defined but may require clarification, better coordination, or improved communication throughout the organization. As a result, management anticipates, but responds less quickly to changes in the market, business, and technological needs of the entity. Management normally identifies weaknesses and takes appropriate corrective action. However, greater reliance is placed on audit and regulatory intervention to identify and resolve concerns. While internal-control weaknesses may exist, there are no significant supervisory concerns. As a result, supervisory action is informal and limited.

Financial institutions rated URSIT composite 3 exhibit some degree of supervisory concern due to a combination of weaknesses that may range from moderate to severe. If weaknesses persist, further deterioration in the condition and performance of the institution is likely. Risk-management processes may not effectively identify risks and may not be appropriate for the size, complexity, or risk profile of the entity. Strategic plans are vaguely defined and may not provide adequate direction for IT initiatives. As a result, management often has difficulty responding to changes in the business, market, and technological needs of the entity. Self-assessment practices are weak and generally reactive to audit and regulatory exceptions. Repeat concerns may exist, indicating that management may lack the ability or willingness to resolve concerns. While financial or operational failure is unlikely, increased supervision is necessary. Formal or informal supervisory action may be necessary to secure corrective action.

Financial institutions rated URSIT composite 4 operate in an unsafe and unsound environment that may impair the future viability of the entity. Operating weaknesses are indicative of serious managerial deficiencies. Risk-management processes inadequately identify and monitor risk, and practices are not appropriate given the size, complexity, and risk profile of the entity. Strategic plans are poorly defined and not coordinated or communicated throughout the organization. As a result, management and the board are not committed to, or may be incapable of, ensuring that technological needs are met. Management does not perform self-assessments and demonstrates an inability or unwillingness to correct audit and regulatory concerns. Failure of the financial institution may be likely unless IT problems are remedied. Close supervisory attention is necessary and, in most cases, formal enforcement action is warranted.

Financial institutions rated URSIT composite 5 exhibit critically deficient operating performance and are in need of immediate remedial action. Operational problems and serious weaknesses may exist throughout the organization. Risk-management processes are severely deficient and provide management little or no perception of risk relative to the size, complexity, and risk profile of the entity. Strategic plans do not exist or are ineffective, and management and the board provide little or no direction for IT initiatives. As a result, management is unaware of or inattentive to the technological needs of the entity. Management is unwilling or incapable of correcting audit and regulatory concerns. Ongoing supervisory attention is necessary.

URSIT Component Ratings

Audit

Financial institutions and service providers are expected to provide independent assessments of their exposure to risks and of the quality of internal controls associated with the acquisition, implementation, and use of IT. Audit practices should address the IT risk exposures throughout the institution and the exposures of its service provider(s) in the areas of user and data center operations, client/server architecture, local and wide area networks, telecommunications, information security, electronic data interchange, systems development, and contingency planning. This rating should reflect the adequacy of the organization's overall IT audit program, including the internal and external auditor's abilities to detect and report significant risks to management and the board of directors on a timely basis. It should also reflect the internal and external auditor's capability to promote a safe, sound, and effective operation. The performance of an audit is rated based upon an assessment of factors such as—

- the level of independence maintained by audit and the quality of the oversight and support provided by the board of directors and management;
- the adequacy of audit's risk-analysis methodology used to prioritize the allocation of audit resources and to formulate the audit schedule;
- the scope, frequency, accuracy, and timeliness of internal and external audit reports;
- the extent of audit participation in application development, acquisition, and testing, to ensure the effectiveness of internal controls and audit trails;
- the adequacy of the overall audit plan in providing appropriate coverage of IT risks;
- the auditor's adherence to codes of ethics and professional audit standards;
- the qualifications of the auditor, staff succession, and continued development through training;
- the existence of timely and formal follow-up and reporting on management's resolution of identified problems or weaknesses; and
- the quality and effectiveness of internal and external audit activity as it relates to IT controls.

A rating of 1 indicates strong audit performance. Audit independently identifies and reports weaknesses and risks to the board of directors or its audit committee in a thorough and timely manner. Outstanding audit issues are monitored until resolved. Risk analysis ensures that audit plans address all significant IT operations, procurement, and development activities with appropriate scope and frequency. Audit work is performed in accordance with professional auditing standards and report content is timely, constructive, accurate, and complete. Because audit is strong, examiners may place substantial reliance on audit results.

A rating of 2 indicates satisfactory audit performance. Audit independently identifies and reports weaknesses and risks to the board of directors or audit committee, but reports may be less timely. Significant outstanding audit issues are monitored until resolved. Risk analysis ensures that audit plans address all significant IT operations, procurement, and development activities; however, minor concerns may be noted with the scope or frequency. Audit work is performed in accordance with professional auditing standards; however, minor or infrequent problems may arise with the timeliness, completeness, and accuracy of reports. Because audit is satisfactory, examiners may rely on audit results but because minor concerns exist, examiners may need to expand verification procedures in certain situations.

A rating of 3 indicates less than satisfactory audit performance. Audit identifies and reports weaknesses and risks; however, independence may be compromised and reports presented to the board or audit committee may be less than satisfactory in content and timeliness. Outstanding audit issues may not be adequately monitored. Risk analysis is less than satisfactory. As a result, the audit plan may not provide sufficient audit scope or frequency for IT operations, procurement, and development activities. Audit work is generally performed in accordance with professional auditing standards; however, occasional problems may be noted with the timeliness, completeness, or accuracy of reports. Because audit is less than satisfactory, examiners must use caution if they rely on the audit results.

A rating of 4 indicates deficient audit performance. Audit may identify weaknesses and risks, but it may not independently report to the board or audit committee, and report content may be inadequate. Outstanding audit issues may not be adequately monitored and resolved. Risk analysis is deficient. As a result, the audit plan does not provide adequate audit scope or frequency for IT operations, procurement, and development activities. Audit work is often inconsistent with professional auditing standards, and the timeliness, accuracy, and completeness of reports is unacceptable. Because audit is deficient, examiners cannot rely on audit results.

A rating of 5 indicates critically deficient audit performance. If an audit function exists, it lacks sufficient independence and, as a result, does not identify and report weaknesses or risks to the board or audit committee. Outstanding audit issues are not tracked and no follow-up is performed to monitor their resolution. Risk analysis is critically deficient. As a result, the audit plan is ineffective and provides inappropriate audit scope and frequency for IT operations, procurement, and development activities.

Audit work is not performed in accordance with professional auditing standards and major deficiencies are noted regarding the timeliness, accuracy, and completeness of audit reports. Because audit is critically deficient, examiners cannot rely on audit results.

Management

The management rating reflects the abilities of the board and management as they apply to all aspects of IT acquisition, development, and operations. Management practices may need to address some or all of the following IT-related risks: strategic planning, quality assurance, project management, risk assessment, infrastructure and architecture, end-user computing, contract administration of third-party service providers, organization and human resources, and regulatory and legal compliance. Generally, directors need not be actively involved in day-to-day operations; however, they must provide clear guidance regarding acceptable risk-exposure levels and ensure that appropriate policies, procedures, and practices have been established. Sound management practices are demonstrated through active oversight by the board of directors and management, competent personnel, sound IT plans, adequate policies and standards, an effective control environment, and risk monitoring. The management rating should reflect the board's and management's ability as it applies to all aspects of IT operations. The performance of management and the quality of risk management are rated based on an assessment of factors such as—

- the level and quality of oversight and support of the IT activities by the board of directors and management;
- the ability of management to plan for and initiate new activities or products in response to information needs and to address risks that may arise from changing business conditions;
- the ability of management to provide information reports necessary for informed planning and decision making in an effective and efficient manner;
- the adequacy of, and conformance with, internal policies and controls addressing the IT operations and risks of significant business activities;
- the effectiveness of risk-monitoring systems;
- the timeliness of corrective action for reported and known problems;
- the level of awareness of and compliance with laws and regulations;
- the level of planning for management succession;
- the ability of management to monitor the services delivered and to measure the organization's progress toward identified goals effectively and efficiently;
- the adequacy of contracts and management's ability to monitor relationships with third-party servicers;
- the adequacy of strategic planning and risk-management practices to identify, measure, monitor, and control risks, including management's ability to perform self-assessments; and
- the ability of management to identify, measure, monitor, and control risks and to address emerging IT needs and solutions.

A rating of 1 indicates strong performance by management and the board. Effective risk-management practices are in place to guide IT activities, and risks are consistently and effectively identified, measured, controlled, and monitored. Management immediately resolves audit and regulatory concerns to ensure sound operations. Written technology plans, policies and procedures, and standards are thorough and properly reflect the complexity of the IT environment. They have been formally adopted, communicated, and enforced throughout the organization. IT systems provide accurate, timely reports to management. These reports serve as the basis of major decisions and as an effective performance-monitoring tool. Outsourcing arrangements are based on comprehensive planning; routine management supervision sustains an appropriate level of control over vendor contracts, performance, and services provided. Management and the board have demonstrated the ability to promptly and successfully address existing IT problems and potential risks.

A rating of 2 indicates satisfactory performance by management and the board. Adequate risk-management practices are in place and guide IT activities. Significant IT risks are identified, measured, monitored, and controlled; however, risk-management processes may be less structured or inconsistently applied and modest weaknesses exist. Management routinely resolves audit and regulatory concerns to ensure effective and sound operations; however, corrective actions may not always be implemented in a timely manner. Technology plans, policies and procedures, and standards are adequate and formally adopted. However, minor weaknesses may exist in management's ability to communicate and enforce them throughout the organization. IT systems provide quality reports to management which serve as a basis for major decisions and a tool for performance planning and monitoring. Isolated or temporary problems with timeliness, accuracy, or consistency of reports may exist. Outsourcing arrangements are adequately planned and controlled by management, and provide for a general understanding of vendor contracts, performance standards, and services provided. Management and the board have demonstrated the ability to address existing IT problems and risks successfully.

A rating of 3 indicates less than satisfactory performance by management and the board. Risk-management practices may be weak and offer limited guidance for IT activities. Most IT risks are generally identified; however, processes to measure and monitor risk may be flawed. As a result, management's ability to control risk is less than satisfactory. Regulatory and audit concerns may be addressed, but time frames are often excessive and the corrective action taken may be inappropriate. Management may be unwilling or incapable of addressing deficiencies. Technology plans, policies and procedures, and standards exist, but may be incomplete. They may not be formally adopted, effectively communicated, or enforced throughout the organization. IT systems provide requested reports to management, but periodic problems with accuracy, consistency, and timeliness lessen the reliability and usefulness of reports and may adversely affect decision making and performance monitoring. Outsourcing arrangements may be entered into without thorough planning. Management may provide only cursory supervision that limits their understanding of vendor contracts, performance standards, and services provided. Management and the board may not be capable of addressing existing IT problems and risks, which is evidenced by untimely corrective actions for outstanding IT problems.

A rating of 4 indicates deficient performance by management and the board. Risk-management practices are inadequate and do not provide sufficient guidance for IT activities. Critical IT risks are not properly identified, and processes to measure and monitor risks are deficient. As a result, management may not be aware of and is unable to control risks. Management may be unwilling or incapable of addressing audit and regulatory deficiencies in an effective and timely manner. Technology plans, policies and procedures, and standards are inadequate, and have not been formally adopted, or effectively communicated throughout the organization, and management does not effectively enforce them. IT systems do not routinely provide management with accurate, consistent, and reliable reports, thus contributing to ineffective performance monitoring or flawed decision making. Outsourcing arrangements may be entered into without planning or analysis, and management may provide little or no supervision of vendor contracts, performance standards, or services provided. Management and the board are unable to address existing IT problems and risks, as evidenced by ineffective actions and longstanding IT weaknesses. Strengthening of management and its processes is necessary.

A rating of 5 indicates critically deficient performance by management and the board. Risk-management practices are severely flawed and provide inadequate guidance for IT activities. Critical IT risks are not identified, and processes to measure and monitor risks do not exist or are not effective. Management's inability to control risk may threaten the continued viability of the institution. Management is unable or unwilling to correct audit- and regulatory-identified deficiencies, and immediate action by the board is required to preserve the viability of the institution. If they exist, technology plans, policies and procedures, and standards are critically deficient. Because of systemic problems, IT systems do not produce management reports which are accurate, timely, or relevant. Outsourcing arrangements may have been entered into without management planning or analysis, resulting in significant losses to the financial institution or ineffective vendor services.

Development and Acquisition

The rating of development and acquisition reflects an organization's ability to identify, acquire, install, and maintain appropriate IT resources. Management practices may need to address all or parts of the business process for implementing any kind of change to the hardware or software used. These business processes include an institution's purchase of hardware or software, development and programming performed by the institution, purchase of services from independent vendors or affiliated data centers, or a combination of these activities. The business process is defined as all phases taken to implement a change, including researching alternatives available, choosing an appropriate option for the organization as a whole, and converting to the new system or integrating the new system with existing systems. This rating reflects the adequacy of the institution's systems-development methodology and related risk-management practices for acquisition and deployment of IT. This rating also reflects the board and management's ability to enhance and replace IT prudently in a controlled environment. The performance of systems development and acquisition and related risk-management practice is rated based on an assessment of factors such as—

- the level and quality of oversight and support of systems development and acquisition activities by senior management and the board of directors;
- the adequacy of the organizational and management structures to establish accountability and responsibility for IT systems and technology initiatives;
- the volume, nature, and extent of risk exposure to the financial institution in the area of systems development and acquisition;
- the adequacy of the institution's Systems Development Life Cycle (SDLC) and programming standards;
- the quality of project-management programs and practices that are followed by developers, operators, executive management or owners, independent vendors or affiliated servicers, and end-users;
- the independence of the quality-assurance function and the adequacy of controls over program changes;
- the quality and thoroughness of system documentation;
- the integrity and security of the network, system, and application software;
- the development of IT solutions that meet the needs of end-users; and
- the extent of end-user involvement in the system-development process.

A rating of 1 indicates strong systems-development, acquisition, implementation, and change-management performance. Management and the board routinely demonstrate successfully the ability to identify and implement appropriate IT solutions while effectively managing risk. Project-management techniques and the SDLC are fully effective and supported by written policies, procedures, and project controls that consistently result in timely and efficient project completion. An independent quality-assurance function provides strong controls over testing and program-change management. Technology solutions consistently meet end-user needs. No significant weaknesses or problems exist.

A rating of 2 indicates satisfactory systems-development, acquisition, implementation, and change-management performance. Management and the board frequently demonstrate the ability to identify and implement appropriate IT solutions while managing risk. Project management and the SDLC are generally effective; however, weaknesses may exist that result in minor project delays or cost overruns. An independent quality-assurance function provides adequate supervision of testing and program-change management, but minor weaknesses may exist. Technology solutions meet end-user needs. However, minor enhancements may be necessary to meet original user expectations. Weaknesses may exist; however, they are not significant and are easily corrected in the normal course of business.

A rating of 3 indicates less than satisfactory systems-development, acquisition, implementation, and change-management performance. Management and the board may often be unsuccessful in identifying and implementing appropriate IT solutions; therefore, unwarranted risk exposure may exist. Project-management techniques and the SDLC are weak and may result in frequent project delays, backlogs, or significant cost overruns. The quality-assurance function may not be independent of the programming function, which may have an adverse impact on the integrity of testing and program-change management. Technology solutions generally meet end-user needs, but often require an inordinate level of change after implementation. Because of weaknesses, significant problems may arise that could result in disruption to operations or significant losses.

A rating of 4 indicates deficient systems-development, acquisition, implementation, and change-management performance. Management and the board may be unable to identify and implement appropriate IT solutions and do not effectively manage risk. Project-management techniques and the SDLC are ineffective and may result in severe project delays and cost overruns. The quality-assurance function is not fully effective and may not provide independent or comprehensive review of testing controls or program-change management. Technology solutions may not meet the critical needs of the organization. Problems and significant risks exist that require immediate action by the board and management to preserve the soundness of the institution.

A rating of 5 indicates critically deficient systems-development, acquisition, implementation, and change-management performance. Management and the board appear to be incapable of identifying and implementing appropriate IT solutions. If they exist, project-management techniques and the SDLC are critically deficient and provide little or no direction for development of systems or technology projects. The quality-assurance function is severely deficient or not present, and unidentified problems in testing and program-change management have caused significant IT risks. Technology solutions do not meet the needs of the organization. Serious problems and significant risks exist which raise concern for the financial institution’s ongoing viability.

Support and Delivery

The rating of support and delivery reflects an organization’s ability to provide technology services in a secure environment. It reflects not only the condition of IT operations but also factors such as reliability, security, and integrity, which may affect the quality of the information-delivery system. The factors include user support and training, as well as the ability to manage problems and incidents, operations, system performance, capacity planning, and facility and data management. Risk-management practices should promote effective, safe, and sound IT operations that ensure the continuity of operations and the reliability and availability of data. The scope of this component rating includes operational risks throughout the organization. The rating of IT support and delivery is based on a review and assessment of requirements such as—

- the ability to provide a level of service that meets the requirements of the business;
- the adequacy of security policies, procedures, and practices in all units and at all levels of the financial institution;
- the adequacy of data controls over preparation, input, processing, and output;
- the adequacy of corporate contingency planning and business resumption for data centers, networks, and business units;
- the quality of processes or programs that monitor capacity and performance;
- the adequacy of controls and the ability to monitor controls at service providers;
- the quality of assistance provided to users, including the ability to handle problems;
- the adequacy of operating policies, procedures, and manuals;
- the quality of physical and electronic security, including the privacy of data; and
- the adequacy of firewall architectures and the security of connections with public networks.

A rating of 1 indicates strong IT support and delivery performance. The organization provides technology services that are reliable and consistent. Service levels adhere to well-defined service-level agreements and routinely meet or exceed business requirements. A comprehensive corporate contingency and business-resumption plan is in place. Annual contingency-plan testing and updating is performed, and critical systems and applications are recovered within acceptable time frames. A formal written data-security policy and awareness program is communicated and enforced throughout the organization. The logical and physical security for all IT platforms is closely monitored, and security incidents and weaknesses are identified and quickly corrected. Relationships with third-party service providers are closely monitored. IT operations are highly reliable, and risk exposure is successfully identified and controlled.

A rating of 2 indicates satisfactory IT support and delivery performance. The organization provides technology services that are generally reliable and consistent; however, minor discrepancies in service levels may occur. Service performance adheres to service agreements and meets business requirements. A corporate contingency and business-resumption plan is in place, but minor enhancements may be necessary. Annual plan testing and updating is performed, and minor problems may occur when recovering systems or applications. A written data-security policy is in place but may require improvement to ensure its adequacy. The policy is generally enforced and communicated throughout the organization, for example, through a security-awareness program. The logical and physical security for critical IT platforms is satisfactory. Systems are monitored, and security incidents and weaknesses are identified and resolved within reasonable time frames. Relationships with third-party service providers are monitored. Critical IT operations are reliable and risk exposure is reasonably identified and controlled.

A rating of 3 indicates that the performance of IT support and delivery is less than satisfactory and needs improvement. The organization provides technology services that may not be reliable or consistent. As a result, service levels periodically do not adhere to service-level agreements or meet business requirements. A corporate contingency and business-resumption plan is in place but may not be considered comprehensive. The plan is periodically tested; however, the recovery of critical systems and applications is frequently unsuccessful. A data-security policy exists; however, it may not be strictly enforced or communicated throughout the organization. The logical and physical security for critical IT platforms is less than satisfactory. Systems are monitored; however, security incidents and weaknesses may not be resolved in a timely manner. Relationships with third-party service providers may not be adequately monitored. IT operations are not acceptable, and unwarranted risk exposures exist. If not corrected, weaknesses could cause performance degradation or disruption to operations.

A rating of 4 indicates deficient IT support and delivery performance. The organization provides technology services that are unreliable and inconsistent. Service-level agreements are poorly defined and service performance usually fails to meet business requirements. A corporate contingency and business-resumption plan may exist, but its content is critically deficient. If contingency testing is performed, management is typically unable to recover critical systems and applications. A data-security policy may not exist. As a result, serious supervisory concerns over security and the integrity of data exist. The logical and physical security for critical IT platforms is deficient. Systems may be monitored, but security incidents and weaknesses are not successfully identified or resolved. Relationships with third-party service providers are not monitored. IT operations are not reliable and significant risk exposure exists. Degradation in performance is evident and frequent disruption in operations has occurred.

A rating of 5 indicates critically deficient IT support and delivery performance. The organization provides technology services that are not reliable or consistent. Service-level agreements do not exist, and service performance does not meet business requirements. A corporate contingency and business-resumption plan does not exist. Contingency testing is not performed, and management has not demonstrated the ability to recover critical systems and applications. A data-security policy does not exist, and a serious threat to the organization's security and data integrity exists. The logical and physical security for critical IT platforms is inadequate, and management does not monitor systems for security incidents and weaknesses. Relationships with third-party service providers are not monitored, and the viability of a service provider may be in jeopardy. IT operations are severely deficient, and the seriousness of weaknesses could cause failure of the financial institution if not addressed.

OUTSOURCING

Banking organizations are increasingly relying on services provided by other entities to support a range of banking operations. Outsourcing of information- and transaction-processing activities, either to affiliated institutions or third-party service providers, may help banking organizations manage data processing and related personnel costs, improve services, and obtain expertise not available internally. At the same time, the reduced operational control over outsourced activities may expose an institution to additional risks. The federal banking agencies have established procedures to examine and evaluate the adequacy of institutions' controls over service providers, which can be found in the FFIEC's *IS Handbook* and related guidance. Additional information on specific areas is provided later in this section.

The FFIEC has issued guidance on the risk management of outsourced technology services. (See SR-00-17.) This supplemental bank interagency guidance contains many of the same sound practices and recommendations that are in SR-00-4 and this section. However, the FFIEC policy provides banking organizations with additional specific information that may be useful when considering their outsourcing risk-management practices. The guidance focuses on the risk-management process of identifying, measuring, monitoring, and controlling the risks associated with outsourcing technology services. While outsourcing can improve banking services, help to control costs, and provide the technical assistance needed to maintain and expand product offerings, it also introduces additional risks that need to be addressed. The guidance includes four key elements to address those risks: risk assessment, service-provider selection, contract provisions and review, and ongoing service-provider monitoring. An appendix to the policy statement provides examples of considerations that may be relevant when performing due diligence in selecting a service provider, contracting with service providers, and conducting ongoing service-provider monitoring. The FFIEC policy statement and its appendix are included as an appendix at the end of this section.

In the development of the examination scope and risk profile, examiners should determine which information- and transaction-processing activities critical to the institution's core operations are outsourced. During the on-site examination, the adequacy of the institution's risk management for these critical service providers should be assessed and evaluated. The overall assessment should be reflected in the relevant components of the URSIT examination rating or the Uniform Financial Institution Rating System, if an information-systems rating is not assigned.

Outsourcing Risks

The outsourcing of information and transaction processing involves operational risks that are similar to those that arise when the functions are performed internally, such as threats to the availability of systems used to support customer transactions, the integrity or security of customer account information, or the integrity of risk-management information systems. Under outsourcing arrangements, however, the risk-management measures commonly used to address these risks, such as internal controls and procedures, are generally under the direct operational control of the service provider. Nevertheless, the serviced institution would bear the associated risk of financial loss, reputational damage, or other adverse consequences.

Some outsourcing arrangements also involve direct financial risks to the serviced institution. For example, in some transaction-processing activities, a service provider has the ability to process transactions that result in extensions of credit on behalf of the serviced institution.[6] A service provider may also collect or disburse funds, exposing the institution to liquidity and credit risks if the service provider fails to perform as expected.

Risk Management

The Federal Reserve expects institutions to ensure that controls over outsourced information- and transaction-processing activities are equivalent to those that would be implemented if the activity were conducted internally. (See SR-00-4.) The institution's board of directors and senior management should understand the key risks associated with the use of service providers for its critical operations, commensurate with the scope and risks of the outsourced activity and its importance to the institution's business. They should ensure that an appropriate oversight program is in place to monitor each service provider's controls, condition, and performance. The following eight areas should be included in this process:

1. *Risk assessment.* Before entering into an outsourcing arrangement, the institution should assess the key risks that may arise and options for controlling these risks. Factors influencing the risk assessment could include how critical the outsourced function is to the institution; the nature of activities to be performed by the service provider, including handling funds or implementing credit decisions; the availability of alternative service providers for the particular function; insurance coverage available for particular risks; and the cost and time required to switch service providers if problems arise.
2. *Selection of service provider.* In selecting a service provider for critical information- or transaction-processing functions, an institution should perform sufficient due diligence to satisfy itself of the service provider's competence and stability, both financially and operationally, to provide the expected services and meet any related commitments.[7]
3. *Contracts.* The written contract between the institution and the service provider should clearly specify, at a level of detail commensurate with the scope and risks of the outsourced activity, all relevant terms, conditions, responsibilities, and liabilities of both parties. These would normally include terms such as—
   - required service levels, performance standards, and penalties;
   - internal controls, insurance, disaster-recovery capabilities, and other risk-management measures maintained by the service provider;
   - data and system ownership and access;
   - liability for delayed or erroneous transactions and other potential risks;
   - provisions for the institution to require and have access to internal or external audits or other reviews of the service provider's operations and financial condition;

6. For example, an institution may authorize a service provider to orginate payments, such as ACH credit transfers, on behalf of customers. The institution is required by law or contract to honor these types of transactions.

7. When the service provider is affiliated with the serviced institution, sections 23A and 23B of the Federal Reserve Act may apply. In particular, section 23B provides that the terms of transactions between a bank and its nonbank affiliate must be comparable to the terms of similar transactions between nonaffiliated parties.

- compliance with any applicable regulatory requirements and access to information and operations by the institution's supervisory authorities; and
- provisions for handling disputes, contract changes, and contract termination.

Terms and conditions should be assessed by the institution to ensure that they are appropriate for the particular service being provided and result in an acceptable level of risk to the institution.[8] Contracts for outsourcing of critical functions should be reviewed by the institution's legal counsel.

4. *Policies, procedures, and control.* The service provider should implement internal-control policies and procedures, data-security and contingency capabilities, and other operational controls analogous to those that the institution would use if the activity were performed internally. Appropriate controls should be placed on transactions processed or funds handled by the service provider on behalf of the institution. The service provider's policies and procedures should be reviewed by client institutions.
5. *Ongoing monitoring.* The institution should review the operational and financial performance of critical service providers on an ongoing basis to ensure that the service provider is meeting and can continue to meet the terms of the arrangement. The institution's staff should have sufficient training and expertise to review the service provider's performance and risk controls.
6. *Information access.* The institution must ensure that it has complete and immediate access to information that is critical to its operations and that is maintained or processed by a service provider. Records maintained at the institution must be adequate to enable examiners to review its operations fully and effectively, even if a function is outsourced.
7. *Audit.* The institution's audit function should review the oversight of critical service providers. Audits of the outsourced function should be conducted according to a scope and frequency appropriate for the particular function. Serviced institutions should conduct audits of the service provider or regularly review the service provider's internal or external audit scope and findings. Service providers should have an effective internal-audit function or should commission comprehensive, regular audits from a third-party organization. The reports of external auditors are commonly based on the AICPA's Statement of Auditing Standards [SAS] No. 70 "Reports on the Processing of Transactions by Service Organizations," as amended by SAS No. 78, "Consideration of Internal Control in a Financial Statement Audit: An Amendment to Statement on Auditing Standards No. 55." These statements contain the external-auditor reporting tools commonly used for service providers. SAS 70 reports, however, should not be relied on to the same extent as an audit. There are two types of SAS 70 reports:
   - *Reports on controls placed in operation* is an auditor's report on a service oganization's description of the controls that may be relevant to a user organization's internal control as it relates to an audit of financial statements. It also reports on whether such controls were suitably designed to achieve specified control objectives. Lastly, it reports on whether the controls had been placed in operation as of a specific date.
   - *Reports on controls placed in operation and tests of operating performance* is an auditor's report on a service organization's controls as described above, but the report also includes information on whether the controls that were tested were operating with sufficient effectiveness to provide reasonable, but not absolute, assurance that the related control objectives were achieved during the period specified.

   Audit results, audit reports, and management responses must be available to examiners upon request.
8. *Contingency plans.* The serviced institution should ensure adequate business-resumption planning and testing by the service provider. When appropriate based on the scope and risks of the outsourced function and the condition and performance of the service provider, the serviced institution's contingency plan may also include plans for the continuance of processing activities, either in-house or with another provider, in the event that the service provider is no longer able to provide the contracted services or the

8. Additional information regarding common contract provisions can be found later in this section and in the FFIEC's *IS Handbook.* In addition, FFIEC Supervisory Policy SP-5 requires each serviced institution to evaluate the adequacy of its service provider's contingency plans.

arrangement is otherwise terminated unexpectedly.

International Considerations

In general, the arrangements for outsourcing critical information- or transaction-processing functions to service providers outside the United States should be conducted according to the risk-management guidelines described above. In addition, the Federal Reserve expects that these arrangements will not diminish the ability of U.S. supervisors to review effectively the domestic or foreign operations of U.S. banking organizations and the U.S. operations of foreign banking organizations. See SR-00-4. In particular, examiners should evaluate the adequacy of outsourcing arrangements in the following six areas:

1. *Oversight and compliance.* The institution is expected to demonstrate adequate oversight of a foreign service provider, such as through comprehensive audits conducted by the service provider's internal or external auditors, the institution's own auditors, or foreign bank supervisory authorities. The arrangement must not hinder the ability of the institution to comply with all applicable U.S. laws and regulations, including, for example, requirements for accessibility and retention of records under the Bank Secrecy Act.
2. *Information access.* The outsourcing arrangement should not hinder the ability of U.S. supervisors to reconstruct the U.S. activities of the organization in a timely manner, if necessary. Outsourcing to jurisdictions where full and complete access to information may be impeded by legal or administrative restrictions on information flows will not be acceptable unless copies of records pertaining to U.S. operations are also maintained at the institution's U.S. office.
3. *Audit.* Copies of the most recent audits of the outsourcing arrangement must be maintained in English at the institution's U.S. office and must be made available to examiners upon request.
4. *Contingency plan.* The institution's contingency plan must include provisions to ensure timely access to critical information and service resumption in the event of unexpected national or geographic restrictions or disruptions affecting a foreign service provider's ability to provide services. Depending on the scope and risks of the outsourced function, this may necessitate back-up arrangements with other U.S. or foreign service providers in other geographic areas.
5. *Foreign banking organizations.* With the exception of a U.S. branch or agency of a foreign bank that relies on the parent organization for information- or transaction-processing services, foreign banking organizations should maintain at the U.S. office documentation of the home office's approval of outsourcing arrangements supporting its U.S. operations, whether to a U.S. or foreign service provider. The organization's U.S. office should also maintain documentation demonstrating appropriate oversight of the service provider's activities, such as written contracts, audit reports, and other monitoring tools. When appropriate, the Federal Reserve will coordinate with a foreign banking organization's home-country supervisor to ensure that it does not object to the outsourcing arrangement.
6. *Foreign branches or subsidiaries of U.S. banks and Edge corporations.* Documentation relating to outsourcing arrangements of the foreign operations of U.S. banking organizations with foreign service providers should be made available to examiners upon request.

INFORMATION-PROCESSING ENVIRONMENT

Many factors influence an institution's decision about whether to use internal or external data processing services, including the initial investment, operating costs, and operational flexibility. Historically, small financial institutions, which usually lack the funds or transaction volume to justify an in-house information system, were the chief users of external data processing companies. However, as advances in technology have decreased the cost of data processing, small institutions have become much more willing to invest in an in-house information system. At the same time, some financial institutions with internal information systems have discovered that they can save money by using external data processing companies for certain banking applications. Other financial institutions have engaged national companies or facilities-management organizations to assume their processing operations, while certain holding companies have organized their data processing departments as subsidiaries to centralize operations for their affiliate institutions.

The decision to establish an internal data processing center is a major one. Any bank's board of directors and management considering such a decision should thoroughly review and consider alternatives before proceeding. While a bank may gain a number of competitive advantages from an in-house facility, there are also many risks associated with this decision. Technological advances have reduced the price of small computer networks and made them more affordable, but banks should not use this as the sole justification for an internal data processing center.

A comprehensive feasibility study should precede any decision to develop an in-house system. This study should describe the costs, benefits, and risks and also give management the opportunity to compare current and future needs with existing abilities. The FFIEC's *IS Handbook* contains a complete discussion of feasibility studies.

The management of a financial institution must carefully identify the organization's needs for data processing. After these needs are properly identified (including the customers' needs for these services), management must carefully evaluate how the institution can best meet them. The costs and complexity of changing data processing arrangements can be substantial, so management must ensure that all related costs and benefits are identified and considered before deciding on a service. The following are the major external providers of data processing and IT services for financial institutions.

Correspondent Banks

Small financial institutions sometimes receive their IT services from a major correspondent bank. These services may be just one of a host of services available from the correspondent. Historically, the correspondent bank has been the least expensive servicer for many institutions. Correspondent banks may offset some of their own IT costs by using their excess processing capacity to provide services to correspondents.

Affiliated Financial Institutions and Banking Organizations

IT departments in holding companies or subsidiaries are one common form of an affiliated servicer. An affiliated data center may offer cost savings to other affiliates, since all parties are generally using the same software system. The serviced institutions can eliminate the duplication of tasks, and the affiliated data center and the overall organization can realize cost savings through economies of scale. Thus, charges for IT services to affiliates are generally very competitive.

Regulatory guidelines strictly govern IT-servicing arrangements between affiliated institutions. Sections 23A and 23B of the Federal Reserve Act (12 USC 371c and 371c-1) address the question of allowable transactions between affiliates. These statutes also state that the terms of transactions between affiliated parties must be comparable to the terms of similar transactions between nonaffiliated parties. An affiliated data center is allowed to set fees to recover its costs or to recover its costs plus a reasonable profit, or to set charges for data processing services that are comparable to those of a nonaffiliated servicer. Other restrictions may also apply.

Independent Service Bureaus

Independent service bureaus are present in most areas, but mergers and acquisitions have caused the number of bureaus to decline. When management investigates a service bureau's operations, it should determine if the servicer is familiar with the IT needs of financial institutions. Determining the percentage of the service bureau's business that comes from financial institutions will help the institution select a vendor that specializes in this type of processing. Independent service bureaus are normally responsive to user requests for specialized programs, since developing these programs for clients is generally a significant source of revenue. Tailoring a software program to a particular institution's needs becomes less attractive to the independent service bureau if the institution accounts for only a small portion of the bureau's workload or if the bureau offers a standardized software package as its primary product. However, some standardized software systems allow a modest amount of processing and report adjustments without requiring servicer modifications. Also, report-generator software, which provides clients with customized reports they can prepare without any help from the service bureau, is sometimes available from service bureaus.

Cooperative Service Corporations

A cooperative service corporation is a data processing facility formed by a group of financial institutions that agrees to share the operating costs. Under the right circumstances, this arrangement works well. For this strategy to succeed, however, all members of the group must be the same approximate size and have similar IT requirements. Typically, each institution owns a share of the facility or bears a share of the costs on a pro rata basis through investment in a bank service corporation. There must be a strong working relationship among the institutions. Although the institutions are not directly involved in the data processing center's daily operations, they are ultimately responsible for the center's success or failure.

One advantage of a cooperative service corporation is that individual institutions have increased control over the design of the data processing operation. Therefore, institutions can tailor computerized applications to meet their own needs. Resource pooling often provides for economies of scale as well, and cooperative ventures normally attract more highly skilled and more experienced employees.

Facilities-Management Providers

Medium- and large-sized financial institutions that already have an in-house data processing facility are the most likely users of facilities-management (FM) contracts. Small institutions typically do not have the work volume that is a prerequisite to hiring an FM company. Service contracts with FM companies are usually for a minimum term of five years, during which time the FM company assumes full responsibility for the institution's data processing operations. The institution pays the FM company a monthly fee to reimburse it for the costs of providing IT services plus a profit. The FM company usually carries out its tasks in the institution's former data processing center.

Financial institutions have various reasons for using FM companies, such as controlling or reducing the growth of data processing costs, ensuring better management of data-center personnel, or using more modern software systems. Management of financially strained institutions may enter into FM arrangements to augment their capital position by selling their equipment or facilities to the FM company.

Although an institution's contract with an FM company may provide a quick and easy solution to data processing problems with minimal involvement of senior officials, management should be aware of potential problems. FM contracts can have clauses that require the institution to pay more for services as work volume grows and can also contain provisions for periodic increases. The contract may include a substantial penalty for cancellation. Another risk is that the FM company may make personnel changes that are not advantageous to the institution, such as reassigning its best workers elsewhere or reducing the size of the data processing staff. Bank management should make sure that FM service contracts contain specific quality-measurement clauses and should monitor the quality of data processing services provided.

Other Purchased Services

Computer Time

A financial institution that designed its own data processing system and that maintains its own files only needs to rent computer time from an external servicer. This arrangement usually occurs when the financial institution's equipment or schedule makes it unable to handle some unusual processing task.

Time-Shared Computer Services

Most external providers of time-sharing services have a library of standardized programs available to any user. A user also may generate programs and store them in a reserved library. Financial institutions frequently use time-sharing services for financial analysis rather than recordkeeping. Applications with low input and output requirements and repetitive calculations, such as those required for a securities portfolio, lend themselves to a time-sharing arrangement. The external servicer in this arrangement normally does not maintain the client institution's data files. Financial institutions that store master files on the external servicer's equipment should maintain adequate documentation to facilitate the examination process. Under this arrangement, management should be concerned about ensuring logical and physical access to the terminal and about the availability of audit trails that indicate who has made changes to master files. Management should establish and monitor controls over passwords, terminals, and access to master files. For a complete discussion of controls over passwords and terminals, see the FFIEC's *IS Handbook.*

Satellite Processing

Satellite (remote) processing has become popular with some financial institutions that are located far away from an external servicer and that must process a large volume of transactions. A distinguishing characteristic of satellite processing is that the institution and the data center each perform a portion of the processing. Although the institution collects the data and sometimes prepares reports, the servicer makes the necessary master-file updates. To capture data and print reports, the serviced institution must acquire a terminal-entry device, a printer, an MICR reader/sorter, and a tape or disk unit. Since the system is usually on-line, the serviced institution must install modems and communications lines linking it to the servicer. The level of skill necessary to perform remote job entry in a satellite system is less sophisticated than the level needed to operate an in-house system. Most of the traditional control functions remain at the institution. The FFIEC's *IS Handbook* contains further information on satellite processing, remote job entry, and distributive processing systems.

Standard Program Packages

Most bank data centers and service bureaus specialize in processing one or more standard software packages. By using the same software for several users, external servicers achieve certain operating economies, which allow them to recover initial development costs more quickly. Most standard software packages are parameter driven, providing the user with some degree of flexibility. For example, in demand deposit and savings applications, standard program modules or common subroutines often allow the user to designate the format and frequency of reports. In addition, the user may select the parameters necessary to generate certain reports, such as the number of inactive days before an account becomes dormant or the minimum dollar amount for checks listed on the large-item report. The user can also be involved in selecting the criteria for interest rates, balance requirements, and other operating values, allowing for a tailored application within a standardized software system.

Tailored Applications

If standard program packages do not meet a financial institution's needs, an external servicer can be hired to design tailored applications to process the institution's data. The institution must clearly describe the proposed system and its operations to the servicer. Internal or external auditor participation in reviewing controls is also advisable. The initial cost of this approach is high, as are the costs of maintaining and updating the tailored applications.

OPERATIONAL AND TECHNOLOGICAL USER CONTROLS

Using computerized programs and networks, banks maintain a large number of accounts and record a high volume of transactions every day. Text-processing systems store vast amounts of correspondence. Transmission of data and funds regularly occurs over public communications links, such as telephone lines and satellite networks. The use of new technologies to transfer funds and records, while improving customer service and the institution's internal operations, has increased the potential for errors and abuse, which can result in loss of funds, lawsuits arising from damaged reputations, improper disclosure of information, and regulatory sanctions.

Controls must be implemented to minimize the vulnerability of all information and to keep funds secure. Bank management must assess the level of control necessary in view of the degree of exposure and the impact of unexpected losses on the institution. Certain practices can strengthen information and financial security. The most basic practices are the implementation of sound policies, practices, and procedures for physical security, separation of duties, internal quality control, hardware and software access controls, and audits. Bank management should institute information-security controls that are designed to—

- ensure the integrity and accuracy of management information systems;
- prevent unauthorized alteration during data creation, transfer, and storage;
- maintain confidentiality;
- restrict physical access;
- authenticate user access;
- verify accuracy of processing during input and output;
- maintain back-up and recovery capability; and
- provide environmental protection against damage or destruction of information.

Although security features vary, they are usually available for all computer systems. The controls adopted should apply to information produced and stored by both automated and manual methods.

Written policies are generally recommended and, in most cases, institutions have chosen to establish and communicate security principles in writing. However, if an institution follows sound fundamental principles to control the risks discussed here, a written policy is not necessarily required. If sound principles are not effectively practiced, management may be required to establish written policies to formally communicate risk parameters and controls. Federal Reserve System policy does, however, require written contingency and disaster-recovery plans.

Examiners should regularly conduct reviews of information security. These reviews may include an assessment of—

- the adequacy of security practices,
- compliance with security standards, and
- management supervision of information-security activities.

When conducting reviews of controls over information security, examiners must understand the difference between master files and transaction files. A master file is a main reference file of information used in a computer system, such as all mortgage loans. It provides information to be used by the program and can be updated and maintained to reflect the results of the processed operation. A transaction file or detail file contains specific transaction information, such as mortgage loan payments.

Manual Controls

The following discussion covers basic operational controls in a financial institution receiving external IT services. Similar controls should also be applied to information processed by an IT department within a user's own institution.

Separation of Duties

A basic form of operational control is separation of duties. With this control in place, no one person should be able to both authorize and execute a transaction, thereby minimizing the risk of undetected improper activities. Data-center personnel should not initiate transactions or correct data except when it is necessary to complete processing in a reasonable time period. If this unusual situation arises, proper authorization should be obtained from data center and bank management. Both the servicer and the serviced institution should maintain documentation of these approvals, including details of the circumstances requiring the action. The same person normally should not perform input and output duties. However, in some instances, staff limitations may make one person responsible for several activities, such as—

- preparing batches and blocks or other input for entry to the system or shipment to the servicer;
- operating data-entry equipment, including check reader/sorter machines, proof machines, or data-conversion devices;
- preparing rejects and nonreaders for reentry into the system;
- reconciling output to input or balancing the system;
- distributing output to ultimate users; and
- posting the general ledger and balancing computer output to the general ledger.

Rotation of assignments and periodic scheduled absences may improve internal controls by preventing one person from controlling any one job for an extended time period (and by providing cross-training and back-up for all personnel). When vacations are scheduled, management may require staff to take uninterrupted vacations that are long enough to allow pending transactions to clear. These practices are most effective if vacations or other types of absences extend over the end of an accounting period or are for two consecutive weeks. Written policies and procedures may require job rotation.

Application manuals usually consist of a user's guide provided by the servicer that is supplemented by procedures written by the user. Manuals normally cover the preparation and control of source documents, certain control practices for moving documents or electronic images to and from the user and servicer, the daily reconcilement of totals to general ledger, and master-file changes.

Management should implement dual control over automated systems. Personnel should place supervisory holds on customer accounts requiring special attention. For example, dormant accounts, collateral accounts, and accounts with large uncollected funds balances generally have holds that can be removed only by authorizations from two bank officials. In addition, certain types of transactions (for example, master-file changes) should require authorization from two bank officials by means of special codes or terminal keys. When employees add or remove a hold on an account or when the system completes a transaction requiring supervisory approval, the computer should generate an exception report. Assigned personnel not involved in the transaction should promptly review these reports for unusual or unauthorized activity.

Internal Quality Controls

Generally, there are three basic types of information systems, with many combinations and variations:

- *Inquiry-only system.* This system allows the user to search and review machine-readable records, but not to alter them. Controls and security concerns related to this system are few, the major concern being unauthorized access to confidential information.
- *Memo-post system.* More sophisticated than the inquiry-only system, the memo-post system allows the user to create interim records. The servicer performs permanent posting routines using batch-processing systems. Controls for a memo-post system include limiting physical and logical access to the system and restricting certain transactions to supervisory personnel only. Appropriate levels of management should review memo-post reports daily.
- *On-line-post system.* This system, sometimes called a real-time system, requires the strictest controls. On-line-post systems are vulnerable because all accepted transactions are transferred to machine-readable records. In addition to access controls, system reports should record all activity and exceptions. Appropriate levels of management should review these reports daily.

Internal controls fall into three general categories:

- *Administrative controls.* Administrative controls usually consist of management review of daily operations and output reports. Each application includes basic controls and exception reports that are common to all operations. To be effective, operations personnel must properly use exception reports and controls. This is especially true for controlling dormant accounts, check kiting, draws against uncollected funds, overdrafts, and posting computer-generated income and expense entries.
- *Dollar controls.* Dollar controls ensure processing for all authorized transactions. Operations personnel should establish work and control totals before forwarding data records to the data processor. Those same employees should not complete balancing procedures by reconciling trial balances to input, control sheets, and the general ledger. Report distribution should follow a formal procedure. Personnel should account for all rejects corrected and resubmitted.
- *Condoler controls.* Condoler controls are used when dollar values are not present in the data, as in name and address changes. Controls should be established before forwarding work for processing. Management should also implement procedures designed to ensure that its servicer processes all condoler transactions. For example, personnel should check new-account reports against new-account input forms or written customer-account applications to make sure that data are properly entered. To protect data integrity, management should develop procedures to control master-file and program changes. These procedures should also verify that the servicer is making

only authorized changes and ensure that data processing employees do not initiate master-file changes.

Technological Controls

Encryption

Encryption is a process by which mathematical algorithms are used to convert plain text into encrypted strings of meaningless symbols and characters. This helps prevent unauthorized viewing and altering of electronic data during transmission or storage. The industry commonly uses the Data Encryption Standard (DES) for encoding personal identification numbers (PINs) on access cards, storing user passwords, and transferring funds on large-dollar payment networks.

Message-Authentication Code

A message-authentication code (MAC) is a code designed to protect against unauthorized alteration of electronic data during transmission or storage. This code is used with data encryption to further secure transmission of large-dollar payments.

User Passwords

User passwords consist of a unique string of characters that a programmer, computer operator, or user must supply before gaining access to the system or data. These are individual access codes that should be specific to the user and known only to the user. Other security features of passwords should, at a minimum, require the users to change them periodically and store them in encrypted files. In addition, the passwords should be composed of a sufficient number of alphanumeric characters to make them difficult to guess. User passwords should not be displayed during the access process and should not be printed on reports.

Security Software

Security software is software designed to restrict access to computer-based data, files, programs, utilities, and system commands. Some systems can control access by user, transaction, and terminal. The software can generate reports that log actual and attempted security violations as well as access to the system.

Restricted Terminals

Limiting certain types of transactions to certain terminals or groups of terminals can help reduce exposure to loss. The offsetting problem is that loss of the ability to use these terminals can stop processing for an entire application. Bank management should therefore evaluate both the exposure and processing risks.

An automatic time-out feature can minimize the exposure risk. Since unauthorized users may target an unattended terminal, this feature automatically signs off the user when there has been no activity for a certain period of time. Using time-of-day restrictions can also limit unauthorized use of terminals during periods when an entire department or section would be unattended.

Restricted Transactions

Restricted transactions are specialized transactions that can be performed only by supervisory or management personnel. Examples include reversing transactions, dollar adjustments to customer accounts, and daily balancing transactions. Management should periodically review user needs and the appropriateness of restricting the performance of these transactions. System-generated reports can be used to review this activity more frequently.

Activity and Exception Reports

Report output will vary, depending on the sophistication of the data communications and applications software. Management should receive activity reports that detail transactions by terminal, operator, and type. More sophisticated software will produce activity and exception reports on other criteria, such as the number of inquiries by terminal, unsuccessful attempts to access the system, unauthorized use of restricted information, and any unusual activities (that is, infrequently used transactions).

Activity reports are used to monitor system use and may not be printed daily. However, management should periodically review and summarize these reports in an effort to ensure that machines are used efficiently. Exception reports should be produced and reviewed daily by designated personnel who have no conflicting responsibilities. A problem with many reporting systems is that the log contains a record of every event, making it cumbersome and more difficult to identify problems.

Controls Over Software-Program-Change Requests

Requests for system changes, such as software-program changes, should be documented on a standard change-request form. The form is used to describe the request and document the review and approval process. It should contain the following information:

- date of the change request
- sequential control number
- program or system identification
- reason for the change
- description of the requested change
- person requesting the change
- benefits contemplated from the change
- projected cost
- signed approval authorizing the change including, at a minimum, the user, IT personnel with the proper authority, and an auditor (at least for significant changes)
- name of programmer assigned to make the change
- anticipated completion date
- user and information systems approval of the completed program change
- implementation procedures (steps for getting the program into the production library)
- audit review of change (if deemed necessary)
- documented sign-off

End-User Computing

End-user computing results from the transfer of information-processing capabilities from centralized data centers onto the user's desktop. End-user computing systems may range in size and computing power from laptop notebook computers to stand-alone personal computers, client-server networks, or small systems with sufficient computing power to process all significant applications for a financial institution. Small systems that are entirely supported by a hardware or software vendor are referred to as turnkey systems. Control considerations discussed throughout this subsection generally apply to all end-user computing systems.

In many cases, end-user systems are linked by distributed processing networks. Linking several microcomputers together and passing information between them is called networking. A system configured in this manner is commonly called a local area network (LAN). The ability to decentralize the data processing function is largely a result of the development of powerful microcomputers or PCs. Microcomputers are now powerful enough to process significant applications when used as stand-alone systems. These microcomputers can also be connected to a host computer and configured to serve as a data-entry or display terminal. In this terminal-emulation mode, information can be passed between the host and the PC with the processing occurring at either machine.

When linked by a network, end-user computing offers several advantages to financial institutions, including—

- low cost compared with other platforms,
- efficiency through the sharing of resources,
- ease of expansion for future growth ,
- enhanced communication capabilities,
- portability,
- data availability, and
- ease of use.

While end-user computing systems provide several advantages, they also have greater risks to data integrity and data security, including—

- difficulty in controlling access to the system and in controlling access to confidential information that may be stored on individual personal computers and not on the system (such as payroll records, spreadsheets, budgets, and information intended for the board of directors of the financial institution),
- the lack of sophisticated software to ensure security and data integrity,
- insufficient capabilities to establish audit trails,
- inadequate program testing and documentation,
- lack of segregated duties of data-entry personnel.

As the trend toward distributed processing continues, financial institutions should have proper policies, procedures, and reporting to ensure the accurate and timely processing of information. The controls governing access in an end-user computing environment should be no less stringent than those used in a traditional mainframe environment. Strict rules should govern the ability of users to access information. As a general rule, no user should be able to access information that is beyond what is needed to perform the tasks required by his or her job description. In this new environment, management and staff should assume responsibility for the information assets of the organization.

CONTINGENCY PLANNING, RECORD PROTECTION, AND RETENTION

Data communications systems are susceptible to software, hardware, and transmission problems that may make them unusable for extended periods of time. If a financial institution depends on data communication for its daily operations, appropriate back-up provisions are necessary. Back-up is the ability to continue processing applications in the event the communications system fails. Management can provide back-up by various methods, including batch-processing systems, intelligent terminals or PCs operating in an off-line mode, data capture at the controller if transmission lines are lost, redundant data communication lines, and back-up modems.

Regardless of the method used, FFIEC interagency issuances and specific supporting Federal Reserve System policy issuances that address corporate contingency planning require a comprehensive back-up plan with detailed procedures. When using a batch back-up system, operations personnel must convert data to a machine-readable format and transport the data to the servicer. This process may require additional personnel (data-entry operators and messengers) and equipment. An institution's contingency plan should include detailed procedures on how to obtain and use the personnel and equipment. Because on-line systems are updated or improved frequently, a batch back-up may not remain compatible. Institution personnel should perform periodic tests of batch and other back-up capabilities to ensure that protection is available and that employees are familiar with the plan.

Institutions should create computerized back-up copies of the institution's critical records and have alternative methods of processing those records. When IT operations are performed outside the institution, both the servicer and the financial institution should have adequate control over the records. Bank management should determine which records are best protected by the servicer and which are best protected internally. Service contracts should outline the servicer's responsibility for storing bank records. If the servicer does not or will not permit specific reference to record retention in the contract, a general reference may be sufficient. The institution should obtain a copy of the servicer's back-up policy and retention procedures, and bank management should thoroughly understand which records are protected by whom and to what extent.

The bank should also review the servicer's software and hardware back-up arrangements. It should review the service provider's contingency plan and results of routine tests of the contingency plan. The review should determine how often data and software back-ups are made, the location of stored materials, and which materials are stored at that site. Management should also determine the availability of software replacement and vendor support, as well as the amount and location of duplicate software documentation. Software replacement and documentation procedures should be developed for both operating and application systems.

Management should review the servicer's hardware back-up arrangements to determine if (1) the servicer has a contract with a national recovery service and, if so, the amount and type of back-up capacity provided under the contract; (2) the servicer has an alternate data center with sufficient capacity and personnel to provide full service if necessary; or (3) multiple processing sites within the same facility are available for disaster-processing problems and if each site has an alternate power supply. The alternate site should be able to provide continued processing of data and transmission of reports.

Contracts or contingency plans should specify the availability of source documentation in the event of a disaster, including insolvency of the servicer. FFIEC interagency issuances and Federal Reserve System policy statements require financial institutions to evaluate the adequacy of a servicer's contingency plan and to ensure that its own contingency plan is compatible with the servicer's plan.

Since the duplication of records may vary from site to site, most organizations develop schedules for automatic retention of records on a case-by-case basis. The only way to ensure sufficient record protection is to continually review the flow of documents, data, and reports. Some records may be available in both hard-copy and machine-readable formats. In addition to determining the types of back-up records, management should determine whether it is possible to re-create current data from older records. Certain records also have uses apart from their value in reconstructing current data, such as meeting institutional and regulatory reporting requirements. These records usually include month-end, quarter-end, and year-end files.

The location of an external data center is another factor to consider when evaluating retention procedures. If the external data center is located in a building adjacent to the institution, the possibility that a disaster may affect both organizations increases. Such a situation may make off-site storage of back-up materials even more important. If, on the other hand, the serviced institution is located far from the data center, physical shipment of both input and output may become necessary. Management should determine if fast, reliable transportation between the two sites is available.

If a major disaster occurs, an alternate facility may not be available to process duplicated machine-readable media. Management should consider remote record storage that would facilitate the manual processing of records, if necessary. Furthermore, microfilming all items before shipment would protect the institution if any items are lost, misplaced, or destroyed. Optical-disk storage, which involves scanning and storing a document electronically, offers another alternative for storage and retrieval of original data after processing has occurred. The FFIEC's *IS Handbook* and related FFIEC and Federal Reserve System issuances are sources of information about planning for unexpected contingencies.

Processing personnel should regularly copy and store critical institution records in an off-site location that is sufficiently accessible to obtain records in a reasonable time period. These records should include data files, programs, operating systems, and related documentation. This also applies to critical data in hard-copy documents. In addition, an inventory of the stored information should be maintained along with a defined retention period.

AUDITS

Examiners need to determine the appropriateness of the scope and frequency of audit activities related to information systems and the reliability of internal or third-party audits of servicer-processed work. Furthermore, examiners should review the methods by which the board of directors is apprised of audit findings, recommendations, and corrective actions taken. In reviewing audit activities, examiners should consider the following factors (if applicable):

- the practicality of the financial institution's having an internal IT auditor and, if the institution has an internal IT auditor, the auditor's level of training and experience
- the training and experience of the institution's external auditors
- the audit functions performed by the institution's outside auditors, the servicer, the servicer's outside auditor, and supervisory personnel
- internal IT audit techniques currently being followed

The audit function should review controls and operating procedures that help protect the institution from losses caused by irregularities and willful manipulations of the data processing system. Thus, a regular, comprehensive audit of IT activities is necessary. Additionally, designated personnel at each serviced institution should periodically perform "around-the-computer" audit examinations, such as:

- developing data controls (proof totals, batch totals, document counts, number of accounts, and prenumbered documents) at the institution before submitting data to the servicer and sampling the controls periodically to ensure their accuracy;
- spot-checking reconcilement procedures to ensure that output totals agree with input totals, less any rejects;
- sampling rejected, unpostable, holdover, and suspense items to determine why they cannot be processed and how they were disposed of (to make sure they were properly corrected and re-entered on a timely basis);

- verifying selected master-file information (such as service-charge codes), reviewing exception reports, and cross-checking loan extensions to source documents;
- spot-checking computer calculations, such as the dollar amounts of loan rebates, interest on deposits, late charges, service charges, and past-due loans, to ensure proper calculations;
- tracing transactions to final disposition to ensure audit trails are adequate;
- reviewing source documents to ascertain whether sensitive master-file change requests were given the required supervisory approval;
- assessing the current status of controls by either visiting the servicer or reviewing independent third-party reviews of the servicer;
- reviewing processing procedures and controls; and
- evaluating other audits of the servicer.

In addition, ‘‘through-the-computer’’ audit techniques allow the auditor to use the computer to check data processing steps. Audit software programs are available to test extensions and footings and to prepare verification statements.

Regardless of whether an institution processes data internally or externally, the board of directors must provide an adequate audit program for all automated records. If the institution has no internal IT audit expertise, the nontechnical ‘‘around-the-computer’’ methods will provide minimum coverage, but not necessarily adequate coverage. A comprehensive external IT audit, similar to those discussed in the FFIEC’s *IS Handbook*, should be carried out to supplement nontechnical methods.

INSURANCE

A financial institution should periodically review its insurance coverage to ensure that the amount of coverage is adequate to cover any exposure that may arise from using an external IT provider. To determine what coverage is needed, the institution should review its internal operations, the transmission or transportation of records or data, and the type of processing performed by the servicer. This review should identify risks to data, namely the accountability for data, at both the user and servicer locations and while in transit. Insurance covering physical disasters, such as fires, floods, and explosions, should be sufficient to cover replacement of the data processing system. Coverage that protects specialized computer and communications equipment may be more desirable than the coverage provided by regular hazard insurance. Expanded coverage protects against water infiltration, mechanical breakdown, electrical disturbances, changes in temperature, and corrosion. The use of an ‘‘agreed-amount’’ endorsement can provide for full recovery of covered loss.

Bank management should also review the servicer’s insurance coverage to determine if the amounts and types are adequate. Servicer coverage should be similar to what the financial institution would normally purchase if it were performing its data processing internally. Servicer-provided coverage should complement and supplement the bank’s coverage.

If a loss is claimed under the user’s coverage, the user need only prove that a loss occurred to make a claim. However, if the loss is claimed under the servicer’s coverage, the institution must prove that a loss occurred and also that the servicer was responsible for the loss.

Examiners should review the serviced institution’s blanket bond coverage, as well as similar coverage provided by the servicer. The coverage period may be stated in terms of a fixed time period. The loss, the discovery, and the reporting of the loss to the insurer must occur during that stated period. Extended discovery periods are generally available at additional cost if an institution does not renew its bond. The dollar amount of the coverage now represents an aggregate for the stated period. Each claim paid, including the loss, court costs, and legal fees, reduces the outstanding amount of coverage, and recoveries do not reinstate previous levels of coverage. Since coverage extends only to locations stated in the policy, the policy must individually list all offices. Additionally, policies no longer cover certain types of documents in transit.

The bank’s board of directors should be involved in determining insurance coverage since each board member will be acknowledging the terms, conditions, fees, riders, and exclusions of the policy. Insurance companies consider any provided information as a warranty of coverage. Any omission of substantive information could result in voided coverage.

The bank or servicer should consider buying additional coverage. Media-reconstruction policies defray costs associated with recovering data contained on the magnetic media. Media-replacement policies replace blank media. Extra-expense policies reimburse organizations for expenses incurred over and above the normal cost of operations. In addition, servicers often purchase policies covering unforeseen business interruptions and the liabilities associated with errors and omissions. Both servicer and banking organizations may purchase transit insurance that covers the physical shipment of source documents. Additionally, electronic funds transfer system (EFTS) liability coverage is available for those operations that use electronic transmission.

Several factors may influence an institution's decision to purchase insurance coverage or to self-insure: the cost of coverage versus the probability of occurrence of a loss, the cost of coverage versus the size of the loss of each occurrence, and the cost of coverage versus the cost of correcting a situation that could result in a loss. Some institutions engage risk consultants to evaluate these risks and the costs of insuring against them.

SERVICE CONTRACTS

Contract Practices

A poorly written or inadequately reviewed contract can be troublesome for both the serviced financial institution and the servicer. To avoid or minimize contract problems, bank legal counsel who are familiar with the terminology and specific requirements of a data processing contract should review it to protect the institution's interests. Since the contract likely sets the terms for a multiyear understanding between the parties, all items agreed on during negotiations must be included in the final signed contract. Verbal agreements are generally not enforceable, and contracts should include wording such as "no oral representations apply" to protect both parties from future misunderstandings. The contract should also establish baseline performance standards for data processing services and define each party's responsibilities and liabilities, where possible.

Although contracts between financial institutions and external data processing companies are not standardized in a form, they share a number of common elements. For a further discussion of IT contract elements and considerations, see the FFIEC's *IS Handbook*.

Additionally, section 225 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) states, "An [FDIC-] insured depository institution may not enter into a written or oral contract with any person to provide goods, products or services to or for the benefit of such depository institution if the performance of such contract would adversely affect the safety or soundness of the institution." An institution should ascertain during contract negotiations whether the servicer can provide a level of service that meets the needs of the institution over the life of the contract. The institution is also responsible for making sure it accounts for each contract in accordance with GAAP. Regulatory agencies consider contracting for excessive servicing fees and/or failing to properly account for such transactions an unsafe and unsound practice. When entering into service agreements, banks must ensure that the method by which they account for such agreements reflects the substance of the transaction and not merely its form. See FFIEC Supervisory Policy SP-6, "Interagency Statement on EDP Service Contracts."

Risk of Termination

Many financial institutions have become so dependent on outside data processing servicers that any extended interruption or termination of service would severely disrupt normal operations. Termination of services generally occurs according to the terms of the service contract. Banks may also experience an interruption of services that is caused by a physical disaster to the servicer, such as a fire or flood, or by bankruptcy. The serviced institution must prepare differently for each type of termination. The contract should allow either party to terminate the agreement by notifying the other party 90 to 180 days in advance of the termination date, which should give a serviced institution adequate time to locate and contract with another servicer.

Termination caused by physical disaster occurs infrequently, but it may present the institution with a more serious problem than termination by contract. However, if the servicer has complied with basic industry standards and maintains a proper contingency plan, disruption of services to users will ordinarily be minimal. The contingency plan must require the servicer to maintain current data files and programs at an alternate site and arrange for back-up processing time with another data center. At a minimum, these provisions should allow the servicer to process the most important data applications. Since equipment vendors can often replace damaged machines within a few days, the servicer should be able to resume processing with little delay. The servicer, not the serviced institution, is responsible for the major provisions of its back-up contingency plan. However, the institution must have a plan that complements the servicer's.

Termination caused by bankruptcy of the servicer is potentially the most devastating to a serviced institution. There may not be advance notice of termination or an effective contingency plan (because servicer personnel may not be available). In this situation, the serviced institution is responsible for finding an alternate processing site.

Although user institutions can ordinarily obtain data files from a bankrupt servicer with little trouble, the programs (source code) and documentation required to process those files are normally owned by the servicer and are not available to the user institutions. These programs are often the servicer's only significant assets. Therefore, a creditor of a bankrupt servicer, in an attempt to recover outstanding debts, will seek to attach those assets and further limit their availability to user institutions. The bankruptcy court may provide remedies to the user institutions, but only after an extended length of time.

An escrow agreement is an alternative to giving vendors sole control of the source code. In this agreement, which should either be part of the service contract or a separate document, the financial institution would receive the right to access source programs under certain conditions, such as discontinued product support or the financial insolvency of the vendor. A third party would retain these programs and related documents in escrow. Periodically, the financial institution should determine that the source code maintained in escrow is up-to-date, for example, an independent party should verify the version number of the software. Without an escrow agreement, a serviced institution has two alternatives: (1) pay off the creditor and hire outside specialists to operate the center or (2) convert data files to another servicer. Either alternative is likely to be costly and cause severe operating delays.

Institutions should normally determine the financial viability of its servicer annually. Once the review is complete, management must report the results to the board of directors or a designated committee. At a minimum, management's review should contain a careful analysis of the servicer's annual financial statement. Management may also use other sources of information to determine a servicer's condition, such as investment analyst reports and bond ratings. Reports of independent auditors and examination reports for certain service providers obtainable from appropriate regulatory agencies may contain useful information.

AUTOMATED CLEARINGHOUSE

Automated clearinghouses (ACHs) form a nationwide electronic payments system used by a large number of depository institutions and corporations. ACH rules and regulations are established by the National Automated Clearing House Association (NACHA) and the local ACH associations, and they are referenced in the ACH operating circulars of the Federal Reserve Banks.

ACH is a value-based system that supports both credit and debit transactions. In ACH credit transactions, funds flow from the depository institution originating the transaction to the institutions receiving the transactions. Examples of credit payments include direct deposits of payroll, dividend and interest payments, Social Security payments, and corporate payments to contractors and vendors. In a debit transaction, funds flow from the depository institutions receiving the transaction instructions to the institution originating the transaction. Examples of ACH debit transactions include collection of insurance premiums, mortgage and loan payments, consumer bill payments, and transactions to facilitate corporate cash management. ACH transactions are deposited in batches at Federal Reserve Banks (or private-sector ACH processors) for processing one or two business days before the settlement date. These transactions are processed and delivered to the receiving institutions through the nightly processing cycle for a given day.

ACH transactions continue to grow significantly. Additional uses of the ACH continue to be developed as depository institutions, corporations, and consumers realize its efficiency and low cost compared with large-dollar payments systems and check payments. One area of growth is the use of debit transactions for the collection of large payments due to the originator, such as the cash concentration of a company's nationwide branch or subsidiary accounts into one central account and other recurring contractual payments.

While several organizations can be involved in processing ACH transactions, the Federal Reserve System is the principal ACH processor. For the Federal Reserve ACH system, depository institutions send ACH transactions to and receive ACH transactions from one of the Federal Reserve processing sites via a communications system linking each location. Access may be by direct computer interface or intelligent terminal connections.

As with any funds-transfer system, the ACH system has inherent risks, including error, credit risk, and fraud. When reviewing ACH activities, examiners should evaluate the following:

- agreements covering delivery and settlement arrangements maintained by the depository institution as an originator or receiver of ACH transactions
- monitoring of the institution's and customer's intraday positions
- balancing procedures of ACH transactions processed
- the credit policy and effectiveness of procedures to control intraday and overnight overdrafts, resulting from extensions of credit to an ACH customer, to cover the value of credit transfers originated (Since ACH transactions may be originated one or two days before the settlement date, the originating institution is exposed to risk from the time it submits ACH credit transfers to the ACH processor to the time its customer funds those transfers.)
- uncollected-funds controls and the related credit policy for deposits created through ACH debit transactions (ACH debits can be returned for insufficient funds in the payor's account or for other reasons, such as a court order.)
- exception reports (that is, large-item and new-account reports)
- control procedures for terminals through which additions, deletions, and other forms of maintenance could be made to customer databases
- the retention of all entries, return entries, and adjustment entries transmitted to and received from the ACH for a period of six years after the date of transmittal

RETAIL FUNDS-TRANSFER SYSTEMS

Automation has enabled banks to electronically perform many retail banking functions formerly handled manually by tellers, bookkeepers, data-entry clerks, and other banking personnel. Accordingly, the need for physical banking facilities and related staff has been reduced. Electronic funds transfer (EFT) and related banking services have also brought access to and control of accounts closer to the consumer through the use of widely distributed unmanned terminals and merchant facilities. EFT-related risk to a financial institution for individual customer transactions is generally low, since the transactions are usually for relatively small amounts. However, weaknesses in controls that could lead to incorrect or improper use of several accounts could lead to significant losses or class action suits against a financial institution. Examinations of retail EFT facilities should focus on the potential large-scale risks of a given product. Examples of retail EFT systems include automated teller machines, point-of-sale networks, debit and "smart" cards, and home banking.

Automated Teller Machines

An automated teller machine (ATM) is a terminal that is capable of performing many routine banking services for the customer. ATMs handle deposits, transfers between savings and checking accounts, balance inquiries, withdrawals, small short-term loans, and loan payments. ATMs may also handle other transactions, such as cash advances on credit cards, statement printing, and postage-stamp dispensing. ATMs usually operate 24 hours a day and are located not only on bank premises but in other locations, such as shopping malls and businesses. Daily withdrawals are usually, and should be, limited to relatively small amounts ($200 to $500). Deposits are processed in the same manner as if they were handled by a teller. ATMs are generally activated through the use of a plastic card encoded with a machine-readable customer identification number and the customer's entry of a corresponding personal identification number (PIN). Some financial institutions may refer to this identification number as the personal identification code (PIC).

ATMs operate in either off-line or on-line mode. Off-line transactions are those that occur when the customer's account balance is not available for verification. This situation can be the result of telecommunication problems between the financial institution and the ATM network. In addition, an off-line transaction can occur when a customer's account balance is not available because the financial institution is updating its files. Financial institutions usually update their files during low-volume periods. In either case, transactions are usually approved up to the daily withdrawal limit, which is a risk to the bank because a customer can withdraw more than is available in the account. On-line systems are directly connected to a financial institution's computer system and the corresponding customer account information. The computer processes each transaction immediately and provides immediate account-balance verification. With either system, a card is normally captured (kept by the ATM) if misuse is indicated (for example, the card has been reported stolen or too many attempts have been made with an invalid PIN).

Financial institutions are usually members of several ATM networks, which can be regional and national. Through these networks, separate institutions allow each other's customers to use their ATM machines. This is known as an interchange system. To be involved in an interchange system, a financial institution must either be an owner or member of the ATM network.

Fraud, robbery, and malfunction are the major risks of ATMs. The use of plastic cards and PINs are a deterrent, but there is still the risk that an unauthorized individual may obtain them. Customers may even be physically accosted while making withdrawals or deposits at ATM locations. Institutions have decreased this risk by installing surveillance cameras and access-control devices. For example, the ATM card can be used as an access-control device, unlocking the door to a separate ATM enclosure and relocking it after the customer has entered. Fraud may also result from risks associated with the issuance of ATM cards, the capture of cards, and the handling of customer PINs. Appropriate controls are needed to prevent the financial institution's personnel from unauthorized access to unissued cards, PINs, and captured cards.

Point-of-Sale Systems

A point-of-sale (POS) system transaction is defined as an electronic transfer of funds from a customer's checking or savings account to a merchant's account to pay for goods or services. Transactions are initiated from POS terminals located in department stores, supermarkets, gasoline stations, and other retail outlets. In an electronic POS system, a customer pays for purchases using a plastic card (such as an ATM, credit, or debit card). The store clerk enters the payment information into the POS terminal, and the customer verifies the transaction by entering a PIN. This results in a debit to the customer's account and a credit to the merchant's account.

POS transactions may be processed through either single-institution unshared systems or multi-institution shared networks. Participants in a shared system settle daily, on a net transaction basis, between each other. In unshared systems, the merchants and customers have accounts with the same financial institution. Thus, the need to settle between banks is eliminated.

As with other EFT systems, POS transactions are subject to the risk of loss from fraud, mistakes, and system malfunction. POS fraud is caused by stolen cards and PINs, counterfeit cards, and unauthorized direct computer access. The system is also susceptible to errors such as debiting or crediting an account by too much or too little, or entering unauthorized transactions. For the most part, POS systems usually deal with these risks by executing bank-merchant and bank-customer contracts that delineate each party's liabilities and responsibilities. Also, consumers are protected by state and federal statutes limiting their liability if they give notice of a lost, stolen, or mutilated card within a specified time period. Other risks inherent in POS systems are computer malfunction or downtime. Financial institutions offering POS services should provide for back-up of their records through adequate contingency planning. Internal control guidelines for POS systems should address the following:

- confidentiality and security of customer-account information, including protection of PINs
- maintenance of contracts between banks and merchants, customers and banks, and banks and networks
- policies and procedures for credit and check

authorization, floor limits, overrides, and settlement and balancing
- maintenance of transaction journals to provide an adequate audit trail
- generation and review of daily exception reports with provisions for follow-up of exception items
- provisions for back-up and contingency planning
- physical security surrounding POS terminals

Internal Controls for Retail EFT Systems

Regardless of the EFT system employed, financial institutions should ensure that adequate internal controls are in place to minimize errors, discourage fraud, and provide an adequate audit trail. Recommended internal-control guidelines for all systems include:

- establishing measures to establish proper customer identification (such as PINs) and maintain their confidentiality
- installing a dependable file-maintenance and retention system to trace transactions
- producing, reviewing, and maintaining exception reports to provide an audit trail

The most critical element of EFT systems is the need for undisputed identification of the customer. Particular attention should be given to the customer-identification systems. The most common control is the issuance of a unique PIN that is used in conjunction with a plastic card or, for noncard systems, an account number. The following PIN control guidelines, as recommended by the American Bankers Association, are encouraged.

Storage:

- PINs should not be stored on other source instruments (for example, plastic cards).
- Unissued PINs should never be stored before they are issued. They should be calculated when issued, and any temporary computer storage areas used in the calculation should be cleared immediately after use.
- PINs should be encrypted on all files and databases.

Delivery:

- PINs should not appear in printed form where they can be associated with customers' account numbers.
- Bank personnel should not have the capability to retrieve or display customers' PIN numbers.
- All the maintenance to PINs stored in databases should be restricted. Console logs and security reports should be reviewed to determine any attempts to subvert the PIN security system.
- PIN mailers should be processed and delivered with the same security accorded the delivery of bank cards to cardholders. (They should never be mailed to a customer together with the card).

Usage:

- The PIN should be entered only by the cardholder and only in an environment that deters casual observation of entries.
- The PIN should never be transmitted in unencrypted form.
- PIN systems should record the number of unsuccessful PIN entries and should restrict access to a customer's account after a limited number of attempts.
- If a PIN is forgotten, the customer should select a new one rather than have bank personnel retrieve the old one, unless the bank has the ability to generate and mail a hard copy of the PIN directly to the customer without giving bank personnel the ability to view the PIN.

Control and security:

- Systems should be designed, tested, and controlled to preclude retrieval of stored PINs in any form.
- Application programs and other software containing formulas, algorithms, and data used to calculate PINs must be subject to the highest level of access control for security purposes.
- Any data-recording medium, for example, magnetic tape and removable disks, used in the process of assigning, distributing, calculating, or encrypting PINs must be cleared immediately after use.
- Employees with access to PIN information must be subject to security clearance and must be covered by an adequate surety bond.

System design:

- PIN systems should be designed so that PINs can be changed without reissuing cards.
- PINs used on interchange systems should be designed so that they can be used or changed without any modification to other participants' systems.
- Financial institutions electing to use encryption as a security technique for bank card systems are strongly encouraged to consider the data encryption standards established by the National Institute of Standards and Technology.

In addition, institutions should consider controls over other aspects of the process. Control guidelines appropriate for plastic cards include those covering procurement, embossing or encoding, storage, and mailing. Controls over terminal sharing and network switching are also appropriate. Institutions should address back-up procedures and practices for retail funds-transfer systems and insurance coverage for these activities.

APPENDIX—RISK MANAGEMENT OF OUTSOURCED TECHNOLOGY SERVICES

Purpose and Background

This statement focuses on the risk-management process of identifying, measuring, monitoring, and controlling the risks associated with outsourcing technology services.[1] Financial institutions should consider the guidance outlined in this statement and the attached appendix in managing arrangements with their technology service providers.[2] While this guidance covers a broad range of issues that financial institutions should address, each financial institution should apply those elements based on the scope and importance of the outsourced services as well as the risk to the institution from the services.

Financial institutions increasingly rely on services provided by other entities to support an array of technology-related functions. While outsourcing to affiliated or nonaffiliated entities can help financial institutions manage costs, obtain necessary expertise, expand customer product offerings, and improve services, it also introduces risks that financial institutions should address. This guidance covers four elements of a risk-management process: risk assessment, selection of service providers, contract review, and monitoring of service providers.[3]

Risk Assessment

The board of directors and senior management are responsible for understanding the risks associated with outsourcing arrangements for technology services and ensuring that effective risk-management practices are in place. As part of this responsibility, the board and management should assess how the outsourcing arrangement will support the institution's objectives and strategic plans and how the service provider's relationship will be managed. Without an effective risk-assessment phase, outsourcing technology services may be inconsistent with the institution's strategic plans, too costly, or introduce unforeseen risks.

Outsourcing of information and transaction processing and settlement activities involves risks that are similar to the risks that arise when these functions are performed internally. Risks include threats to security, availability and integrity of systems and resources, confidentiality of information, and regulatory compliance. In addition, the nature of the service provided, such as bill payment, funds transfer, or emerging electronic services, may result in entities performing transactions on behalf of the institution, such as collection or disbursement of funds, that can increase the levels of credit, liquidity, transaction, and reputation risks.[4]

Management should consider additional risk-management controls when services involve the use of the Internet. The broad geographic reach, ease of access, and anonymity of the Internet require close attention to maintaining secure systems; intrusion detection and reporting systems; and customer authentication, verification, and authorization. Institutions should also understand that the potential risks introduced are a function of a system's structure, design, and controls and not necessarily the volume of activity.

An outsourcing risk assessment should consider the following:

- strategic goals, objectives, and business needs of the financial institution
- ability to evaluate and oversee outsourcing relationships
- importance and criticality of the services to the financial institution
- defined requirements for the outsourced activity
- necessary controls and reporting processes

1. The *FFIEC Information Systems Examination Handbook* is a reference source that contains further discussion and explanation of a number of concepts addressed in this FFIEC guidance.

2. Technology service providers encompass a broad range of entities including but not limited to affiliated entities, nonaffiliated entities, and alliances of companies providing products and services. This may include but is not limited to core processing; information and transaction processing and settlement activities that support banking functions such as lending, deposit-taking, funds transfer, fiduciary, or trading activities; Internet-related services; security monitoring; systems development and maintenance; aggregation services; digital certification services; and call centers.

3. The federal banking agencies have authority to regulate and examine services provided to insured depository institutions under 12 USC 1867(c), 12 USC 1786(a), and 12 USC 1464(d)(7).

4. For example, emerging electronic services may include aggregation. Aggregation is a service that gathers on-line account information from many web sites and presents that information in a consolidated format to the customer.

- contractual obligations and requirements for the service provider
- contingency plans, including availability of alternative service providers, costs, and resources required to switch service providers
- ongoing assessment of outsourcing arrangements to evaluate consistency with strategic objectives and service-provider performance
- regulatory requirements and guidance for the business lines affected and technologies used

Due Diligence in Selecting a Service Provider

Once the institution has completed the risk assessment, management should evaluate service providers to determine their ability, both operationally and financially, to meet the institution's needs. Management should convey the institution's needs, objectives, and necessary controls to the potential service provider. Management also should discuss provisions that the contract should contain. The appendix to this statement contains some specific factors for management to consider in selecting a service provider.

Contract Issues

Contracts between the institution and service provider should take into account business requirements and key risk factors identified during the risk-assessment and due-diligence phases. Contracts should be clearly written and sufficiently detailed to provide assurances for performance, reliability, security, confidentiality, and reporting. Management should consider whether the contract is flexible enough to allow for changes in technology and the financial institution's operations. Appropriate legal counsel should review contracts prior to signing.

Institutions may encounter situations where service providers cannot or will not agree to terms that the institution requests to manage the risk effectively. Under these circumstances, institutions should either not contract with that provider or supplement the service provider's commitments with additional risk-mitigation controls. The appendix to this statement contains some specific considerations for management in contracting with a service provider.

Service-Provider Oversight

Institutions should implement an oversight program to monitor each service provider's controls, condition, and performance. Responsibility for the administration of the service-provider relationship should be assigned to personnel with appropriate expertise to monitor and manage the relationship. The number of personnel, functional responsibilities, and the amount of time devoted to oversight activities will depend, in part, on the scope and complexity of the services outsourced. Institutions should document the administration of the service-provider relationship. Documenting the process is important for contract negotiations, termination issues, and contingency planning. The appendix to this statement contains some specific factors to consider regarding oversight of the service provider.

Summary

The board of directors and management are responsible for ensuring adequate risk-mitigation practices are in place for effective oversight and management of outsourcing relationships. Financial institutions should incorporate an outsourcing risk-management process that includes a risk assessment to identify the institution's needs and requirements; proper due diligence to identify and select a provider; written contracts that clearly outline duties, obligations, and responsibilities of the parties involved; and ongoing oversight of outsourcing technology services.

Appendix—Risk Management of Outsourced Technology Services

Due Diligence in Selecting a Service Provider

Some of the factors that institutions should consider when performing due diligence in selecting a service provider are categorized and listed below. Institutions should review the service provider's due-diligence process for any of its significant supporting agents (i.e., subcontractors, support vendors, and other parties). Depending on the services being outsourced and the level of in-house expertise, institutions should consider whether to hire or consult with qualified independent sources. These sources include consultants, user groups, and trade associations that are familiar with products and services offered by third parties. Ultimately, the depth of due diligence will vary depending on the scope and importance of the outsourced services as well as the risk to the institution from these services.

Technical and industry expertise.

- Assess the service provider's experience and ability to provide the necessary services and supporting technology for current and anticipated needs.
- Identify areas where the institution would have to supplement the service provider's expertise to fully manage risk.
- Evaluate the service provider's use of third parties or partners that would be used to support the outsourced operations.
- Evaluate the experience of the service provider in providing services in the anticipated operating environment.
- Consider whether additional systems, data conversions, and work are necessary.
- Evaluate the service provider's ability to respond to service disruptions.
- Contact references and user groups to learn about the service provider's reputation and performance.
- Evaluate key service-provider personnel that would be assigned to support the institution.
- Perform on-site visits, where necessary, to better understand how the service provider operates and supports its services.

Operations and controls.

- Determine adequacy of the service provider's standards, policies, and procedures relating to internal controls, facilities management (e.g., access requirements, sharing of facilities, etc.), security (e.g., systems, data, equipment, etc.), privacy protections, maintenance of records, business-resumption contingency planning, systems development and maintenance, and employee background checks.
- Determine if the service provider provides sufficient security precautions, including, when appropriate, firewalls, encryption, and customer-identity authentication, to protect institution resources as well as detect and respond to intrusions.
- Review audit reports of the service provider to determine whether the audit scope, internal controls, and security safeguards are adequate.
- Evaluate whether the institution will have complete and timely access to its information maintained by the provider.
- Evaluate the service provider's knowledge of regulations that are relevant to the services they are providing (e.g., Regulation E, privacy and other consumer protection regulations, Bank Secrecy Act, etc.).
- Assess the adequacy of the service provider's insurance coverage including fidelity, fire, liability, data losses from errors and omissions, and protection of documents in transit.

Financial condition.

- Analyze the service provider's most recent audited financial statements and annual report as well as other indicators (e.g., publicly traded bond ratings), if available.
- Consider factors such as how long the service provider has been in business and the service provider's market share for a given service and how it has fluctuated.
- Consider the significance of the institution's proposed contract on the service provider's financial condition.
- Evaluate technological expenditures. Is the service provider's level of investment in technology consistent with supporting the institution's activities? Does the service provider have the financial resources to invest in and support the required technology?

Contract Issues

Some considerations for contracting with service providers are discussed below. This listing is not all-inclusive, and the institution may need to evaluate other considerations based on its unique circumstances. The level of detail and relative importance of contract provisions varies with the scope and risks of the services outsourced.

Scope of service. The contract should clearly describe the rights and responsibilities of parties to the contract. Considerations include—

- time frames and activities for implementation and assignment of responsibility (implementation provisions should take into consider-

ation other existing systems or interrelated systems to be developed by different service providers (e.g., an Internet banking system being integrated with existing core applications or systems customization));
- services to be performed by the service provider including duties such as software support and maintenance, training of employees, or customer service;
- obligations of the financial institution;
- the contracting parties' rights in modifying existing services performed under the contract; and
- guidelines for adding new or different services and for contract renegotiation.

Performance standards. Institutions should generally include performance standards defining minimum service-level requirements and remedies for failure to meet standards in the contract. For example, common service-level metrics include percent system uptime, deadlines for completing batch processing, or number of processing errors. Industry standards for service levels may provide a reference point. The institution should periodically review overall performance standards to ensure consistency with its goals and objectives.

Security and confidentiality. The contract should address the service provider's responsibility for security and confidentiality of the institution's resources (e.g., information, hardware). The agreement should prohibit the service provider and its agents from using or disclosing the institution's information, except as necessary to or consistent with providing the contracted services, to protect against unauthorized use (e.g., disclosure of information to institution competitors). If the service provider receives nonpublic personal information regarding the institution's customers, the institution should notify the service provider to assess the applicability of the privacy regulations. Institutions should require the service provider to fully disclose breaches in security resulting in unauthorized intrusions into the service provider that may materially affect the institution or its customers. The service provider should report to the institution when material intrusions occur, the effect on the institution, and corrective action to respond to the intrusion.

Controls. Consideration should be given to contract provisions addressing control over operations such as—

- internal controls to be maintained by the service provider;
- compliance with applicable regulatory requirements;
- records to be maintained by the service provider;
- access to the records by the institution;
- notification by the service provider to the institution and the institution's approval rights regarding material changes to services, systems, controls, key project personnel allocated to the institution, and new service locations;
- setting and monitoring of parameters relating to any financial functions, such as payments processing and any extensions of credit on behalf of the institution; and
- insurance coverage to be maintained by the service provider.

Audit. The institution should generally include in the contract the types of audit reports the institution is entitled to receive (e.g., financial, internal-control, and security reviews). The contract can specify audit frequency, cost to the institution associated with the audits if any, as well as the rights of the institution and its agencies to obtain the results of the audits in a timely manner. The contract may also specify rights to obtain documentation regarding the resolution of audit-disclosed deficiencies and inspect the processing facilities and operating practices of the service provider. Management should consider, based upon the risk-assessment phase, the degree to which independent internal audits completed by service-provider audit staff can be used and the need for external audits and reviews (e.g., SAS 70 type I and II reviews).[5]

For services involving access to open networks, such as Internet-related services, special attention should be paid to security. The institution may wish to include contract terms requiring periodic audits to be performed by an independent party with sufficient expertise. These audits may include penetration testing, intrusion detection, and firewall configuration. The institution should receive sufficiently detailed reports on the findings of these ongoing audits to

5. AICPA Statement of Auditing Standards 70, "Reports of Processing of Transactions by Service Organizations," known as SAS 70 reports, are one commonly used form of external review. Type I SAS 70 reports review the service provider's policies and procedures. Type II SAS 70 reports provide tests of actual controls against policies and procedures.

adequately assess security without compromising the service provider's security. It can be beneficial to both the service provider and the institution to contract for such ongoing tests on a coordinated basis given the number of institutions that may contract with the service provider and the importance of the test results to the institution.

Reports. Contractual terms should discuss the frequency and type of reports the institution will receive (e.g., performance reports, control audits, financial statements, security, and business-resumption testing reports). Guidelines and fees for obtaining custom reports should also be discussed.

Business-resumption and contingency plans. The contract should address the service provider's responsibility for backup and record protection, including equipment, program and data files, and maintenance of disaster-recovery and contingency plans. Responsibilities should include testing of the plans and providing results to the institution. The institution should consider interdependencies among service providers when determining business-resumption testing requirements. The service provider should provide the institution with operating procedures the service provider and institution are to implement in the event business-resumption contingency plans are implemented. Contracts should include specific provisions for business-recovery time frames that meet the institution's business requirements. The institution should ensure that the contract does not contain any provisions that would excuse the service provider from implementing its contingency plans.

Subcontracting and multiple-service-provider relationships. Some service providers may contract with third parties in providing services to the financial institution. To provide accountability, it may be beneficial for the financial institution to seek an agreement with and designate a primary contracting service provider. The institution may want to consider including a provision specifying that the contracting service provider is responsible for the service provided to the institution regardless of which entity is actually conducting the operations. The institution may also want to consider including notification and approval requirements regarding changes to the service provider's significant subcontractors.

Cost. The contract should fully describe fees and calculations for base services, including any development, conversion, and recurring services, as well as any charges based upon volume of activity and for special requests. Cost and responsibility for purchase and maintenance of hardware and software may also need to be addressed. Any conditions under which the cost structure may be changed should be addressed in detail including limits on any cost increases.

Ownership and license. The contract should address ownership and allowable use by the service provider of the institution's data, equipment/hardware, system documentation, system and application software, and other intellectual property rights. Other intellectual property rights may include the institution's name and logo, its trademark or copyrighted material, domain names, web site designs, and other work products developed by the service provider for the institution. The contract should not contain unnecessary limitations on the return of items owned by the institution. Institutions that purchase software should consider establishing escrow agreements. These escrow agreements may provide for the following: institution access to source programs under certain conditions (e.g., insolvency of the vendor), documentation of programming and systems, and verification of updated source code.

Duration. Institutions should consider the type of technology and current state of the industry when negotiating the appropriate length of the contract and its renewal periods. While there can be benefits to long-term technology contracts, certain technologies may be subject to rapid change and a shorter-term contract may prove beneficial. Similarly, institutions should consider the appropriate length of time required to notify the service provider of the institutions' intent not to renew the contract prior to expiration. Institutions should consider coordinating the expiration dates of contracts for interrelated services (e.g., web site, telecommunications, programming, network support) so that they coincide, where practical. Such coordination can minimize the risk of terminating a contract early and incurring penalties as a result of necessary termination of another related service contract.

Dispute resolution. The institution should consider including in the contract a provision for a dispute-resolution process that attempts to resolve problems in an expeditious manner as well as provide for continuation of services during the dispute-resolution period.

Indemnification. Indemnification provisions generally require the financial institution to hold the service provider harmless from liability for the negligence of the institution and vice versa. These provisions should be reviewed to reduce the likelihood of potential situations in which the institution may be liable for claims arising as a result of the negligence of the service provider.

Limitation of liability. Some service-provider standard contracts may contain clauses limiting the amount of liability that can be incurred by the service provider. If the institution is considering such a contract, consideration should be given to whether the damage limitation bears an adequate relationship to the amount of loss the financial institution might reasonably experience as a result of the service provider's failure to perform its obligations.

Termination. The extent and flexibility of termination rights sought can vary depending upon the service. Contracts for technologies subject to rapid change, for example, may benefit from greater flexibility in termination rights. Termination rights may be sought for a variety of conditions including change in control (e.g., acquisitions and mergers), convenience, substantial increase in cost, repeated failure to meet service levels, failure to provide critical services, bankruptcy, company closure, and insolvency.

Institution management should consider whether or not the contract permits the institution to terminate the contract in a timely manner and without prohibitive expense (e.g., reasonableness of cost or penalty provisions). The contract should state termination and notification requirements with time frames to allow the orderly conversion to another provider. The contract must provide for return of the institution's data, as well as other institution resources, in a timely manner and in machine-readable format. Any costs associated with transition assistance should be clearly stated.

Assignment. The institution should consider contract provisions that prohibit assignment of the contract to a third party without the institution's consent, including changes to subcontractors.

Oversight of Service Provider

Some of the oversight activities management should consider in administering the service-provider relationship are categorized and listed below. The degree of oversight activities will vary depending upon the nature of the services outsourced. Institutions should consider the extent to which the service provider conducts similar oversight activities for any of its significant supporting agents (i.e., subcontractors, support vendors, and other parties) and the extent to which the institution may need to perform oversight activities on the service provider's significant supporting agents.

Monitor financial condition and operations.

- Evaluate the service provider's financial condition periodically.
- Ensure that the service provider's financial obligations to subcontractors are being met in a timely manner.
- Review audit reports (e.g., SAS 70 reviews, security reviews) as well as regulatory examination reports, if available, and evaluate the adequacy of the service providers' systems and controls including resource availability, security, integrity, and confidentiality.[6]
- Follow up on any deficiencies noted in the audits and reviews of the service provider.
- Periodically review the service provider's policies relating to internal controls, security, systems development and maintenance, and backup and contingency planning to ensure they meet the institution's minimum guidelines, contract requirements, and are consistent with the current market and technological environment.
- Review access control reports for suspicious activity.
- Monitor changes in key service-provider project personnel allocated to the institution.
- Review and monitor the service provider's insurance policies for effective coverage.

6. Some services provided to insured depository institutions by service providers are examined by the FFIEC member agencies. Regulatory examination reports, which are only available to clients/customers of the service provider, may contain information regarding a service provider's operations. However, regulatory reports are not a substitute for a financial institution's due diligence in oversight of the service provider.

- Perform on-site inspections in conjunction with some of the reviews performed above, where practicable and necessary.
- Sponsor coordinated audits and reviews with other client institutions.

Assess quality of service and support.

- Regularly review reports documenting the service provider's performance. Determine if the reports are accurate and allow for a meaningful assessment of the service provider's performance.
- Document and follow up on any problem in service in a timely manner. Assess service-provider plans to enhance service levels.
- Review system-update procedures to ensure appropriate change controls are in effect and ensure authorization is established for significant system changes.
- Evaluate the provider's ability to support and enhance the institution's strategic direction including anticipated business-development goals and objectives, service-delivery requirements, and technology initiatives.
- Determine adequacy of training provided to financial institution employees.
- Review customer complaints on the products and services provided by the service provider.
- Periodically meet with contract parties to discuss performance and operational issues.
- Participate in user groups and other forums.

Monitor contract compliance and revision needs.

- Review invoices to ensure proper charges for services rendered, the appropriateness of rate changes, and new service charges.
- Periodically review the service provider's performance relative to service-level agreements, determine whether other contractual terms and conditions are being met, and whether any revisions to service-level expectations or other terms are needed given changes in the institution's needs and technological developments.
- Maintain documents and records regarding contract compliance, revision, and dispute resolution.

Maintain business-resumption contingency plans.

- Review the service provider's business-resumption contingency plans to ensure that any services considered mission critical for the institution can be restored within an acceptable time frame.
- Review the service provider's program for contingency-plan testing. For many critical services, annual or more frequent tests of the contingency plan are typical.
- Ensure service-provider interdependencies are considered for mission-critical services and applications.

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1. To explicitly consider IT when developing risk assessments and supervisory plans.
2. To assess the types and levels of risks associated with information technology.
3. To exercise appropriate judgment in determining the level of review, given the characteristics, size, and business activities of the organization.
4. To develop a broad understanding of the organization's approach, strategy, and structure with regard to IT activities within and across business lines.
5. To assess the adequacy of IT architecture and the ability of the current infrastructure to meet operating objectives, including the effective integration of systems and sources of data.
6. To assess the adequacy of the system of controls to safeguard the integrity of the data processed in critical information systems.
7. To determine if the board has developed, implemented, and tested contingency plans that will ensure the continued operation of the institution's critical information systems.
8. To ensure that operating procedures and controls are commensurate with the potential for and risks associated with security breaches, which may be either physical or electronic, inadvertent or intentional, or internal or external.
9. To determine the scope and adequacy of the IT audit function.
10. To evaluate IT outsourcing risk and outsourcing arrangements involving major lines of business.
11. To determine if the institution is complying with all applicable laws, rules, and regulations.
12. To prepare comments for the report of examination on significant deficiencies and recommended corrective action.
13. To assign an URSIT rating and/or determine the impact of IT risks on the CAMELS or risk ratings.
14. To update the workpapers with any information that will facilitate future examinations.

1. Determine the role and importance of IT to the organization and any unique IT characteristics or issues. Identify and list or update the major automated banking applications. For those applications processed by outside service providers, indicate the name and location of each service provider.
2. Incorporate an analysis of IT activities into risk assessments, supervisory plans, and scope memoranda, considering the size, activities, and complexity of the organization, as well as the degree of reliance on these systems across particular business lines.
3. Assess the organization's critical IT systems—those that support its major business activities—and the degree of reliance those activities have on IT systems. (See the *FFIEC Information Systems Examination Handbook* (1996 edition) for more information on reviewing the IT function.)
4. Determine if the systems are delivering the services necessary for the organization to conduct its business in a safe and sound manner.
5. Determine whether the board of directors and senior management are adequately identifying, measuring, monitoring, and controlling risks associated with IT for the overall organization and its major business activities.
6. Determine if the IT strategy for the significant business activities or the organization is consistent with the organization's mission and business objectives and whether the IT function has effective management processes to execute that strategy.
7. Review the reliability, accuracy, and completeness of information delivered in key business lines.
8. Review the organization's information security program and assess the adequacy of policies, procedures, and controls.
9. Determine the capability of back-up systems, presented in contingency plans, to mitigate business disruption.
10. Ascertain the quality of the internal or external IT audit function or any independent application reviews to ensure the integrity, security, and availability of the organization's systems.
11. Complete or update the information technology internal control questionnaire (section 4060.4) for the specific applications identified in step 1 of these procedures, noting any of the following:
    a. internal-control exceptions and noncompliance with written policies, practices, and procedures
    b. violations of law
    c. exceptions to IT-servicing contracts
    d. overall evaluation of services provided to the bank, including any problems experienced with the servicer
12. Complete or update the ''Safeguarding of Customer Information'' portion of the internal control questionnaire. (See section 4060.4.) Examiners should use this information to assess an institution's compliance with the interagency guidelines for the standards for safeguarding customer information. Depending on the nature of the institution's operations and the extent of prior supervisory review, all questions may not need to be answered fully. Other examination resources may also be used (for example, the *FFIEC Information Systems Examination Handbook*). Examiners should conduct a review that is a sufficient basis for evaluating the overall written information security program of the institution and its compliance with the interagency guidelines.
13. Determine whether the institution's controls over outsourcing information- and transaction-processing activities are adequate. Evaluate the adequacy of controls over outsourcing arrangements in the following areas:
    a. outsourcing risk assessment
    b. selection of service providers
    c. contracts
    d. policies, procedures, and controls
    e. ongoing monitoring
    f. information access
    g. audit
    h. contingency plan
14. Determine whether the bank has properly notified the Federal Reserve Bank of new outsourced services in accordance with the Bank Service Corporation Act, 12 USC 1865.
15. Review any recent IT reports of examination on the institution's service providers

performed by the Federal Reserve or other regulatory authorities and note any deficiencies. Also, obtain a listing of any deficiencies noted in the latest audit review. Determine that all deficiencies have been properly corrected.

16. For banks with material in-house processing, use the Uniform Rating System for Information Technology (URSIT) rating system to help evaluate the entity's overall risk exposure and risk-management performance. Evaluate the areas identified within each relevant URSIT component to assess the institution's ability to identify, measure, monitor, and control IT risks.
17. Determine the extent of supervisory attention needed to ensure that IT weaknesses are addressed and that associated risk is properly managed. Determine the impact on CAMELS, the operational-risk rating, and any other risk ratings.
18. Prepare comments for the report of examination on any significant deficiencies and recommended corrective action.
19. Update the workpapers with any information that will facilitate future examinations.

Review the bank's internal controls, policies, practices, and procedures regarding information technology. The bank's system should be documented completely and concisely and should include, where appropriate, narrative description, flowcharts, copies of forms used, and other pertinent information. Items below that are marked with an asterisk require substantiation by observation or testing.

SERVICER SELECTION

1. Before entering into any service arrangement, did management consider—
   a. alternative servicers and related costs?
   b. the financial stability of the servicer?
   c. the control environment at the data center?
   d. emergency backup provisions?
   e. the ability of the servicer to handle future processing requirements?
   f. requirements for termination of service?
   g. the quality of reports?
   h. insurance requirements?
2. Is there an annual reevaluation of the servicer's performance that includes—
   a. its financial condition?
   b. costs?
   c. its ability to meet future needs?
   d. its quality of service?

CONTRACTS

*3. Is each automated application covered by a written contract?

*4. Were contracts reviewed by legal counsel?

5. Does each service contract cover the following areas:
   a. ownership and confidentiality of files and programs?
   b. liability limits for errors and omissions?
   c. frequency, content, and format of input and output?
   d. the fee structure, including—
      - current fees?
      - provisions for changing fees?
      - fees for special requests?
   e. provisions for backup and record protection?
   f. the notice required (either party) for termination of service and the return of customer records in machine-readable form?
   g. time schedules for receipt and delivery of work, including processing priorities?
   h. the insurance carried by the servicer?
   i. liability for documents in transit?
   j. audit responsibility?
   k. a provision to supply the serviced institution with yearly financial statements (preferably audited with both consolidated and unconsolidated figures when applicable)?

INSURANCE

*6. Does the serviced institution's insurance coverage include the following provisions:
   a. extended blanket bond fidelity coverage to employees of the servicer?
   b. insurance on documents in transit, including the cash letter?
   c. if the serviced institution is relying on the servicer or an independent courier for insurance described in 6a. and b. above, is adequate evidence of that coverage on file?

OPERATIONAL CONTROLS

*7. Are duties adequately separated for the following functions:
   a. input preparation?
   b. operation of data-entry equipment?
   c. preparation of rejects and unposted items for reentry?
   d. reconcilement of output to input?
   e. output distribution?
   f. reconcilement of output to general ledger?
   g. posting general ledger?

8. Are employee duties periodically rotated for control and training purposes?
9. Do supervisors or officers—
   a. adequately review exception reports?
   b. approve adjusting entries?

10. Are servicer personnel prohibited from initiating transactions or correcting data?
11. Are individuals prohibited from initiating or authorizing a transaction and then executing it?
12. Are employees at the serviced institution required to be absent from their duties (by vacation or job rotation) for two consecutive weeks?
13. Are master-file changes—
    a. requested in writing?
    b. approved by a supervisor?
    c. verified as correct after processing?

*14. Are exception reports prepared for—
    a. unposted and rejected items?
    b. supervisory override transactions?
    c. master-file changes (before and after)?
    d. dormant-account activity?

*15. Does each user department—
    a. establish dollar and nondollar controls before they are sent for processing?
    b. receive all scheduled output reports even when the reports contain no activity?
    c. review all output and exception reports?

*16. Are current user manuals available for each application, and are they used by the employees?

17. Does each user manual cover—
    a. preparation and control of source documents?
    b. control, format, and use of output?
    c. settlement and reconcilement procedures?
    d. error-correction procedures?
18. Are users satisfied with the servicer's performance and output reports? (If not, explain.)
19. Are computer-generated entries subsequently reviewed and approved by appropriate officials?

*20. Does the serviced institution copy all source documents, including cash letters, on microfilm before they leave the premises? If so—
    a. is the microfilm stored in a secure location with limited access?
    b. is an inventory and usage log maintained?

COMMUNICATION CONTROLS

*21. Is user access to the data communication network controlled by—
    a. user number?
    b. physical keys?
    c. passwords?
    d. other safeguards (explain)?

22. Are periodic changes made to numbers, keys, or passwords and are they adequately controlled?
23. Are identification numbers or passwords suppressed on all printed output and video displays?
24. Are terminals controlled as to—
    a. what files can be accessed?
    b. what transactions can be initiated?
    c. specific hours of operations?
25. Do controls over restricted transactions and overrides include—
    a. supervisory approval?
    b. periodic management review?

*26. Are there exception reports which indicate—
    a. all transactions made at a terminal?
    b. all transactions made by an operator?
    c. restricted transactions?
    d. correcting and reversing entries?
    e. dates and times of transactions?
    f. unsuccessful attempts to gain access to the system or to restricted information?
    g. unusual activity?

27. Overall, are there adequate procedures in effect that prevent unauthorized use of the data communication systems?
28. To back up on-line systems—
    a. are off-line capabilities available (explain)?
    b. are the off-line capabilities periodically tested?

AUDITING

29. Is there an internal auditor or member of management not directly involved in EDP activities who has been assigned responsibility for the audit function?
30. Does that individual have any specialized audit or EDP training?
31. Are there written internal-audit standards and procedures that require—
    a. review of all automated applications?
    b. reports to the board of directors?
    c. audit workpapers?
32. Does the person responsible for the

audit function perform the following procedures:

a. test the balancing procedures of all automated applications, including the disposition of rejected and unposted items?
b. periodically sample master-file information to verify it against source documents?
c. spot-check computer calculations such as interest on deposits, loans, securities, loan rebates, service charges, and past-due loans?
d. verify output report totals?
e. check accuracy of exception reports?
f. review master-file changes for accuracy and authorization?
g. trace transactions to final disposition to determine adequacy of audit trails?
h. review controls over program-change requests?
i. perform customer confirmations?
j. other (explain)?

33. Does the serviced institution obtain and review the servicer's internal or external audits or third-party reviews? (If yes, detail exceptions and corrective action.)
34. Has the serviced institution used an independent auditor to evaluate EDP servicing (if yes, detail exceptions and corrective action)?
35. Is the overall audit program for serviced applications considered adequate?

SAFEGUARDING OF CUSTOMER INFORMATION

36. Does the bank have a written information security program or policy? Has the board of directors or an appropriate designated committee of the board approved the written information security program?
37. Is the written information security program appropriate given the size and complexity of the organization and its operations? Does the program contain the objectives of the program, assign responsibility for implementation, and provide methods for compliance and enforcement?
38. Does the bank periodically update its information security program to reflect changes in the bank's operations and systems, as well as changes in threats or risks to the bank's customer information?
39. Does the examination review of the bank's process for assessing risk to its customer information address the following questions:
    a. Has the bank identified the locations, systems, and methods for storing, processing, transmitting, and disposing of its customer information?
    b. Has the bank identified reasonably foreseeable internal and external threats that could result in unauthorized disclosure, misuse, alteration, or destruction of customer information or customer information systems, and has the bank assessed the likelihood of these threats and their potential damage to the bank and its customers?
40. With respect to the bank's risk-management processes for implementing effective measures to protect customer information, does the bank adopt and review appropriate risk-based internal controls and procedures for—
    a. accessing controls on computer systems containing customer information to prevent access by unauthorized staff or other individuals;
    b. preventing employees from providing customer information to unauthorized individuals, including "pretext calling," that is, someone calling a bank and posing as a customer to fraudulently obtain an individual's personal information (see SR-01-11);
    c. providing access restrictions at physical locations containing customer information, such as buildings, computer facilities, and records storage facilities, to permit access to authorized individuals only;
    d. encrypting electronic customer information, including information that is in transit or in storage on networks or systems, when unauthorized individuals are able to gain access to it;
    e. ensuring that modifications to customer information systems are consistent with the bank's information security program;
    f. maintaining dual-control procedures, segregation of duties, and background checks for employees with access to customer information to minimize the

risk of internal misuse of customer information;

g. monitoring systems and procedures to detect unauthorized access to customer information systems that could compromise the security of customer information;
h. maintaining response programs that specify actions to be taken when the bank suspects or detects that unauthorized individuals have gained access to customer information systems (these programs include appropriate reports, such as suspicious-activity reports (SARs) disseminated to regulatory and law enforcement agencies); and
i. providing measures to protect against destruction, loss, or damage of customer information due to potential environmental hazards, such as fire and water damage or technological failures?

41. Have the bank's employees been trained to implement the information security program?
42. Does the bank regularly test the effectiveness of the key controls, systems, and procedures of its information security program? These tests may include, for example, tests of operational contingency plans, system security audits or ''penetration'' tests, and tests of critical internal controls over customer information. Are tests conducted and reviewed independently by the bank's designated staff?
43. Does the bank provide customer information to any service providers, or do any service providers have access to customer information as a result of providing services directly to the bank? If so—
    a. has the bank conducted appropriate due diligence in selecting its service providers, taking into consideration information security?
    b. do the bank's contracts with its service providers require implementation of appropriate information security programs and measures?
    c. where appropriate and based on risk, does the bank monitor its service providers to confirm that they are maintaining appropriate security measures to safeguard the bank's customer information? Does the bank, for example, conduct or review the results of audits, security reviews or tests, or other evaluations?
44. Does the bank's management report at least annually to the board of directors, or to a designated appropriate board committee, on the overall status of the information security program and the extent of the bank's compliance with these guidelines?

CONCLUSION

45. Does the foregoing information constitute an adequate basis for evaluating internal control; that is, no significant deficiencies in areas not covered in this questionnaire impair any controls. Explain negative answers briefly and indicate any additional examination procedures deemed necessary.
46. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered adequate or inadequate.

Electronic banking products and services have been widely adopted by financial institutions in recent years and are now a component of the business strategies at most institutions. Electronic delivery of services can have many benefits for financial institutions and their customers. In some cases, however, these activities can have implications for a financial institution's financial condition, risk profile, and operating performance.

EXAMINATION APPROACH

In general, examiners should review electronic banking activities when these services are newly implemented, particularly in institutions that may not have significant experience or expertise in this area or when an institution is conducting novel activities that may pose a heightened risk. Periodic reviews should be conducted thereafter based on any significant changes to the scope of services or nature of the operations, as indicated by an assessment of risk to the institution.

Clearly, electronic banking concerns could affect an institution's operational-risk profile. Yet, these activities could also affect other financial and business risks, depending on the specific circumstances. Accordingly, examiners should consider an institution's electronic banking activities when developing risk assessments and supervisory plans. Although electronic banking may be assessed within the context of an information technology review, the nontechnical aspects of an electronic banking operation should be reviewed and coordinated closely with other examination areas. Rather than conduct detailed technical reviews, examiners should assess the overall level of risk any electronic banking activities pose to the institution and the adequacy of its approach to managing these risks.

To determine the scope of supervisory activities, close coordination is needed with information technology specialist examiners and consumer compliance examiners during the risk-assessment and planning phase, as well as during on-site examinations. Given the variability of electronic banking environments, the level of technical expertise required for a particular examination will differ across institutions and should be identified during the planning phase of the examination. When the bank has developed the electronic banking products or services internally or when a direct connection exists between the institution's electronic banking system and its core data processing system, consideration should be given to involving an information technology specialist examiner in the on-site review. The determination of the examination scope should be based on factors such as the following:

- implementation of significant new electronic banking products and services since the last examination
- significant changes in the composition or level of customers, earnings, assets, or liabilities generated or affected by the electronic banking activities
- new or significantly modified systems or outsourcing relationships for activities related to electronic banking
- the need for targeted examinations of business lines that rely heavily on the electronic banking systems or activities
- other potential problems or concerns that may have arisen since the last examination or the need to follow up on previous examination or audit issues

Many resources are available to examiners for reviewing electronic banking activities. In addition to the procedures in this section, further information can be found in section 4060.1, "Information Technology," and in the *Federal Financial Institutions Examination Council (FFIEC) Information Systems Examination Handbook.* Other federal banking agencies have issued examination guidance relating to electronic banking, information technology, and information security that may be helpful to examiners in reviewing electronic banking activities. Consumer compliance issues are not addressed in this section.[1]

1. See the Federal Reserve regulations and interagency supervisory guidance, such as the FFIEC's "Guidance on Electronic Financial Services and Consumer Compliance" (July 1998), for further information regarding compliance with consumer laws and regulations.

OVERVIEW OF ELECTRONIC BANKING SERVICES

Types of Services

Electronic banking services are designed to provide banking customers with the capability to conduct banking business remotely through personal computers and other electronic devices. Electronic banking comprises personal computer (PC) banking through traditional proprietary communication channels; retail and corporate Internet banking services; telephone banking; and, potentially, other forms of remote electronic access to banking services.

Both large and small institutions are now offering a variety of Internet-based financial services. Many financial institutions are using the Internet to enhance their service offerings to existing customers. Other organizations may choose to expand their customer base to a wider geographic area by accepting on-line applications for loan and deposit products. A very small number of banking organizations are focusing on the Internet as their primary delivery channel, whether or not they maintain physical branches.

Current electronic banking products and services typically allow customers to obtain information on bank products and services through the bank's Internet web sites, apply online for new products and services, view loan- and deposit-account balances and transactions, transfer funds between accounts, and perform other banking functions. Most electronic banking services now operate using standard Internet browser software installed on the customer's personal computer and do not require that the customer have any additional software or hardware. While electronic banking services have been oriented toward retail customers, many banking organizations are now offering small-business applications and corporate cash-management services through the Internet. These services typically include payroll, automated clearinghouse (ACH), and wire transfers. Wholesale banking services, which have been conducted electronically for many years, are also beginning to move from proprietary networks and communications channels to the Internet.

Information-only web sites provide the most basic and common form of electronic banking service. Most institutions contract with an Internet service provider (ISP) to provide Internet access and "host," or maintain and operate, the institution's web site. In some cases, the web site is maintained on the institution's own computers (web servers). Even if access to account information is not possible through the web site, institutions may receive e-mail inquiries from customers through their web site.

Transactional Internet banking sites allow customers to obtain on-line access to their account information and initiate transactions over the Internet. With most Internet banking services, the customer interacts with a stand-alone Internet banking system that has been preloaded with the customer's account balances, transaction history, and other information. Transactions initiated through the Internet banking system are processed by a separate Internet banking application and periodically posted to the institution's general ledger, deposit, and loan accounting systems. Interface or connection with the financial institution's core data processing and accounting systems typically occurs through either (1) a direct connection to the core processing system over a network or (2) a manual download or transfer of transaction data to a diskette or other portable media, which is then uploaded or sent to the core processing system. Most standardized Internet banking software packages now available have been designed with standard interfaces between Internet banking systems and common core-processing systems and software.

Electronic bill-payment services are typically provided to customers as part of most standard electronic banking services. These services generally include capabilities to pay any third party the customer designates, as well as pay companies designated for routine bill payments, such as utilities and credit card issuers. Electronic bill-presentment services, which are much less common, involve the electronic transmission of billing statements to the customer through e-mail or a web site, for subsequent payment through the electronic banking service. Other more innovative Internet retail-payment mechanisms are being developed, but these typically involve very small-dollar transactions.

Telephone banking, a fairly conventional form of electronic banking, is provided by many institutions. Telephone banking services generally allow customers to check account balances and transactions and to pay bills through touch-tone or voice-response systems. A few banking organizations are also beginning to offer consumer products and services through wireless devices, such as cellular telephones, pagers, personal digital assistants, handheld computers, or other devices that can provide wireless access to an institution's services, either directly or through the Internet. Account aggregation is a web-based service offered by some financial institutions that consolidates customer-account information from multiple financial or commercial web sites and presents it on a single web site. Aggregated information may include information from financial and nonfinancial accounts held by the customer. Some institutions have established "portals," web sites that link customers to a variety of third-party sites, and alliances with other companies to provide banking or nonbanking services.

Operations

There are a variety of operational methods for providing electronic banking services. Banking organizations may perform their core data processing internally but outsource the Internet banking activities to a different vendor or service provider. A dedicated workstation at the financial institution is often used to transmit transaction data files between the institution's core processing system and the Internet application; the workstation also allows the financial institution to update parameters and perform other maintenance. Alternatively, the service provider for Internet banking may interface directly with the bank's core-processing service provider, if that function is also outsourced. In addition, many banking organizations now purchase Internet banking services from their primary core-processing service provider, eliminating the need for external data transmissions. Even with this last structure, the institution maintains a local workstation to provide access to customer information or perform other administrative and maintenance functions for the Internet banking system.

Other institutions operate an electronic banking system in their own computer facilities by purchasing an "off-the-shelf" or turnkey electronic banking software application from a software vendor and then installing the software on their own system. Turnkey options vary from a bank's purchase and use of templates or modules, in which the bank chooses from a selection of standard services, to more complex situations in which the software vendor designs and develops the electronic banking software application to the bank's specifications. Turnkey vendors often provide hardware, software, and ongoing system service and maintenance.

Bill-payment processing is generally conducted through a specialized third-party processor. The payment processor receives payment instructions from the financial institution or the Internet banking service provider, initiates an ACH debit to the account of the customer, and credits the account of the payee. Payments to payees not set up to receive ACH payments, such as individuals and smaller companies, are transmitted by mailing a paper check to the payee.

RISK MANAGEMENT

Board and Management Oversight

Financial institutions commonly implement electronic banking services as a means of delivering existing banking products and services to existing customers. As a result, not all institutions have established a distinct risk-management program for electronic banking. In many cases, policies and procedures for electronic banking activities will be incorporated into existing policies and procedures, such as those governing deposit accounts, payments processing, information security, and lending functions.

Bank management should assess the financial impact of the implementation and ongoing maintenance of electronic banking services. For example, ongoing maintenance and marketing costs of Internet banking operations can be substantial, particularly for smaller banks, depending on the institution's business plan. Bank management should consider the potential impact on the institution's customer base, loan quality and composition, deposit volume, volatility, liquidity sources, and transaction volume, as well as the impact on other relevant factors that may be affected by the adoption of new delivery channels. These areas should be monitored and analyzed on an ongoing basis to ensure that any impact on the institution's financial condition resulting from electronic banking services is appropriately managed and controlled.

In addition, bank management may wish to review periodic reports tracking customer usage, problems such as complaints and downtime, unreconciled accounts or transactions initiated through the electronic banking system, and system usage relative to capacity. Management should also consider the expertise of internal or external auditors to review electronic banking activities and the inclusion of electronic banking activities within audit plans. Insurance policies may need to be updated or expanded to cover losses due to system security breaches, system downtime, or other risks from electronic banking activities.[2]

A change in an institution's business strategy to an Internet-only or Internet-focused operation is generally considered a significant change in business plan.[3] In addition, certain technology operations, such as providing ISP services to the general public, may not be considered permissible banking activities or may be considered permissible by the institution's chartering authority only within certain limitations.

A financial institution should also consider legal ownership of its Internet address (for example, www.bankname.com), also known as its "domain name." Contracts with third-party vendors may specially address any arrangements to have the third-party vendor register the domain name on behalf of the institution.

Operational and Internal Controls

Web Site Information Maintenance

Because an institution's web site is available on an ongoing basis to the general public, appropriate procedures should be established to ensure the accuracy and appropriateness of its information. Key information changes and updates, such as loan rates, are normally subject to documented authorization and dual verification. Establishing procedures and controls to frequently monitor and verify web site information may help prevent any inadvertent or unauthorized modifications or content, which could lead to reputational damage or violations of advertising, disclosure, or other compliance requirements.

In addition, some institutions provide financial-calculator, financial-management, tax-preparation, and other interactive programs to customers. Institutions may provide on-line resources for customers to research available options associated with savings products, mortgages, investments, insurance, or other products and services. To protect the institution from potential liability or reputational harm, the bank should test or otherwise verify the accuracy and appropriateness of these tools.

Banks should carefully consider how links to third-party Internet web sites are presented. Hyperlinks to other web pages provide customers with convenient access to related or local information, as well as provide a means for targeted cross-marketing through agreements between the institution and other web site operators. However, such linkages may imply an endorsement of third-party products, services, or information that could lead to implicit liability for the institution. As a result, institutions commonly provide disclaimers when such links take the customer to a third-party web site. Institutions should ensure that they clearly understand any potential liabilities arising out of any cross-marketing arrangements or other agreements with third parties. Any links to sites offering nondeposit investment or insurance products must comply with relevant interagency guidelines.[4] Links to other sites should be verified regularly for their accuracy, functionality, and appropriateness.

Electronic Banking Accounts, Customer Authentication, and Administrative Controls

Many banks use the same account-opening procedures for electronic applications as they do for mailed or in-person applications. Procedures for accepting electronic account applications generally address areas such as—

2. See section 4040.1, "Management of Insurable Risks," for further information about fraud and computer-related insurance that may be applicable to electronic banking activities.

3. Regulation H sets forth the requirements for membership of state-chartered banks in the Federal Reserve System and imposes certain conditions of membership on applicant banks. A member bank must "at all times conduct its business and exercise its powers with due regard to safety and soundness" and "may not, without the permission of the Board, cause or permit any change in the general character of its business or in the scope of the corporate powers it exercises at the time of admission to membership" (12 CFR 208.3(d)(1) and(2)).

4. See section 4170.3, "Examination Procedures—Retail Sales of Nondeposit Investment Products," and the consumer protection rules for sales of insurance (65 *Fed. Reg.* 75822 (December 4, 2000)).

- the type of funding accepted for initial deposits;
- funds-availability policies for deposits in new accounts;
- the timing of account-number, check, and ATM-card issuance;
- the minimum customer information required to open new accounts;
- single-factor, tiered single-factor, and multi-factor authentication procedures for verification of information provided by the applicant (for example, verifying customer information against credit bureau reports); and
- screening for prior fraudulent account activity, typically using fraud-detection databases.[5]

Authentication procedures. Strong customer-authentication practices are necessary to help institutions detect and reduce fraud, detect and reduce identity theft, and enforce anti–money laundering measures.[6] Customer interaction with institutions is migrating from physical recognition and paper-based documentation to remote electronic access and transaction initiation. Significant risks potentially arise when an institution accepts new customers through the Internet or other purely electronic channels because of the absence of the physical cues that bankers traditionally use to identify individuals. The risks of doing business with unauthorized or incorrectly identified individuals in an electronic banking environment could result in financial loss and reputation damage.

In addition to limiting unauthorized access, effective authentication provides institutions with the appropriate foundation for electronic agreements and transactions. First, effective authentication provides the basis for the validation of parties to the transaction and their agreement to its terms. Second, authentication is a necessary element to establish the *authenticity* of the records evidencing the electronic transaction if there is ever a dispute. Third, authentication is a necessary element for establishing the *integrity* of the records evidencing the electronic transaction. Because state laws vary, management should involve legal counsel in the design and implementation of authentication systems.

5. For information on practices that my help prevent fraudulent account activity, see SR-01-11, ''Identity Theft and Pretext Calling.''

6. See SR-01-20 and the August 8, 2001, FFIEC interagency guidance, ''Authentication in an Electronic Banking Environment,'' that focuses on the risks and risk-management controls related to authentication.

The success of a particular authentication method depends on more than the technology. Success also depends on an institution's having appropriate policies, procedures, and controls. An effective authentication method has the following characteristics: customer acceptance, reliable performance, scalability to accommodate growth, and interoperability with existing systems and future plans.

Institutions can use a variety of authentication tools and methodologies to authenticate customers. These tools include the use of passwords and personal identification numbers (PINs), digital certificates using a public key infrastructure (PKI), physical devices such as smart cards or other types of ''tokens,'' database comparisons, and biometric identifiers. The level of risk protection afforded by each of these tools varies and is evolving as technology changes.

Existing authentication methodologies involve three basic ''factors'':

- something the user *knows* (a password or PIN)
- something the user *possesses* (an ATM card or a smart card)
- something the user *is* (a biometric characteristic, such as a fingerprint or retinal pattern)

Authentication methods that depend on more than one factor typically are more difficult to compromise than single-factor systems. Accordingly, properly designed and implemented multifactor authentication methods are more reliable indicators of authentication and are stronger fraud deterrents. For example, the use of a log-on ID or password is single-factor authentication (something the user knows), whereas a transaction using an ATM typically requires two-factor authentication (something the user possesses—the card—combined with something the user knows—the PIN). In general, multifactor authentication methods should be used on higher-risk systems. Further, institutions should be sensitive to the fact that proper implementation is key to the reliability and security of any authentication system. For example, a poorly implemented two-factor system may be less secure than a properly implemented single-factor system.

Risk assessment. An effective authentication program should be implemented on an enterprise-wide basis to ensure that controls and authentication tools are adequate among all products, services, and lines of business. Authentication processes should be designed to maximize interoperability and should be consistent with the financial institution's overall strategy for electronic banking and e-commerce customer services. The level of authentication a financial institution uses in a particular application should be appropriate to the level of risk in that application.

The implementation of appropriate authentication methods starts with an assessment of the risk posed by the institution's electronic banking systems. The risk should be evaluated in light of the type of customer (retail or commercial), the institution's transactional capabilities (bill payment, wire transfer, or loan origination), the sensitivity and value of the stored information to both the institution and the customer, the ease of using the authentication method, and the size and volume of transactions. The Federal Reserve expects financial institutions to assess the risks to the institution and its customers and to implement appropriate authentication methods to effectively manage risk.

An enterprise-wide approach to authentication requires development of and adherence to corporate standards and architecture, integration of authentication processes within the overall information security framework, risk assessments within the institution's lines of business that support the selection of authentication tools, and a central authority for oversight and risk monitoring. The authentication process should be consistent and support the financial institution's overall security and risk-management programs.

The method of authentication used in a specific electronic application should be appropriate and "commercially reasonable" in light of the reasonably foreseeable risks in that application. Because the standards for implementing a commercially reasonable system may change over time as technology and other procedures develop, financial institutions and service providers should periodically review authentication technology and ensure appropriate changes are implemented.

Single-factor authentication tools, including passwords and PINs, have been widely accepted as commercially reasonable for a variety of retail e-banking activities, including account inquiry, bill payment, and account aggregation. However, financial institutions should assess the adequacy of existing authentication techniques in light of changing or new risks (for example, the increasing ability of hackers to compromise less robust single-factor techniques). Financial institutions are cautioned that single-factor authentication alone may not be commercially reasonable or adequate for high-risk applications and transactions. Instead, multifactor techniques may be necessary. Institutions should recognize that a single-factor system may be "tiered" to enhance security without implementing a two-factor system. A tiered single-factor authentication system would include the use of multiple levels of a single factor (for example, the use of two or more passwords or PINs employed at different points in the authentication process).

Account origination and customer verification. Institutions need to use reliable methods for originating new customer accounts online. Customer-identity verification during account origination is important in reducing the risk of identity theft, fraudulent account applications, and unenforceable account agreements or transactions. In an electronic banking environment, reliance on traditional forms of paper-based authentication is decreased substantially. Accordingly, financial institutions need to use reliable alternative methods. For example, verification of personal information could include the following:

- *Positive verification* to ensure that material information provided by an applicant matches information available from trusted third-party sources. More specifically, an institution can verify a potential customer's identity by comparing the applicant's answers to a series of detailed questions against information in a trusted database (for example, a reliable credit report) to see if the information supplied by the applicant matches information in the database. As the questions become more specific and detailed, correct answers provide the institution with an increasing level of confidence that the applicants are who they say they are.
- *Logical verification* to ensure that information provided is logically consistent. (For example, do the telephone area code, ZIP code, and street address match?)
- *Negative verification* to ensure that information provided has not previously been associated with fraudulent activity. For example, applicant information can be compared against fraud databases to determine whether any of the information is associated with known

incidents of fraudulent behavior. In the case of commercial customers, however, a sole reliance on online electronic database comparison techniques is not adequate since certain documents needed to establish an individual's right to act on a company's behalf (for example, bylaws) are not available from databases. Institutions must still rely on traditional forms of personal identification and document validation combined with electronic verification tools.

Transaction initiation and authentication of established customers. Once an institution has successfully verified a customer's identity during the account-origination process, it should authenticate customers who wish to gain access to the online banking system. Institutions can use a variety of methods to authenticate existing customers. These methods include the use of passwords, PINs, digital certificates and a PKI, physical devices such as tokens, and biometrics.

Minimizing fraud risk. An institution's policies and procedures should address the management of existing customers' accounts to minimize the risk of fraudulent activity. For example, the customer's ability to expand an existing account relationship through the electronic banking system may warrant added controls, such as sending a separate notification to a customer's physical address when online account access is first requested or when PINs, e-mail addresses, or other key parameters are changed.

To mitigate fraud risk, institutions may establish dollar limits on transactions initiated through the electronic banking application, or they may monitor transactions above specified limits, depending on the type of account (for example, consumer versus corporate). These limits or a similar monitoring system may help detect unusual account activity, which could indicate fraudulent transactions or other suspicious activity.

Funds transfer systems and Internet banking. Any manual interface between the electronic banking system and funds transfer systems, such as capabilities for uploading ACH or Fedwire transactions initiated through the electronic banking system to Fedline terminals, should be subject to system-access controls and appropriate internal controls, such as segregation of duties. Some institutions also permit electronic banking customers to initiate electronic (ACH) debits against accounts held at other institutions; reliable controls to verify that the customer is entitled to draw funds from the particular account are needed if this feature is offered.

Electronic bill-payment services are commonly provided as a component of electronic banking services. The institution should have a direct agreement with bill-payment providers, which may be subcontractors of the provider for the institution's Internet banking services. In this situation, it may be difficult for the institution or its customers to obtain timely and accurate information regarding the status of payment requests. As a result, contracts with service providers that encompass bill-payment services should generally address how payments are made, when payments are debited from a customer account, the treatment of payments when the account has insufficient funds on the settlement date, reconcilement procedures, and problem-resolution procedures.

Even when Internet banking operations are outsourced to a service provider, institutions will generally have access to the electronic banking system through a dedicated desktop computer or workstation. This hardware allows the institution to upload and download transaction information; review transaction logs or audit trails; print daily reports; or, in some cases, reset customer passwords, resolve errors, or respond to customer inquiries. These workstations should be located in secure areas and be subject to normal authorization and access controls and transaction audit trails.

Information Security

Electronic banking activities should be addressed in an institution's information security program, which should include compliance with the federal banking agencies' information security standards.[7] Institutions need to pay particular attention to the security of customer information, given the heightened security concerns associated with providing access to customer information over the Internet. An institution's written information security policies and procedures should include electronic banking activities. Institutions should implement prudent controls that limit the risk of unauthorized access to key

7. See section 4060.1 under ''Standards for Safeguarding Customer Information'' for further details and examination procedures. See also SR-01-25.

systems, including password-administration controls, firewalls, encryption of sensitive information while it is in transit or being stored, maintenance of all current updates and security patches to software and operating systems, and controls to prevent insider misuse of information. Sound information security practices include procedures and systems to detect changes to software or files, intrusion-detection systems, and security-vulnerability assessments.

While the technical aspect of information security considerations for electronic banking activities is complex, widely used turnkey software applications for Internet banking generally conform to accepted industry standards for technical security. Detailed assessments of the technical security of specific systems are the responsibility of the institution and its qualified engineers and internal and external auditors. Examiners should focus on the institution's implementation of key security controls for the particular software application.

Any security breaches of an institution's electronic banking service or web site that may lead to potential financial losses or disclosure of sensitive information should be reported to an appropriate management level within the institution. If necessary, the appropriate suspicious-activity report should be filed. Institutions should ensure that their service providers notify them of any computer security breaches in their operations that may affect the institution. Institutions should determine the cause of any such intrusions and develop an appropriate plan to limit any resulting financial losses to the bank and its customers and to prevent recurrence.

Passwords and System-Access Controls

Most institutions use identifiers such as account numbers or ATM card numbers, together with passwords or PINs, to verify the authorization of users accessing the retail electronic banking system. (Wholesale or corporate cash-management systems may use more secure methods, such as smart cards that contain customer credentials, real-time passwords (passwords that can be immediately changed online), or dedicated terminals, to authenticate users.) Prudent password-administration procedures generally require that customer passwords be changed if compromised and that passwords do not automatically default to easily guessed numbers or names. Passwords and PINs are (1) generally encrypted while in transit or storage on insecure networks or computers, (2) suppressed on screen when entered on a keyboard, and (3) suspended after a predetermined number of failed log-in attempts. Institutions should establish clear policies and procedures for retrieving or resetting customer passwords when customers lose or forget their password to minimize the risk that passwords are disclosed to unauthorized individuals.[8]

Firewalls

A firewall is a security control consisting of hardware, software, and other security measures established to protect the bank's internal data and networks, as well as its web sites, from unauthorized external access and use through the Internet. A number of banks and their vendors use various firewall products that meet industry standards to secure their Internet banking services, web sites, and other bank networks. For a firewall to adequately protect a bank's internal networks and systems, it must be properly installed and configured. Firewalls are most effective when all updates and patches to the firewall systems are installed and when the firewall configuration is reassessed after every system change or software update.

Viruses

Computer viruses can pose a threat to information systems and networks that are connected to the Internet. In addition to destroying data and possibly causing system failure, viruses can potentially establish a communication link with an external network, allow unauthorized system access, or even initiate unauthorized data transmission. Widely used protection measures include using anti-virus products that are installed and are resident on a computer or network or providing for virus scanning during downloads of information or the execution of any program. Bank employees and electronic banking customers should be educated about the risks posed to systems by viruses and other malicious programs, as well as about the proper procedures for accessing information to help avoid these threats.

8. See SR-01-20 for further information on password-administration practices.

Encryption of Communications

Information transmitted over the Internet may be accessible to parties other than the sender and receiver. As a result, most retail electronic commerce services use industry-standard secure sockets layer (SSL) technology to encrypt sensitive transactional information between the customer and the web site to minimize the risk of unauthorized access to this information while it is in transit. Although stronger encryption techniques may be warranted for higher-value corporate or wholesale transactions, SSL is generally considered adequate for retail Internet banking transactions.[9]

In addition, many banks accept communications through standard Internet e-mail; in some cases, account applications containing sensitive customer data may be sent to the bank. These communications are generally not protected by SSL or a similar technology but are open to potential unauthorized access. If the electronic banking system does not provide for encrypted e-mail, the bank should ensure that customers (and customer-service representatives) are alerted not to send confidential information by unencrypted e-mail.

Security Testing and Monitoring

Assessments of information security vulnerability, penetration testing, and monitoring help ensure that appropriate security precautions have been implemented and that system security configurations are appropriate. Some institutions contract with third-party security experts to provide these services. Vulnerability assessments provide an overall analysis of system security and report any system vulnerabilities. Such assessments can detect known security flaws in software and hardware, determine system susceptibility to known threats, and identify vulnerabilities such as settings that are contrary to established security policies.

Penetration testing and vulnerability assessments identify an information system's vulnerability to intrusion. Penetration tests examine system security by mimicking external intrusion attempts to circumvent the security features of a system. However, a penetration test is only a snapshot in time and does not guarantee that the system is secure.

Intrusion detection is an ongoing process that monitors the system for intrusions and unusual activities. Intrusion-detection systems, which can be installed on individual computers and at locations on a network, can be configured to alert appropriate system personnel to potential intrusions at the time they occur. In addition, the detection systems provide ongoing reporting and monitoring of unusual events such as potential intrusions or patterns of misuse.

Contingency Planning

Periodic downtime and outages are common with online services. But when the duration or disruption of these outages is significant, it can lead to reputational risk for the institution. For many institutions, short disruptions of electronic banking services may not have a material effect on their operations or customers, as other delivery channels are available. Nevertheless, electronic banking services should be covered by an institution's business-continuity plans. Institutions should assess their disaster-recovery needs by considering the length of time that electronic banking services could be unavailable to customers or for internal processing, and then design backup capabilities accordingly. In some cases, institutions may need to establish the capability to move processing to a different network or data center, or to move electronic banking services to a backup web site.

Typically, the electronic banking system includes capabilities to generate backup files on tapes, diskettes, or other portable electronic media containing key transaction and customer data. Web site information should also be subject to periodic backup. Security and internal controls at backup locations should be as sophisticated as those in place at the primary site. If a bank outsources electronic banking operations to a service provider, the institution should have a full understanding of the service provider's contingency and business-recovery commitments.[10]

9. The industry is moving toward a standard of 128-bit encryption for SSL communications.

10. For additional information on business resumption and contingency planning in relation to outsourcing, see section 4060.1, "Information Technology," and the *FFIEC Information Systems Examination Handbook*.

Outsourcing Arrangements

Many institutions outsource electronic banking operations to an affiliate or third-party vendor. In addition to operating the Internet banking software application, service providers may provide services such as web site hosting and development, Internet access, and customer service or call-center maintenance. As with other areas of a bank's operations, examiners should evaluate the adequacy of the institution's oversight of its critical service providers.[11]

Banking organizations should consider requiring Internet banking service providers to obtain periodic security reviews performed by an independent party. The client institution should receive reports summarizing the findings.

11. See section 4060.1, ''Information Technology,'' and the *FFIEC Information Systems Examiniation Handbook* for information on risk management for outsourcing arrangements.

1. To develop an understanding of the significance of the bank's electronic banking activities within and across business lines.
2. To assess the types and levels of risks associated with the bank's electronic banking activities.
3. To exercise appropriate judgment when determining the level of review, given the characteristics, size, and business activities of the organization.
4. To assess the current and potential impact of electronic banking activities on the institution's financial profile and condition.
5. To assess the adequacy of risk management and oversight of electronic banking activities, including outsourced activities.
6. To determine if the institution is complying with other applicable laws, rules and regulations.
7. To prepare examination report comments on significant deficiencies and recommended corrective action.
8. To determine the impact, if any, of electronic banking risks on the CAMELS rating, information technology rating, and risk-management ratings.
9. To update the workpapers with any information that will facilitate future examinations.

1. Identify the bank's current and planned electronic banking activities and review the bank's public Internet web sites. Consider whether the bank provides the following types of services:
   a. telephone banking
   b. retail Internet banking services
   c. corporate or wholesale Internet banking services
   d. Internet service provider (ISP)
   e. brokerage services over the Internet
   f. insurance services over the Internet
   g. trust services over the Internet
   h. account aggregation
   i. electronic bill payment
   j. other activities (for example, web portals, financial calculators, cross-marketing arrangements and alliances, or unique services)
2. Review prior examination findings and workpapers related to electronic banking, including consumer compliance, information technology, and other examination areas that may be relevant.
3. Determine if material changes have been made to electronic banking products, services, or operations since the last examination and if any significant changes are planned in the near future.
4. Determine the significance of the bank's electronic banking activities. Consider the following areas:
   a. approximate percentages and numbers of customers (for example, loan and deposit) that regularly use electronic banking products and services
   b. lending and deposit volumes generated from Internet applications
   c. the current monthly transaction and dollar volume for electronic banking services
   d. costs and fees to operate the system and related services or marketing programs
5. Incorporate an analysis of electronic banking activities into risk assessments, supervisory plans, and scope memoranda, considering the size, activities, and complexity of the organization, as well as the significance of the activities across particular business lines.
6. Assess the level of risk and the current or potential impact of electronic banking activities on the organization's earnings, liquidity, asset quality, operational risk, and consumer compliance. Communicate any concerns to examiners reviewing these areas.
7. Determine if the bank operates its web sites, electronic banking systems, or core data processing systems internally and whether any activities are outsourced to a vendor. If outsourced, all activities should be supported by written agreements that have been reviewed by the bank's legal counsel. Identify the location of the following operations:
   a. design and maintenance of the bank's public web site or home page
   b. computer or server for the bank's public web site
   c. development and maintenance of the bank's electronic banking systems
   d. computer or server for the bank's electronic banking systems
   e. customer service (for example, a call center) for electronic banking services
   f. electronic bill-payment processing or other ancillary services
8. If the bank operates the electronic banking system or core data processing system in-house, review the topology (schematic diagram) of the systems and networks, and determine whether there is a direct, online connection between the bank's core processing systems and the electronic banking system.
9. If the bank operates the electronic banking system or core data processing system in-house, review the transaction-processing flows between the electronic banking system and the bank's core processing systems and identify key control points. Determine whether information is exchanged in a real-time, batch (overnight), or hybrid-processing mode.
10. Review any available audits or third-party reviews of vendors or service providers the bank uses, such as SAS 70 reports.[1] Review any Federal Financial Institutions Examina-

1. The American Institute of Certified Public Accountants (AICPA) Statement of Auditing Standards (SAS) No. 70 "Reports on the Processing of Transactions by Service Organizations," as amended by SAS No. 78, "Consideration of Internal Control in a Financial Statement Audit: An Amendment to Statement on Auditing Standards No. 55."

tion Council (FFIEC) Shared Application Software Review (SASR) reports or any FFIEC or other supervisory examination reports of service providers that the institution uses.

11. Determine the adequacy of risk management for electronic banking activities (including single-factor and tiered single-factor or multifactor authentication methods for prospective and existing customers), given the level of risk these activities pose to the institution.[2] Complete or update relevant portions of the electronic banking internal control questionnaire as needed for the specific electronic banking activities identified in the previous steps of these procedures to evaluate the adequacy of—
    a. policies and procedures governing electronic banking activities,
    b. internal controls and security for electronic banking activities,
    c. audit coverage for electronic banking activities,
    d. monitoring and compliance efforts,
    e. vendor and outsourcing management, and
    f. board and management oversight.
12. Perform additional analysis and review, consulting with information technology specialists, consumer compliance specialists, or other subject-matter experts as needed, on areas of potential concern.
13. Determine the impact of any electronic banking activities or internal-control deficiencies on the financial condition of the organization.
14. Determine the extent of supervisory attention needed to ensure that any weaknesses are addressed and that associated risk is adequately managed.
15. Determine the impact of any deficiencies on the CAMELS rating, information technology rating, operational-risk rating, and any other relevant supervisory ratings.
16. Prepare comments for the examination report on any significant deficiencies and recommended corrective action.
17. Update the workpapers with any information that will facilitate future examinations.

2. See SR-01-20, "FFIEC Guidance on Authentication."

Review the bank's internal controls, policies, practices, and procedures for electronic banking activities. Complete those questions necessary to assess whether any potential concerns warrant further review.

POLICIES AND PROCEDURES

1. Are updates and changes to the bank's public web sites—
   a. made only by authorized staff?
   b. subject to dual verification?
2. Are web site information and links to other web sites regularly verified and reviewed by the bank for—
   a. accuracy and functionality?
   b. potential reputational, compliance, and legal risk?
   c. appropriate disclaimers?
3. Do operating policies and procedures include—
   a. procedures for and controls over opening new customer accounts submitted through electronic channels to verify potential customer identity and financial condition?
   b. single-factor and tiered single-factor or multifactor procedures for authenticating the identity of prospective and existing customers when administering access to the electronic banking system (for example, customer passwords, personal identification numbers (PINs), or account numbers)?
   c. requirements for review of or controls over wire transfers or other large transfers initiated through the electronic banking system, in order to watch for potentially suspicious activity?
   d. appropriate authorizations for electronic debits initiated against accounts at other institutions, if such transfers are allowed?
   e. depending on the type of account, dollar limits on transactions over a given time period initiated through the electronic banking service?
   f. reconcilement and accounting controls over transactions initiated through the electronic banking system, including electronic bill-payment processing?
4. Do written information security policies and procedures address electronic banking products and services?
5. Are business-recovery procedures adequate? Consider whether the procedures address—
   a. events that could affect the availability of the electronic banking system, such as system outages, natural disasters, or other disruptions?
   b. planned recovery times that are consistent with how important electronic banking activities are to the institution?
6. Has management established an incident-response plan to handle potential system security breaches, web site disruptions, malicious tampering with the web site, or other problems?

AUDIT AND INDEPENDENT REVIEW

1. Do the bank's internal and external audit programs address electronic banking activities and systems?
2. Is the level of audit review commensurate with the risks in electronic banking activities and systems?
3. Do audits address—
   a. the review and testing of the bank's internal controls relating to electronic banking?
   b. the review of service-provider performance relative to contract terms, if services are outsourced?
   c. the review of the service providers' internal or external audits or third-party reviews, if services are outsourced?
4. Is management's response to any audit recommendations timely and appropriate?

INTERNAL CONTROLS AND SECURITY

1. Has the bank or service provider implemented a firewall to protect the bank's web site?
2. Are ongoing monitoring and maintenance arrangements for the firewall in place to ensure that it is properly maintained and configured?

3. If the bank uses a turnkey electronic banking software package or outsources to a service provider—
   a. are bank staff familiar with key controls detailed by the vendor's security and operating manuals and training materials?
   b. are workstations that interface with the service provider's system for administrative procedures or transfer of files and data kept in a secure location with appropriate password or other access control, dual-verification procedures, and other controls?
4. Does the bank's control of customer access to the electronic banking system include—
   a. procedures to ensure that only appropriate staff are authorized to access electronic banking systems and data, including access to any workstations connected to a remote system located at a service provider?
   b. levels of authentication methods that are commensurate with the level of risk in the bank's electronic banking applications?
   c. the length and composition of passwords and PINs?
   d. encryption of passwords and PINs in transit and storage?
   e. the number of unsuccessful log-on attempts before the password is suspended?
   f. procedures for resetting customer passwords and PINs?
   g. automatic log-off controls for user inactivity?
5. Have security-vulnerability assessments and penetration tests of electronic banking systems been conducted and the results reviewed by the bank?
6. Has the bank or its service provider established—
   a. an intrusion-detection system for electronic banking applications?
   b. procedures to detect changes in electronic banking files and software?
   c. measures to protect the electronic banking system from computer viruses?
   d. procedures for ensuring on an ongoing basis that electronic banking applications, operating systems, and the related security infrastructure incorporate patches and upgrades that are issued to address known security vulnerabilities in these systems?
7. If e-mail is used to communicate with customers, are communications encrypted or does the bank advise customers not to send confidential information through e-mail?

MONITORING AND COMPLIANCE

1. Are adequate summary reports made available to management to allow for monitoring of—
   a. web site usage?
   b. transaction volume?
   c. system-problem logs?
   d. exceptions?
   e. unreconciled transactions?
   f. other customer or operational issues?
2. Has management established adequate procedures for monitoring and addressing customer problems with electronic banking products and services?
3. Does management accurately reports its primary public web site address on its Consolidated Report of Condition and Income?
4. Have required suspicious-activity reports involving electronic banking, including any computer intrusions, been filed?

VENDORS AND OUTSOURCING

1. Is each significant vendor, service provider, consultant, or contractor relationship that is involved in development and maintenance of the electronic banking services covered by a written, signed contract? Depending on the nature and criticality of the services, do contracts specify—
   a. minimum service levels and remedies or penalties for nonperformance?
   b. liability for failed, delayed, or erroneous transactions processed by the service provider and for other transactions in which losses may be incurred (for example, insufficient funds)?
   c. contingency plans, recovery times in the event of a disruption, and responsibility for backup of programs and data?
   d. data ownership, data usage, and compliance with the bank's information security policies?
   e. bank access to the service provider's

financial information and results of audits and security reviews?
   f. insurance to be maintained by the service provider?
2. Has legal counsel reviewed the contracts to ensure they are legally enforceable and that they reasonably protect the bank from risk?
3. Has the bank ensured that any service provider responsible for hosting or maintaining the bank's web site has implemented—
   a. controls to protect the bank's web site from unauthorized alteration and malicious attacks?
   b. procedures to notify the bank in the event of such incidents?
   c. regular backup of the bank's web site information?
4. Depending on the nature and criticality of the services, does the bank conduct initial and periodic due-diligence reviews of service providers, including—
   a. reviewing the service provider's standards, policies, and procedures relating to internal controls, security, and business contingency to ensure they meet the bank's minimum standards?
   b. monitoring performance relative to service-level agreements and communicating any deficiencies to the service provider and to bank management?
   c. reviewing reports provided by the service provider on response times, availability and downtime, exception reports, and capacity reports, and communicating any concerns to bank management and the vendor?
   d. periodically reviewing the financial condition of the service provider and determining whether backup arrangements are warranted as a result?
   e. reviewing third-party audits, SAS 70 reports, and regulatory examination reports on the service provider, if available, and following up on any findings with the service provider?
   f. conducting on-site audits of the service provider, if appropriate based on the level of risk?
   g. participating in user groups?
   h. ensuring the bank's staff receives adequate training and documentation from the vendor or service provider?
5. If the bank operates a turnkey electronic banking software package—
   a. is software held under an escrow agreement?
   b. has the bank established procedures to ensure that relevant program files and documentation held under the software escrow agreement are kept current and complete?
6. If a vendor maintains the bank's electronic banking system, does the bank monitor the on-site or remote access of its systems by the vendor, through activity logs or other measures?

BOARD AND MANAGEMENT OVERSIGHT

1. Does the board, or an appropriate committee, approve the introduction of new electronic banking products and services based on a written business plan and risk analysis commensurate with the proposed planned activity?
2. Has the bank considered—
   a. whether the service is designed to provide information or existing services to existing customers or to attract new customers?
   b. whether financial incentives will be offered to attract customers through the electronic banking service and the financial impact of such incentives on the bank?
   c. the potential impact of electronic banking products and services on the composition of the bank's customer base?
   d. the projected financial impact of the new service, including up-front and operating costs and any impact on fees or other revenue or expenses?
   e. internal controls appropriate for the new product or service?
   f. whether adequate management reports are provided and subject to periodic review?
   g. whether any new nonbanking activities are permissible under applicable state and federal banking laws?
   h. the extent of outsourcing and responsibilities for managing vendor and service-provider relationships?
3. Has the bank evaluated the adequacy of its insurance coverage to cover operational risks in its electronic banking activities?

4. Has the bank's legal counsel been involved in the development and review of electronic banking agreements (for example, agreements with third-party vendors)? Has the bank's legal counsel also been involved in the development and review of its authentication methods to ensure that the methods provide a foundation to enforce agreements and transactions and to validate the parties involved, consistent with applicable state laws?

Dividends are distributions of earnings to owners.[1] Dividends can influence an investor's willingness to purchase corporate stock since the investor generally expects reasonable investment returns. Although dividends usually are declared and paid in either cash or stock, occasionally they are used to distribute real or personal property. Dividend payments may reduce capital in some banks to the point of supervisory concern. Accordingly, on November 14, 1985, the Federal Reserve Board issued a policy statement on the payment of dividends by state member banks and bank holding companies. (See *Federal Reserve Regulatory Service* at 4–877.) In addition, certain statutory limitations apply to the payment of dividends.

Examiners should also be aware of a bank's parent company cash-flow needs. In addition to the payment of dividends, the parent company may need cash for debt service or to fund its operations. When establishing dividend levels from a bank subsidiary, the parent company should not set a dividend rate that will place undue pressure on the bank's ability to maintain an adequate level of capital.

Declaration of a dividend requires formal action by the board of directors to designate the medium of payment, dividend rate, shareholder record date, and date of payment. Dividends may be declared at the discretion of the board.[2] Dividends are recorded on the bank's books as a liability (dividends payable) on the date of declaration.

1. Other payments not called dividends may also be distributions of earnings to owners. These distributions or "constructive dividends" may be termed fees, bonuses, or other payments. Constructive dividends are distinct from legitimate fees, bonuses, and other payments, which are reasonable, adequately documented, and for valuable goods and services provided to the bank. Constructive dividends may create a potential tax liability and indicate control issues or insider self-dealing, and they may portend shareholder lawsuits against insiders, board members, and the bank.

2. At a minimum, board of directors minutes approving declaration and payment of a dividend should include three components: (1) the "as of" date to identify shareholders of record to receive the dividend (date of record), (2) an amount or description of the dividend, and (3) identification of the date on which the dividend payment is to take place (date of payment). There may also be additional legal requirements that should be documented, depending on state laws and the nature of the dividend.

SUMMARY OF POLICY STATEMENT ON PAYMENT OF DIVIDENDS

Adequate capital is critical to the health of individual banking organizations and to the safety and stability of the banking system. A major determinant of a financial institution's capital adequacy is earnings strength and whether earnings are retained or paid to shareholders as cash dividends. Dividends are the primary way that banking organizations provide return to shareholders on their investment.

During profitable periods, dividends represent a return of a portion of a banking organization's net earnings to its shareholders. During less profitable periods, dividend rates are often reduced or sometimes eliminated. The payment of cash dividends that are not fully covered by earnings, in effect, represents the return of a portion of an organization's capital at a time when circumstances may indicate instead the need to strengthen capital and concentrate financial resources on resolving the organization's problems.

As a matter of prudent banking, therefore, a bank or bank holding company generally should continue its existing rate of cash dividends on common stock only if—

- the organization's net income available to common shareholders over the past year has been sufficient to fully fund the dividends; and
- the prospective rate of earnings retention appears consistent with the organization's capital needs, asset quality, and overall financial condition.

Any banking organization whose cash dividends are inconsistent with either of these criteria should seriously consider reducing or eliminating its dividends. Such an action will help conserve the organization's capital base and help it weather a period of adversity.

A banking organization that is experiencing financial problems or that has inadequate capital should not borrow to pay dividends; this would result in increased leverage at the very time the organization needs to reduce its debt or conserve its capital. Similarly, the payment of dividends based solely or largely on gains resulting from unusual or nonrecurring events may be imprudent. Unusual or nonrecurring events may include the sale of assets, the effects of accounting changes, the postponement of large expenses to future periods, or negative provisions to the allowance for loan and lease losses.

STATUTORY LIMITATIONS

Three major federal statutory limitations govern the payment of dividends by banks. These limitations, included in sections 1831o, 56, and 60 of title 12 of the United States Code (12 USC 1831o, 56, and 60), apply to cash dividends or property dividends paid with assets other than cash. However, common stock dividends (dividends payable in common stock to all the common shareholders of the bank) may be paid regardless of the statutory limitations since such dividends do not reduce the bank's capital. In addition, the examiner needs to be aware of any state laws governing dividend payments.

Prompt Corrective Action

Section 1831o, also referred to as the prompt-corrective-action (PCA) provision, was adopted in 1991 as part of the Federal Deposit Insurance Corporation Improvement Act. Section 1831o applies to all insured depository institutions, including state member banks, and is implemented through section 208.40 of Regulation H. This regulatory section prohibits the payment of dividends when a bank is deemed to be undercapitalized or when the payment of the dividend would make the bank undercapitalized in accordance with the PCA framework. An organization that is undercapitalized for purposes of PCA must cease paying dividends for as long as it is deemed to be undercapitalized. Once earnings have begun to improve and an adequate capital position has been restored, dividend payments may resume in accordance with federal and state statutory limitations and guidelines.

Sections 56 and 60

Sections 56 and 60 (sections 5204 and 5199 of the Revised Statutes) were first adopted as part of the National Bank Act more than 100 years ago. Although these sections were made applicable to national banks, they also apply to state member banks under the provisions of section 9 of the Federal Reserve Act.[3] These sections are implemented through section 208.5 of Regulation H.

Under section 56, prior regulatory and shareholder approval must be obtained if the dividend would exceed the bank's undivided profits (retained earnings), as reportable in its Reports of Condition and Income (call reports).[4] In addition, the bank may include amounts contained in its surplus account, if the amounts reflect transfers made in prior periods of undivided profits and if regulatory approval for the transfer back to undivided profits is obtained.

Under section 60, prior regulatory approval to declare a dividend must be obtained if the total of all dividends declared during the calendar year, including the proposed dividend, exceeds the (1) sum of the net income earned during the year-to-date and (2) the retained net income of the prior two calendar years as reported in the bank's call reports. In determining this limitation, any dividends declared on common or preferred stock during the period and any required transfers to surplus or a fund for the retirement of any preferred stock must be deducted from net earnings to determine the net income and retained net income.[5]

The statutory limitations are tied to the declaration date of the dividend because, at that time, shareholders expect the dividends will be paid, a liability is recorded, and the bank's capital is reduced. If the bank's board of directors wishes to declare a dividend between call report dates, the earnings or losses incurred since the last call report date should be considered in the calculation. Thus, if a bank's dividend-paying capacity might be limited under sections 56 or 60, the bank should ensure it has

3. State-chartered banks that are not members of the Federal Reserve System (state nonmember banks) are not subject to sections 56 and 60. However, they may be subject to similar dividend restrictions under state law.

4. Although the language of section 56 could imply that a dividend cannot be declared in excess of the limit even if regulatory approval were obtained, a "return of capital" to shareholders is allowed under section 59 if the bank obtains prior regulatory approval and the approval of at least two-thirds of each class of shareholders.

5. In rare circumstances when the surplus of a state member bank is less than what applicable state law requires the bank to maintain relative to its capital stock account, the bank may be required to transfer amounts from its undivided profits account to surplus. This may arise, for example, because some states require surplus to equal or exceed 100 percent of the capital stock account. Such required transfers would reduce the section 60 calculation.

sufficient capacity to declare the dividend by maintaining sufficient documentation to substantiate its earnings or losses on an accrual basis for the period since the last call report date.

REQUEST FOR REGULATORY APPROVAL

When regulatory approval is required for dividend payments under section 56 or 60, the request should be submitted to the appropriate Federal Reserve Bank. In section 265.11(e)(4) of the Rules Regarding Delegation of Authority, the Reserve Banks have been delegated authority to permit a state member bank to declare dividends in excess of section 60 limits. Before approving the request, the Reserve Bank should consider if the proposed dividend is consistent with the bank's capital needs, asset quality, strength of management, and overall financial condition.

If applicable, examiners should verify that prior approval was obtained from the Federal Reserve Bank, and, if required, at least two-thirds of each class of stockholders before the dividend was paid. Violations of law or nonconformance with the Federal Reserve Board's policy statement should be discussed with bank management and noted in the examination report.

1. To determine if the policies, practices, procedures, and internal controls regarding dividends are adequate and whether they are being followed.
2. To determine if bank directors, officers, and employees are operating in compliance with the established guidelines.
3. To evaluate the propriety and consistency of the bank's present and planned dividend policy in light of existing conditions and future plans.
4. To determine that the scope of the audit function is adequate.
5. To determine if any dividends declared exceed the section 1831o limitation, and, if so, to inform the enforcement section of the Federal Reserve Bank.
6. To determine if any dividends declared exceed the section 56 and 60 limitations, and, if so, whether the respective required approvals from the Federal Reserve Bank and shareholders were obtained.
7. To determine whether the dividend payments comply with the Board's policy statement concerning dividend payments of banks and bank holding companies.
8. To determine compliance with other applicable laws and regulations.
9. To initiate corrective action when policies, procedures, or internal controls are deficient or when violations of laws or regulations have been noted.

1. If selected for use, complete or update the internal control questionnaire.
2. Based on the evaluation of internal controls and the work performed by internal or external auditors, determine the scope of the examination.
3. Test for compliance with policies, practices, procedures, and internal controls. Also obtain a listing of any deficiencies noted in the latest internal or external auditor reports from the examiner who is assigned to internal control. Determine if appropriate corrective action has been taken.
4. a. If dividends were declared since the last examination, complete the dividend-limitations worksheets to determine whether the bank was in compliance with the following sections of the U.S. Revised Statutes, as they are interpreted by section 208.5 of Regulation H:
      - section 5199 (12 USC 60), which establishes a restriction based on the current and prior two years' retained net income, as adjusted for required transfers to surplus or transfers to a fund for the retirement of any preferred stock. Table 1 on the next page may be used for the calculation.
      - section 5204 (12 USC 56), which establishes a restriction on dividends based on the bank's retained earnings (undivided profits), as adjusted for any surplus transferred, with prior regulatory approval, as needed, back to undivided profits and the excess, if any, of statutory bad debts over the allowance for loan and lease losses (ALLL).[1]

   b. For the calculations in table 1, determine whether the dividend exceeded the section 56 or 60 limits and, if so, whether the dividend received prior approval. Dividends declared in excess of the section 56 limitation must receive prior Federal Reserve approval and approval by at least two-thirds of the shares of each class of stock outstanding, pursuant to 12 USC 59. Dividends declared in excess of the section 60 limitation must receive prior Federal Reserve approval.
5. Review the examination findings with the examiner-in-charge in preparation for discussion with appropriate management.
6. Prepare examination-report comments on the bank's dividend practices, including any deficiencies noted.
7. Update the workpapers with the current dividend-limitations worksheets, as well as any information that will facilitate future examinations.

1. Although section 56 seems to require that a bank deduct its statutory bad debts from its undivided profits, this adjustment is not generally necessary. Under generally accepted accounting principles, banks are required to reserve for bad debts in the ALLL, which reduces the bank's undivided profits. Banks are thus required to deduct only the excess of statutory bad debts of the bank's ALLL, and such excess rarely occurs. Statutory bad debts represent matured obligations due a bank on which the interest is past due and unpaid for six months or more, unless the debts are well secured and in the process of collection. The second part of table 1 illustrates the section 56 dividend-limitation calculation.

Table 1—Dividend-Limitation Computations

References to schedules in this table are to the schedules in the Consolidated Reports of Condition and Income (bank call reports).

Section 60 Computation

	Year 20_	*Year* 20_	*Year* 20_	*Total*
Net income (loss) (schedule RI, item 12)	___	___	___	___
Less: Required transfers to surplus under state law (generally zero) or transfers to a fund for the retirement of any preferred stock	___	___	___	___
Less: Common and preferred stock dividends declared (schedule RI-A, item 8 + item 9)	___	___	___	___
Retained net profits available for dividends before adjustments	___	___	___	___
Adjustments for dividends in excess of income (if any)[1]	___	___	___	___
Retained net profits available for dividends after adjustments	___	___	___	___[2]

1. Any excess may be attributed to the prior two years by first applying the excess to the earlier year, and then the immediately preceding year, net of any previous-year adjustments. See section 208.5 of Regulation H for further guidance.
2. This is the section 60 limitation.

Section 56 Computation

	Year 20_
Retained earnings (undivided profits) (schedule RC, item 26a)	___
Add: Surplus in excess of state regulatory requirements that was earned and is transferred, with prior regulatory approval, back to undivided profits	___
Less: Excess of statutory bad debts over the allowance for loan and lease losses (generally zero)	___
Section 56 limitation	___

Review the bank's internal controls, policies, practices and procedures for paying dividends. The bank's system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used and other pertinent information. Items marked with an asterisk require substantiation by observation or testing.

GENERAL

1. Does the bank employ the services of an independent dividend paying agent?
*2. Has the board of directors passed a resolution designating those officers who are authorized to sign dividend checks?
*3. Are unused dividend checks under dual control?
*4. Does the bank's system require separation of duties regarding custody, authorization, preparation, signing and distribution of dividend checks?
*5. Are dividend checks reconciled in detail before mailing?
*6. Is control maintained over the use of serially numbered dividend checks to ensure that they are issued sequentially?

CONCLUSION

1. Does the foregoing information provide an adequate basis for evaluating internal control? If significant deficiencies in areas not included in this questionnaire impair controls, indicate additional examination procedures deemed necessary.
2. Based on a composite evaluation, as evidenced by answers to the foregoing questions, is internal control considered adequate?

Employee benefit trusts are specialized trusts most commonly established to provide retirement benefits to employees. However, they may also be established for employee stock ownership or thrift purposes, or to provide medical, accident, and disability benefits. There are qualified and unqualified plans. Retirement plans are qualified under section 401 of the Internal Revenue Code (IRC), and employee benefit trusts are tax exempt under section 501(a) of the IRC. The major types of qualified plans are profit sharing, money purchase, stock bonus, employee stock ownership plans (ESOPS), 401(k) plans, and defined benefit pension plans.

Since 1974, state jurisdiction of employee benefit trusts and their administration has been largely preempted by a comprehensive scheme of federal laws and regulations under the Employee Retirement Income Security Act of 1974 (ERISA). ERISA is divided into four titles: Title I, ''Protection of Employee Benefit Rights,'' includes the fiduciary responsibility provisions (in part 4) that are interpreted and enforced by the U.S. Department of Labor (DOL). Title II, ''Amendments to the Internal Revenue Code Relating to Retirement Plans,'' is similar to Title I, but the Internal Revenue Service (IRS) is responsible for its enforcement. Title III, ''Jurisdiction, Administration, Enforcement,'' grants jurisdiction and powers for administration to various governmental units. Title IV, ''Plan Termination Insurance,'' establishes the Pension Benefit Guaranty Corporation (PBGC). The PBGC ensures that defined benefit plans have sufficient resources to provide minimum levels of benefits to participants. In addition to the PBGC, the primary agencies that have promulgated necessary regulations and interpretations pursuant to ERISA are the DOL and IRS. However, state and federal banking agencies also have a recognized role under this statute.

Numerous laws affecting employee benefit plans have been enacted since the adoption of ERISA; however, the most sweeping changes were imposed by the Tax Reform Act of 1986. These changes include (1) imposing numerous excise taxes on employers and employees for failure to meet new plan contribution and distribution rules, (2) lowering the maximum amount of contributions and benefits allowed under qualified defined contribution and defined benefit plans, (3) lowering the amount an individual can contribute to a 401(k) plan, and (4) providing new nondiscrimination rules covering plan contributions and distributions. Virtually all qualified plans had to be amended to comply with this law.

A specific statutory provision of ERISA mandates the exchange of information among federal agencies. Accordingly, the federal banking agencies have entered into an agreement with the DOL whereby a banking agency noting any possible ERISA violations that meet certain specific criteria will refer the matter to the DOL.

ERISA imposes very complex requirements on banks acting as trustees or in other fiduciary capacities for employee benefit trusts. Severe penalties can result from violations of statutory obligations. With respect to a bank's own employees' retirement plan, the bank (or ''plan sponsor''), regardless of whether it is named trustee, is still a ''party-in-interest'' pursuant to the statute. Therefore, unless a transaction qualifies for narrowly defined statutory exemptions (or unless it is the subject of a specific ''individual'' exemption granted by the DOL), any transaction involving the purchase or sale of an asset of the plan from or to the bank, any affiliate, officer, or employee could constitute a prohibited transaction under ERISA.

The current and projected costs of employee benefit plans should be analyzed for their impact on the expenses and overall financial condition of the bank. Excessive pension or profit-sharing benefits, large expense accounts, employment contracts, or bonuses for officers or directors (especially if they are also large shareholders) could prove detrimental and even lead to civil liability for the bank or its board.

Depending on the type of plan and the allocations of its fiduciary duties, certain reporting, disclosure, and plan design requirements are imposed on the plan sponsor and/or its designated supervising committee. Therefore, a bank should have appropriate expertise, policies, and procedures to properly administer the type of employee benefit accounts established for its employees.

If an examiner, as part of any examination assignment, detects possible prohibited transactions, self-dealing, or other questionable activities involving the bank's employee benefit plan, an appropriate investigation should be undertaken. Substantial conversions of existing defined benefit plans or plan assets into holdings of bank or affiliate stock, under certain circumstances, could involve ERISA violations. An examiner should refer a complicated question arising out of any of these situations to the examiner-in-charge for resolution or submission to the Reserve Bank.

Part I of the following examination procedures (section 4080.3) should be completed for every commercial bank examination; part II should also be completed if the employee benefit plan is not trusteed by the bank or by an affiliate bank subject to supervision by a federal banking agency. Parts I and II may be completed by a trust specialist, if available. When a bank trust department is named as trustee, the examiner should determine whether compliance with ERISA was reviewed during the previous trust examination. If not, then part II should be completed.

Employee Benefit Trusts
Examination Objectives
Effective date May 1996

Section 4080.2

1. To determine if the policies, practices, procedures, internal controls, and available expertise regarding employee benefit trusts are adequate.
2. To determine if bank officers are operating in conformance with the established guidelines.
3. To evaluate the impact of employee benefit plans and related benefits on the financial condition of the bank.
4. To determine compliance with laws, regulations, and instrument provisions.
5. To initiate corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws, regulations, or the governing instruments have been noted.

PART I

1. If selected for implementation, complete or update the Employee Benefit Trusts section of the Internal Controls Questionnaire.
2. Test for compliance with policies, practices, procedures and internal controls in conjunction with performing the remaining examination procedures. Also obtain a listing of any deficiencies noted in the latest review done by internal/external auditors from the examiner assigned ''Internal Control,'' and determine if appropriate corrections have been made.
3. Determine the approximate number, size and types of employee benefit plans held for the benefit of the bank's officers and employees.
4. Obtain plan instruments or amendments thereto (if any) and summarize key features for the work papers. As appropriate, add or update the following information:
   a. Date of adoption of new plan or amendment and brief summary of the plan or amendment.
   b. Parties or committees named trustee and (if different) person(s) responsible for making investment decisions.
   c. Individuals, committees or outside parties named as responsible for plan administration.
   d. Basic investment/funding characteristics (e.g., ''non-contributory profit-sharing, up to 100% in own BHC stock;'' ''contributory defined benefit pension plan, purchasing diversified securities,'' etc.).
   e. Latest Form 5500 (IRS) filed for plan (may be omitted if plan administrator is an affiliate bank or bank holding company).

   Example: First Bank established a non-contributory profit sharing trust in 1975 for all officers and employees. Latest amendment, as of December 31, 19XX, made technical alterations to the vesting and forfeiture provisions. The most recent available valuation of the trust's assets, dated June 30, 19XX, indicated total assets of $22,093,000 (market value). Assets were comprised of U.S. government securities (42%), listed stocks (53%) and cash equivalents. Bank of ___________, as trustee, has sole investment responsibility.
5. If a plan is a defined benefit pension plan, ascertain the actuarily-determined amount of unfunded pension liability, if any, and the bank's arrangements for amortization. (Note: Unfunded pension liability represents a contingent liability per instructions for the Report of Condition.)
6. Determine if the current and projected costs of the employee benefit plan(s) is reasonable in light of the bank's financial condition.

Complete part II of these procedures, if applicable, then continue to step 7, below. Part II is to be completed when a plan for the bank's employees is administered by the bank or a bank committee and is not trusteed by the bank itself or an affiliate bank subject to supervision by a federal banking agency.

7. Determine whether any instances of possible violations of ERISA have been noted, and that as to each such instance, full information has been developed for current workpapers to support a referral to DOL pursuant to SR-81-697/TR-81-46.

   Note: While the final decision on whether or not to make a referral to the DOL is to be made by the Board's staff after receipt of the report of examination, complete information should always be obtained regarding possible ERISA violations in the event the decision is made to refer the matter. If gathering certain of the information would impose an undue burden upon the resources of the examiners or the bank, Board's staff (Trust Activities Program) should be consulted. Where a significant prohibited transaction such as self dealing has taken place, the bank should be clearly informed that it is expected to undertake all such corrective and/or remedial actions as are necessary under the circumstances. One measure would be for the bank to apply to the DOL for a retroactive exemption under ERISA section 408(a).
8. Reach a conclusion concerning:
   a. The adequacy of policies, practices and

procedures relating to employee benefit trusts.
   b. The manner in which bank officers are operating in conformance with established policy.
   c. The accuracy and completeness of any schedules obtained.
   d. Internal control deficiencies or exceptions.
   e. The quality of departmental management.
   f. Other matters of significance.
9. Prepare in appropriate report format, and discuss with appropriate officer(s):
   a. Violations of laws and regulations.
   b. Recommended corrective action when policies, practices or procedures are deficient.
10. Update the workpapers with any information that will facilitate future examinations.

PART II

1. Review plan asset listings, valuations, or printouts obtained for any instances of possible prohibited transactions (ERISA sections 406(a) and (b)). The listings should include holdings of:
   a. Loans.
   b. Leases.
   c. Real Estate.
   d. Employer stock or other securities or obligations.
   e. Own bank time deposits.
   f. Other assets which might constitute, or result from, prohibited transactions.
2. Review transaction(s)/holding(s) in the previous step for conformity to:
   a. ERISA provisions regarding employer securities or real estate (sections 407(a), (b) and (c)) and related regulations.
   b. Statutory exemptions of ERISA (section 408(b)).
   c. ‘‘Exclusive benefit,’’ prudence and diversification requirements of ERISA (sections 404(a) and (b)).

Review the bank's internal controls, policies, practices and procedures for employee benefit accounts. The bank's system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used and other pertinent information. Part I should be completed as part of every examination; both parts I and II should be completed whenever the plan, administered by the bank or a bank committee, is *not* trusteed by the bank itself or by an affiliate bank subject to supervision by a federal banking agency.

PART I

1. Are new employee benefit plans, significant amendments thereto, and related costs and features approved by the bank's board of directors?

*2. Does the institution obtain and maintain on file the following minimum documentation:
   a. The plan and the corporate resolution adopting it?
   b. IRS ''determination'' or ''opinion'' letter substantiating the tax-exempt status of the plan?
   c. The trust agreement and the corporate resolution appointing the trustee(s), if applicable? (On occasion, fully insured plans may have no named trustee.)
   d. Amendments to the plan or trust documents?

3. If the bank or a committee of its officers and employees acts as plan administrator for any plan(s), does it have internal procedures and/or has it arranged by contract for external administrative expertise sufficient to assure compliance with reporting, disclosure and other administrative requirements of ERISA and related regulations?
4. Have the bank, its officers, directors or employees, or any affiliate(s) entered into any transactions to buy or sell assets to the bank's employee benefit plan(s)?
5. Do plan investments conform to instrument investment provisions?

PART II

1. When exercising fiduciary responsibility in the purchase or retention of employer securities or employer real estate, does the bank have procedures to assure conformity with ERISA section 407 and related provisions?

   Note: The requirements of ERISA and the associated DOL regulation with respect to ''employer securities and employer real estate'' include:

   a. A plan may not acquire or hold any but ''qualifying employer securities and employer real estate.''
   b. A defined benefit plan may hold no more than 10 percent of the fair market value of its assets in qualifying employer securities and/or qualifying employer real property, except as provided by ERISA sections 407(a)(3) or 414(c)(1) and (2), and adopted regulations.
   c. Any dispositions of such property from a plan to a party-in-interest shall conform to ERISA sections 414(c)(3) and (5) and adopted regulations, but certain acquisitions and sales may be made pursuant to the section 408(a) exemption.
   d. The plan instrument, for an eligible individual account plan which is to hold in excess of 10 percent of the fair market value of its assets in qualifying employer securities or real property, shall provide explicitly the extent to which such plan may hold such assets. [ERISA sections 407(b)(1) and (d)(3)]

2. Does the bank have procedures to ensure conformance to the following statutory exemptions (and associated regulations) from the prohibited transactions provisions of ERISA:
   a. Loans made by the plan to parties-in-interest who are participants or beneficiaries? [ERISA section 408(b)(1)]
   b. Investment in deposits which bear a reasonable rate of interest of a bank which is a fiduciary of the plan? [ERISA section 408(b)(4)]

   Note: Other statutory exemptions which may on occasion be applicable are:

   c. Arrangements for office space or legal, accounting or other necessary services? [ERISA section 408(b)(2)]
   d. Loans to employee stock ownership trusts? [ERISA section 408(b)(3)]

e. Transactions between a plan and a collective trust fund maintained by a party-in-interest which is a bank or trust company? [section 408(b)(8)]
f. Providing of any ancillary service by a bank or trust company which is a fiduciary of the plan? [ERISA section 408(b)(6)]

3. If exercising or sharing fiduciary responsibility, does the bank have procedures designed:
   a. To ensure that duties are executed for the exclusive benefit of plan participants and beneficiaries, in accordance with the ''prudent man'' standard? [ERISA sections 404(a)(1)(A) and (B)]
   b. To ensure that investments are diversified, unless it is clearly prudent not to do so or otherwise excepted by other provisions of ERISA? [ERISA section 404(a)(1)(C)]

INTRODUCTION

Interest-rate risk (IRR) is the exposure of an institution's financial condition to adverse movements in interest rates. Accepting this risk is a normal part of banking and can be an important source of profitability and shareholder value. However, excessive levels of IRR can pose a significant threat to an institution's earnings and capital base. Accordingly, effective risk management that maintains IRR at prudent levels is essential to the safety and soundness of banking institutions.

Evaluating an institution's exposure to changes in interest rates is an important element of any full-scope examination and, for some institutions, may be the sole topic for specialized or targeted examinations. Such an evaluation includes assessing both the adequacy of the management process used to control IRR and the quantitative level of exposure. When assessing the IRR management process, examiners should ensure that appropriate policies, procedures, management information systems, and internal controls are in place to maintain IRR at prudent levels with consistency and continuity. Evaluating the quantitative level of IRR exposure requires examiners to assess the existing and potential future effects of changes in interest rates on an institution's financial condition, including its capital adequacy, earnings, liquidity, and, where appropriate, asset quality. To ensure that these assessments are both effective and efficient, examiner resources must be appropriately targeted at those elements of IRR that pose the greatest threat to the financial condition of an institution. This targeting requires an examination process built on a well-focused assessment of IRR exposure before the on-site engagement, a clearly defined examination scope, and a comprehensive program for following up on examination findings and ongoing monitoring. This section provides examiner guidance for assessing both the adequacy of an institution's IRR management process and the quantitative level of its IRR exposure. The section begins with a description of the sources and effects of IRR, followed by a discussion of sound practices for managing IRR. The section then outlines examination considerations in assessing the quantitative level of IRR exposure. Finally, the section discusses key elements of the examination process used to assess IRR including the role and importance of a preexamination risk assessment, proper scoping of the examination, and the testing and verification of both the management process and internal measures of the level of IRR exposure.[1]

SOURCES AND EFFECTS OF IRR

Sources of IRR

As financial intermediaries, banks encounter IRR in several ways. The primary and most discussed source of IRR is differences in the timing of the repricing of bank assets, liabilities, and off-balance-sheet (OBS) instruments. Repricing mismatches are fundamental to the business of banking and generally occur from either borrowing short-term to fund longer-term assets or borrowing long-term to fund shorter-term assets. Such mismatches can expose an institution to adverse changes in both the overall level of interest rates (parallel shifts in the yield curve) and the relative level of rates across the yield curve (nonparallel shifts in the yield curve).

Another important source of IRR, commonly referred to as basis risk, is the imperfect correlation in the adjustment of the rates earned and paid on different instruments with otherwise similar repricing characteristics (for example, a three-month Treasury bill versus a three-month LIBOR). When interest rates change, these differences can change the cash flows and earnings spread between assets, liabilities, and OBS instruments of similar maturities or repricing frequencies.

An additional and increasingly important source of IRR is the options in many bank asset, liability, and OBS portfolios. An option pro-

1. This section incorporates and builds on the principles and guidance provided in SR-96-13, ''Interagency Guidance on Sound Practices for Managing Interest Rate Risk.'' It also incorporates, where appropriate, fundamental risk-management principles and supervisory policies and approaches identified in SR-93-69, ''Examining Risk-Management and Internal Controls for Trading Activities of Banking Organizations''; SR-95-17, ''Evaluating the Risk Management of Securities and Derivative Contracts Used in Nontrading Activities''; SR-95-22, ''Enhanced Framework for Supervising the U.S. Operations of Foreign Banking Organizations''; SR-95-51, ''Rating the Adequacy of Risk Management Processes and Internal Controls at State Member Banks and Bank Holding Companies''; and SR-96-14, ''Risk-Focused Examinations and Inspections.''

vides the holder with the right, but not the obligation, to buy, sell, or in some manner alter the cash flow of an instrument or financial contract. Options may be distinct instruments, such as exchange-traded and over-the-counter contracts, or they may be embedded within the contractual terms of other instruments. Examples of instruments with embedded options include bonds and notes with call or put provisions (e.g., callable U.S. agency notes), loans that give borrowers the right to prepay balances without penalty (e.g., residential mortgage loans), and various types of nonmaturity deposit instruments that give depositors the right to withdraw funds at any time without penalty (e.g., core deposits). If not adequately managed, the asymmetrical payoff characteristics of options can pose significant risk to the banking institutions that sell them. Generally, the options, both explicit and embedded, held by bank customers are exercised to the advantage of the holder, not the bank. Moreover, an increasing array of options can involve highly complex contract terms that may substantially magnify the effect of changing reference values on the value of the option and, thus, magnify the asymmetry of option payoffs.

Effects of IRR

Repricing mismatches, basis risk, options, and other aspects of a bank's holdings and activities can expose an institution's earnings and value to adverse changes in market interest rates. The effect of interest rates on accrual or *reported earnings* is the most common focal point. In assessing the effects of changing rates on earnings, most banks focus primarily on their net interest income—the difference between total interest income and total interest expense. However, as banks have expanded into new activities to generate new types of fee-based and other non-interest income, a focus on overall net income is becoming more appropriate. The non-interest income arising from many activities, such as loan servicing and various asset-securitization programs, can be highly sensitive to changes in market interest rates. As non-interest income becomes an increasingly important source of bank earnings, both bank management and supervisors need to take a broader view of the potential effects of changes in market interest rates on bank earnings.

Market interest rates also affect the *value* of a bank's assets, liabilities, and OBS instruments and, thus, have a direct effect on the value of an institution's equity capital. The effect of rates on the *economic value* of an institution's holdings and equity capital is a particularly important consideration for shareholders, management, and supervisors alike. The economic value of an instrument is an assessment of the present value of its expected net future cash flows, discounted to reflect market rates.[2] By extension, an institution's economic value of equity (EVE) can be viewed as the present value of the expected cash flows on assets minus the present value of the expected cash flows on liabilities plus the net present value of the expected cash flows on OBS instruments. Economic values, which may differ from reported book values due to GAAP accounting conventions, can provide a number of useful insights into the current and potential future financial condition of an institution. Economic values reflect one view of the ongoing worth of the institution and can often provide a basis for assessing past management decisions in light of current circumstances. Moreover, economic values can offer comprehensive insights into the potential future direction of earnings performance since changes in the economic value of an institution's equity reflect changes in the present value of the bank's future earnings arising from its current holdings.

Generally, commercial banking institutions have adequately managed their IRR exposures and few have failed solely as a result of adverse interest-rate movements. Nevertheless, changes in interest rates can have negative effects on bank profitability and must be carefully managed, especially given the rapid pace of financial innovation and the heightened level of competition among all types of financial institutions.

SOUND IRR MANAGEMENT PRACTICES

As is the case in managing other types of risk,

2. For some instruments, economic values may be the same as fair value—especially when prices from active markets are available. The fair value of an instrument is generally considered to be the amount at which the instrument could be exchanged in a current transaction between willing parties other than in a forced or liquidation sale. Even then, the economic values of instruments and firms may differ from fair values due to unique insights on the intrinsic value of instruments derived on a going-concern basis.

sound IRR management involves effective board and senior management oversight and a comprehensive risk-management process that includes the following elements:

- effective policies and procedures designed to control the nature and amount of IRR, including clearly defined IRR limits and lines of responsibility and authority
- appropriate risk-measurement, monitoring, and reporting systems
- systematic internal controls that include the internal or external review and/or audit of key elements of the risk-management process

The formality and sophistication used in managing IRR depends on the size and sophistication of the institution, the nature and complexity of its holdings and activities, and the overall level of its IRR. Adequate IRR management practices can vary considerably. For example, a small institution with noncomplex activities and holdings, a relatively short-term balance-sheet structure presenting a low IRR profile, and senior managers and directors who are actively involved in the details of day-to-day operations may be able to rely on relatively simple and informal IRR management systems.

More complex institutions and those with higher interest-rate risk exposures or holdings of complex instruments may require more elaborate and formal IRR management systems to address their broader and typically more complex range of financial activities, as well as provide senior managers and directors with the information they need to monitor and direct day-to-day activities. The more complex interest-rate risk management processes often employed at these institutions may require more formal internal controls, such as internal and external audits, to ensure the integrity of the information senior officials use to oversee compliance with policies and limits.

Individuals involved in the risk-management process should be sufficiently independent of business lines to ensure adequate separation of duties and avoid potential conflicts of interest. The degree of autonomy these individuals have may be a function of the size and complexity of the institution. In smaller and less complex institutions with limited resources, it may not be possible to completely remove individuals with business-line responsibilities from the risk-management process. In these cases, focus should be directed towards ensuring that risk-management functions are conducted effectively and objectively. Larger, more complex institutions may have separate and independent risk-management units.

Board and Senior Management Oversight

Effective oversight by a bank's board of directors and senior management is critical to a sound IRR management process. The board and senior management should be aware of their responsibilities related to IRR management, understand the nature and level of interest-rate risk taken by the bank, and ensure that the formality and sophistication of the risk-management process is appropriate for the overall level of risk.

Board of Directors

The board of directors has the ultimate responsibility for the level of IRR taken by the institution. The board should approve business strategies and significant policies that govern or influence the institution's interest-rate risk. It should articulate overall IRR objectives and should ensure the provision of clear guidance on the level of acceptable IRR.[3] The board should also approve policies and procedures that identify lines of authority and responsibility for managing IRR exposures.

Directors should understand the nature of the risks to their institution and ensure that management is identifying, measuring, monitoring, and controlling these risks. Accordingly, the board should monitor the performance and IRR profile of the institution and periodically review information that is timely and sufficiently detailed to allow directors to understand and assess the IRR facing the institution's key portfolios and the institution as a whole. The frequency of these reviews depends on the sophistication of the institution, the complexity of its holdings, and the materiality of changes in its holdings between reviews. Institutions holding significant positions in complex instruments or with significant changes in the composition of holdings would be expected to have more frequent reviews. In addition, the board should periodically review

3. For example, objectives for IRR could be set in terms of enhancement to income, liquidity, and value, while IRR limits could be expressed as acceptable levels of volatility in these same areas.

significant IRR management policies and procedures, as well as overall business strategies that affect the institution's IRR exposure.

The board of directors should encourage discussions between its members and senior management, as well as between senior management and others in the institution, regarding the institution's IRR exposures and management process. Board members need not have detailed technical knowledge of complex financial instruments, legal issues, or sophisticated risk-management techniques. However, they are responsible for ensuring that the institution has personnel available who have the necessary technical skills and that senior management fully understands the risks incurred by the institution and is sufficiently controlling them.

A bank's board of directors may meet its responsibilities in a variety of ways, including the identification of selected board members to become directly involved in risk-management activities by participating on board committees or by otherwise gaining a sufficient understanding and awareness of the institution's risk profile through periodic briefings and management reports. Information provided to board members should be presented in a format that members can readily understand and that will assist them in making informed policy decisions about acceptable levels of risk, the nature of risks in current and proposed new activities, and the adequacy of the institution's risk-management process. In short, regardless of the structure of the organization and the composition of its board of directors or delegated board committees, board members must ensure that the institution has the necessary technical skills and management expertise to conduct its activities prudently and consistently within the policies and intent of the board.

Senior Management

Senior management is responsible for ensuring that the institution has adequate policies and procedures for managing IRR on both a long-range and day-to-day basis and that it maintains clear lines of authority and responsibility for managing and controlling this risk. Management should develop and implement policies and procedures that translate the board's goals, objectives, and risk limits into operating standards that are well understood by bank personnel and that are consistent with the board's intent. Management is also responsible for maintaining (1) adequate systems and standards for measuring risk, (2) standards for valuing positions and measuring performance, (3) a comprehensive IRR reporting and monitoring process, and (4) effective internal controls and review processes.

IRR reports to senior management should provide aggregate information as well as sufficient supporting detail so that management can assess the sensitivity of the institution to changes in market conditions and other important risk factors. Senior management should also periodically review the organization's IRR management policies and procedures to ensure that they remain appropriate and sound. Senior management should also encourage and participate in discussions with members of the board and—when appropriate to the size and complexity of the institution—with risk-management staff regarding risk-measurement, reporting, and management procedures.

Management should ensure that analysis and risk-management activities related to IRR are conducted by competent staff whose technical knowledge and experience is consistent with the nature and scope of the institution's activities. The staff should have enough knowledgeable people to serve as backup to key personnel.

Policies, Procedures, and Limits

Institutions should have clear policies and procedures for limiting and controlling IRR. These policies and procedures should (1) delineate lines of responsibility and accountability over IRR management decisions, (2) clearly define authorized instruments and permissible hedging and position taking strategies, (3) identify the frequency and method for measuring and monitoring IRR, and (4) specify quantitative limits that define the acceptable level of risk for the institution. In addition, management should define the specific procedures and approvals necessary for exceptions to policies, limits, and authorizations. All IRR risk policies should be reviewed periodically and revised as needed.

Clear Lines of Authority

Whether through formal written policies or clear operating procedures, management should define the structure of managerial responsibilities and oversight, including lines of authority and responsibility in the following areas:

- developing and implementing strategies and tactics used in managing IRR
- establishing and maintaining an IRR measurement and monitoring system
- identifying potential IRR and related issues arising from the potential use of new products
- developing IRR management policies, procedures and limits, and authorizing exceptions to policies and limits

Individuals and committees responsible for making decisions about interest-rate risk management should be clearly identified. Many medium-sized and large banks and banks with concentrations in complex instruments delegate responsibility for IRR management to a committee of senior managers, sometimes called an asset/liability committee (ALCO). In such institutions, policies should clearly identify ALCO membership, the committee's duties and responsibilities, the extent of its decision-making authority, and the form and frequency of its periodic reports to senior management and the board of directors. An ALCO should have sufficiently broad participation across major banking functions (for example, lending, investment, deposit, funding) to ensure that its decisions can be executed effectively throughout the institution. In many large institutions, the ALCO delegates day-to-day responsibilities for IRR management to an independent risk-management department or function.

Regardless of the level of organization and formality used to manage IRR, individuals involved in the risk-management process (including separate risk-management units, if present) should be sufficiently independent of the business lines to ensure adequate separation of duties and avoid potential conflicts of interest. Also, personnel charged with measuring and monitoring IRR should have a well-founded understanding of all aspects of the institution's IRR profile. Compensation policies for these individuals should be adequate enough to attract and retain personnel who are well qualified to assess the risks of the institution's activities.

Authorized Activities

Institutions should clearly identify the types of financial instruments that are permissible for managing IRR, either specifically or by their characteristics. As appropriate to its size and complexity, the institution should delineate procedures for acquiring specific instruments, managing individual portfolios, and controlling the institution's aggregate IRR exposure. Major hedging or risk-management initiatives should be approved by the board or its appropriate delegated committee before being implemented.

Before introducing new products, hedging, or position-taking initiatives, management should also ensure that adequate operational procedures and risk-control systems are in place. Proposals to undertake such new instruments or activities should contain these features:

- a description of the relevant product or activity
- an identification of the resources required to establish sound and effective IRR management of the product or activity
- an analysis of the risk of loss from the proposed activities in relation to the institution's overall financial condition and capital levels
- the procedures to be used to measure, monitor, and control the risks of the proposed product or activity

Limits

The goal of IRR management is to maintain an institution's interest-rate risk exposure within self-imposed parameters over a range of possible changes in interest rates. A system of IRR limits and risk-taking guidelines provides the means for achieving that goal. Such a system should set boundaries for the institution's level of IRR and, where appropriate, provide the capability to allocate these limits to individual portfolios or activities. Limit systems should also ensure that limit violations receive prompt management attention.

Aggregate IRR limits clearly articulating the amount of IRR acceptable to the firm should be approved by the board of directors and reevaluated periodically. Limits should be appropriate to the size, complexity, and financial condition of the organization. Depending on the nature of an institution's holdings and its general sophistication, limits can also be identified for individual business units, portfolios, instrument types, or specific instruments.[4] The level of detail of risk limits should reflect the characteristics of the institution's holdings, including the various sources of IRR to which the institution is exposed. Limits applied to portfolio categories and individual instruments should be consistent with and complementary to consolidated limits.

IRR limits should be consistent with the institution's overall approach to measuring and managing IRR and should address the potential impact of changes in market interest rates on both reported earnings and the institution's economic value of equity (EVE). From an earnings perspective, institutions should explore limits on net income as well as net interest income to fully assess the contribution of non-interest income to the IRR exposure of the institution. Limits addressing the effect of changing interest rates on economic value may range from those focusing on the potential volatility of the value of the institution's major holdings to a comprehensive estimate of the exposure of the institution's EVE.

The limits for addressing the effect of rates on an institution's profitability and EVE should be appropriate for the size and complexity of its underlying positions. Relatively simple limits identifying maximum maturity/repricing gaps, acceptable maturity profiles, or the extent of volatile holdings may be adequate for institutions engaged in traditional banking activities and with few holdings of long-term instruments, options, instruments with embedded options, or other instruments whose value may be substantially affected by changes in market rates. For more complex institutions, quantitative limits on acceptable changes in its estimated earnings and EVE under specified scenarios may be more appropriate. Banks that have significant intermediate- and long-term mismatches or complex option positions should, at a minimum, have economic value–oriented limits that quantify and constrain the potential changes in economic value or bank capital that could arise from those positions.

Limits on the IRR exposure of earnings should be broadly consistent with those used to control the exposure of a bank's economic value. IRR limits on earnings variability primarily address the near-term recognition of the effects of changing interest rates on the institution's financial condition. IRR limits on economic value reflect efforts to control the effect of changes in market rates on the present value of the entire future earnings stream arising from the institution's current holdings.

IRR limits and risk tolerances may be keyed to specific scenarios of market-interest-rate movements, such as an increase or decrease of a particular magnitude. The rate movements used in developing these limits should represent meaningful stress situations, taking into account historic rate volatility and the time required for management to address exposures. Moreover, stress scenarios should take account of the range of the institution's IRR characteristics, including mismatch, basis, and option risks. Simple scenarios using parallel shifts in interest rates may be insufficient to identify these risks.

Increasingly, large, complex institutions are using advanced statistical techniques to measure IRR across a probability distribution of potential interest-rate movements and express limits in terms of statistical confidence intervals. If properly used, these techniques can be particularly useful in measuring and managing options positions.

Risk-Measurement and -Monitoring Systems

An effective process of measuring, monitoring, and reporting exposures is essential for adequately managing IRR. The sophistication and complexity of this process should be appropriate to the size, complexity, nature, and mix of an institution's business lines and its IRR characteristics.

IRR Measurement

Well-managed banks have IRR measurement systems that measure the effect of rate changes on both earnings and economic value. The latter is particularly important for institutions with significant holdings of intermediate and long-term instruments or instruments with embedded options because their market values can be particularly sensitive to changes in market interest rates. Institutions with significant non-interest income that is sensitive to changes in

4. Section 2020, "Acquisition and Management of Nontrading Securities and Derivative Products," discusses issues in setting price volatility limits in the acquisition of securities and derivatives.

interest rates should focus special attention on net income as well as net interest income. Since the value of instruments with intermediate and long maturities and embedded options is especially sensitive to interest-rate changes, banks with significant holdings of these instruments should be able to assess the potential longer-term impact of changes in interest rates on the value of these positions—the overall potential performance of the bank.

IRR measurement systems should (1) assess all material IRR associated with an institution's assets, liabilities, and OBS positions; (2) use generally accepted financial concepts and risk-measurement techniques; and (3) have well-documented assumptions and parameters. Material sources of IRR include the mismatch, basis, and option risk exposures of the institution. In many cases, the interest-rate characteristics of a bank's largest holdings will dominate its aggregate risk profile. While all of a bank's holdings should receive appropriate treatment, measurement systems should rigorously evaluate the major holdings and instruments whose values are especially sensitive to rate changes. Instruments with significant embedded or explicit option characteristics should receive special attention.

IRR measurement systems should use generally accepted financial measurement techniques and conventions to estimate the bank's exposure. Examiners should evaluate these systems in the context of the level of sophistication and complexity of the institution's holdings and activities. A number of accepted techniques are available for measuring the IRR exposure of both earnings and economic value. Their complexity ranges from simple calculations and static simulations using current holdings to highly sophisticated dynamic modeling techniques that reflect potential future business and business decisions. Basic IRR measurement techniques begin with a maturity/repricing schedule, which distributes assets, liabilities, and OBS holdings into time bands according to their final maturity (if fixed-rate) or time remaining to their next repricing (if floating). The choice of time bands may vary from bank to bank. Those assets and liabilities lacking contractual repricing intervals or maturities are assigned to repricing time bands according to the judgment and analysis of the institution.

Simple maturity/repricing schedules can be used to generate rough indicators of the IRR sensitivity of both earnings and economic values to changing interest rates. To evaluate earnings exposures, liabilities arrayed in each time band can be subtracted from the assets arrayed in the same time band to yield a dollar amount of maturity/repricing mismatch or gap in each time band. The sign and magnitude of the gaps in various time bands can be used to assess potential earnings volatility arising from changes in market interest rates.

A maturity/repricing schedule can also be used to evaluate the effects of changing rates on an institution's economic value. At the most basic level, mismatches or gaps in long-dated time bands can provide insights into the potential vulnerability of the economic value of relatively noncomplex institutions. Such long-term gap calculations along with simple maturity distributions of holdings may be sufficient for relatively noncomplex institutions. On a slightly more advanced, yet still simplistic, level, estimates of the change in an institution's economic value can be calculated by applying economic-value sensitivity weights to the asset and liability positions slotted in the time bands of a maturity/repricing schedule. The weights can be constructed to represent estimates of the change in value of the instruments maturing or repricing in that time band given a specified interest-rate scenario. When these weights are applied to the institution's assets, liabilities, and OBS positions and subsequently netted, the result can provide a rough approximation of the change in the institution's EVE under the assumed scenario. These measurement techniques can prove especially useful for institutions with small holdings of complex instruments.[5] Further refinements to simple risk weighting techniques can be achieved by incorporating the risk of options, the potential for basis risk, and non-parallel shifts in the yield curve using customized risk weights applied to the specific instruments or instrument types arrayed in the maturity repricing schedule.

Larger institutions and those with complex risk profiles that entail meaningful basis or option risks may find it difficult to monitor IRR adequately using simple maturity/repricing analyses. Generally, they will need to employ more

5. James V. Houpt and James A. Embersit, "A Method for Evaluating Interest Rate Risk in Commercial Banks," *Federal Reserve Bulletin*, vol. 77 (August 1991), 625–37 and David M. Wright and James V. Houpt, "An Analysis of Commercial Bank Exposure to Interest Rate Risk," *Federal Reserve Bulletin*, vol. 82 (February 1996), 115–128.

sophisticated simulation techniques. For assessing the exposure of earnings, simulations estimating cash flows and resulting earnings streams over a specific period are conducted based on existing holdings and assumed interest-rate scenarios. When these cash flows are simulated over the entire expected lives of the institution's holdings and discounted back to their present values, an estimate of the change in EVE can be calculated.

Static cash-flow simulations of current holdings can be made more dynamic by incorporating more detailed assumptions about the future course of interest rates and the expected changes in a bank's business activity over a specified time horizon. Combining assumptions on future activities and reinvestment strategies with information about current holdings, these simulations can project expected cash flows and estimate dynamic earnings and EVE outcomes. These more sophisticated techniques, such as option-adjusted pricing analysis and Monte Carlo simulation, allow for dynamic interaction of payment streams and interest rates to better capture the effect of embedded or explicit options.

The IRR measurement techniques and associated models should be sufficiently robust to adequately measure the risk profile of the institution's holdings. Depending on the size and sophistication of the institution and its activities, as well as the nature of its holdings, the IRR measurement system should have the capability to adequately reflect (1) uncertain principal amortization and prepayments; (2) caps and floors on loans and securities, where material; (3) the characteristics of both basic and complex OBS instruments held by the institution; and (4) changing spread relationships necessary to capture basis risk. Moreover, IRR models should provide clear reports that identify major assumptions and allow management to evaluate the reasonableness of and internal consistency among key assumptions.

Data Integrity and Assumptions

The usefulness of IRR measures depends on the integrity of the data on current holdings, validity of the underlying assumptions, and IRR scenarios used to model IRR exposures. Techniques involving sophisticated simulations should be used carefully so that they do not become ''black boxes,'' producing numbers that appear to be precise, but that may be less accurate when their specific assumptions and parameters are revealed.

The integrity of data on current positions is an important component of the risk-measurement process. Institutions should ensure that current positions are delineated at an appropriate level of aggregation (for example, by instrument type, coupon rate, or repricing characteristic) to ensure that risk measures capture all meaningful types and sources of IRR, including those arising from explicit or embedded options. Management should also ensure that all material positions are represented in IRR measures, that the data used are accurate and meaningful, and that the data adequately reflect all relevant repricing and maturity characteristics. When applicable, data should include information on the contractual coupon rates and cash flows of associated instruments and contracts. Manual adjustments to underlying data should be well documented.

Senior management and risk managers should recognize the key assumptions used in IRR measurement, as well as reevaluate and approve them periodically. Assumptions should also be documented clearly and, ideally, the effect of alternative assumptions should be presented so that their significance can be fully understood. Assumptions used in assessing the interest-rate sensitivity of complex instruments, such as those with embedded options, and instruments with uncertain maturities, such as core deposits, should be subject to rigorous documentation and review, as appropriate to the size and sophistication of the institution. Assumptions about customer behavior and new business should take proper account of historical patterns and be consistent with the interest-rate scenarios used.

Nonmaturity Deposits

An institution's IRR measurement system should consider the sensitivity of nonmaturity deposits, including demand deposits, NOW accounts, savings deposits, and money market deposit accounts. Nonmaturity deposits represent a large portion of the industry's funding base, and a variety of techniques are used to analyze their IRR characteristics. The use of these techniques should be appropriate to the size, sophistication, and complexity of the institution.

In general, treatment of nonmaturity deposits should consider the historical behavior of the institution's deposits; general conditions in the institution's markets, including the degree of competition it faces; and anticipated pricing behavior under the scenario investigated. Assumptions should be supported to the fullest extent practicable. Treatment of nonmaturity deposits within the measurement system may, of course, change from time to time based on market and economic conditions. Such changes should be well founded and documented. Treatments used in constructing earnings simulation assessments should be conceptually and empirically consistent with those used in developing EVE assessments of IRR.

IRR Scenarios

IRR exposure estimates, whether linked to earnings or economic value, use some form of forecasts or scenarios of possible changes in market interest rates. Bank management should ensure that IRR is measured over a probable range of potential interest-rate changes, including meaningful stress situations. The scenarios used should be large enough to expose all of the meaningful sources of IRR associated with an institution's holdings. In developing appropriate scenarios, bank management should consider the current level and term structure of rates and possible changes to that environment, given the historical and expected future volatility of market rates. At a minimum, scenarios should include an instantaneous plus or minus 200 basis point parallel shift in market rates.[6] Institutions should also consider the use of multiple scenarios, including the potential effects of changes in the relationships among interest rates (option risk and basis risk) as well as changes in the general level of interest rates and changes in the shape of the yield curve.

The risk-measurement system should support a meaningful evaluation of the effect of stressful market conditions on the institution. Stress-testing should be designed to provide information on the kinds of conditions under which the institution's strategies or positions would be most vulnerable; thus, testing may be tailored to the risk characteristics of the institution. Possible stress scenarios might include abrupt changes in the term structure of interest rates, relationships among key market rates (basis risk), liquidity of key financial markets, or volatility of market rates. In addition, stress scenarios should include conditions under which key business assumptions and parameters break down. The stress-testing of assumptions used for illiquid instruments and instruments with uncertain contractual maturities, such as core deposits, is particularly critical to achieving an understanding of the institution's risk profile. Therefore, stress scenarios may not only include extremes of observed market conditions but also plausible worst-case scenarios.

Management and the board of directors should periodically review the results of stress tests and the appropriateness of key underlying assumptions. Stress-testing should be supported by appropriate contingency plans.

IRR Monitoring and Reporting

An accurate, informative, and timely management information system is essential for managing IRR exposure, both to inform management and support compliance with board policy. Reporting of risk measures should be regular and clearly compare current exposure with policy limits. In addition, past forecasts or risk estimates should be compared with actual results as one tool to identify any potential shortcomings in modeling techniques.

A bank's senior management and its board or a board committee should receive reports on the bank's IRR profile at least quarterly. More frequent reporting may be appropriate depending on the bank's level of risk and its potential for significant change. While the types of reports prepared for the board and for various levels of

6. Analysis of quarterly and annual data on changes of the Constant Maturities Treasury Securities (CMT) over the period of January 1, 1974, to December 31, 1994, suggests that a 200 basis point parallel shift in the yield curve represents a plausible stress scenario for assessing IRR. The following data illustrate that over the past 17 years, quarterly changes in yields on CMTs exceeded 193 bp for the three-month CMT and 137 bp for the 30-year CMT 1 percent of the time. Data on annual yield changes illustrate that yield changes on CMTs exceeded 194 bp 5 percent of the time and exceeded 151 bp 10 percent of the time.

Changes in Yields of Constant Maturities Treasury Securities

	Quarterly changes	*Annual changes*	
	99% confidence level	*95% confidence level*	*90% confidence level*
		Basis Point Change	
3-mo. CMT	193 bp	274 bp	212 bp
1-yr. CMT	191 bp	271 bp	210 bp
2-yr. CMT	180 bp	255 bp	198 bp
3-yr. CMT	175 bp	248 bp	192 bp
5-yr. CMT	166 bp	235 bp	182 bp
7-yr. CMT	161 bp	228 bp	177 bp
10-yr. CMT	152 bp	216 bp	167 bp
30-yr. CMT	137 bp	194 bp	151 bp

management will vary based on the institution's IRR profile, they should, at a minimum, allow senior management and the board or committee to—

- evaluate the level of and trends in the bank's aggregate IRR exposure;
- demonstrate and verify compliance with all policies and limits;
- evaluate the sensitivity and reasonableness of key assumptions;
- assess the results and future implications of major hedging or position-taking initiatives that have been taken or are being actively considered;
- understand the implications of various stress scenarios, including those involving breakdowns of key assumptions and parameters;
- review IRR policies, procedures, and the adequacy of the IRR measurement systems; and
- determine whether the bank holds sufficient capital for the level of risk being taken.

Comprehensive Internal Controls

An institution's IRR management process should be an extension of its overall structure of internal controls. Properly structured, a system of internal controls should promote effective and efficient operations; reliable financial and regulatory reporting; and compliance with relevant laws, regulations, and institutional policies. In determining whether internal controls meet these objectives, examiners should consider the general control environment of the organization; the process for identifying, analyzing, and managing IRR; the adequacy of management information systems; and adherence to control activities such as approvals, confirmations, and reconciliations.

An important element of an institution's internal controls for IRR is management's comprehensive evaluation and review of the various components of the IRR management process. Although procedures for establishing limits and adhering to them may vary among institutions, periodic reviews should be conducted to determine whether the organization enforces its IRR policies and procedures. Positions that exceed established limits should receive the prompt attention of appropriate management and should be resolved according to the process described in approved policies. Periodic reviews of the IRR management process should also be conducted in light of significant changes in the nature of instruments acquired, risk-measurement methodologies, limits, and internal controls that have occurred since the last review.

Reviews of the accuracy and performance of the IRR measurement system should also be conducted and include assessments of the assumptions, parameters, and methodologies used in the institution's IRR measurement system. During a review, examiners should seek to understand, test, and document the current measurement process; evaluate the system's accuracy; and recommend solutions to any identified weaknesses. The results of this review, along with any recommendations for improvement, should be reported to the board and acted upon in a timely manner. Institutions with complex risk exposure are encouraged to have their measurement systems reviewed by external auditors or other knowledgeable outside parties to ensure their adequacy and integrity. Since measurement systems may incorporate one or more subsidiary systems or processes, institutions should ensure that multiple component systems are well integrated and consistent in all critical respects.

The frequency and extent to which an institution should reevaluate its risk-measurement methodologies and models depends, in part, on the specific IRR exposures created by their holdings and activities, the pace and nature of changes in market interest rates, and the extent to which there are new developments in measuring and managing IRR. At a minimum, institutions should review their underlying IRR measurement methodologies and IRR management process annually, and more frequently as market conditions dictate. In many cases, internal evaluations may be supplemented by reviews of external auditors or other qualified outside parties, such as consultants with expertise in IRR management.

Rating the Adequacy of IRR Management

Examiners should incorporate their assessment of the adequacy of IRR management into their overall rating of risk management, which is subsequently factored into the management component of an institution's CAMELS rating. Ratings of IRR management can follow the general framework used to rate overall risk management:

- A rating of 1 or strong would indicate that management effectively identifies and controls the IRR posed by the institution's activities, including those from new products.
- A rating of 2 or satisfactory would indicate that the institution's management of IRR is largely effective, but lacking in some modest degree. It reflects a responsiveness and ability to cope successfully with existing and foreseeable exposures that may arise in carrying out the institution's business plan. While the institution may have some minor risk-management weaknesses, these problems have been recognized and are being addressed. Generally, risks are being controlled in a manner that does not require additional or more than normal supervisory attention.
- A rating of 3 or fair signifies IRR management practices that are lacking in some important ways and, therefore, are a cause for more than normal supervisory attention. One or more of the four elements of sound IRR management are considered fair and have precluded the institution from fully addressing a significant risk to its operations. Certain risk-management practices are in need of improvement to ensure that management and the board are able to identify, monitor, and control adequately all significant risks to the institution.
- A rating of 4 or marginal represents marginal IRR management practices that generally fail to identify, monitor, and control significant risk exposures in many material respects. Generally, such a situation reflects a lack of adequate guidance and supervision by management and the board. One or more of the four elements of sound risk management are considered marginal and require immediate and concerted corrective action by the board and management.
- A rating of 5 or unsatisfactory indicates a critical absence of effective risk-management practices to identify, monitor, or control significant risk exposures. One or more of the four elements of sound risk management is considered wholly deficient, and management and the board have not demonstrated the capability to address deficiencies. Deficiencies in the institution's risk-management procedures and internal controls require immediate and close supervisory attention.

QUANTITATIVE LEVEL OF IRR EXPOSURE

Evaluating the quantitative level of IRR involves assessing the effects of both past and potential future changes in interest rates on an institution's financial condition, including the effects on its earnings, capital adequacy, liquidity, and, in some cases, asset quality. This assessment involves a broad analysis of an institution's business mix, balance-sheet composition, OBS holdings, and holdings of interest rate–sensitive instruments. Characteristics of the institution's material holdings should also be investigated to determine (and quantify) how changes in interest rates might affect its performance. The rigor of this evaluation process should reflect the size, sophistication, and nature of the institution's holdings.

Assessment of the Composition of Holdings

An overall evaluation of an institution's holdings and its business mix is an important first step in evaluating the quantitative level of IRR exposure. The evaluation should focus on identifying (1) major on- and off-balance-sheet positions, (2) concentrations in interest-sensitive instruments, (3) the existence of highly volatile instruments, and (4) significant sources of non-interest income that may be sensitive to changes in interest rates. Identifying major holdings of particular types or classes of assets, liabilities, or off-balance-sheet instruments is particularly pertinent since the interest rate–sensitivity characteristics of an institution's largest positions or activities will tend to dominate its IRR profile. The composition of assets should be assessed to determine the types of instruments held and the relative proportion of holdings they represent, both with respect to total assets and within appropriate instrument portfolios. Examiners should note any specialization or concentration in particular types of investment securities or lending activities and identify the interest-rate characteristics of the instruments or activities. The assessment should also incorporate an evaluation of funding strategies and the composition of deposits, including core deposits. Trends and changes in the composition of assets, liabilities, and off-balance-sheet holdings should be fully assessed—especially when the institution is experiencing significant growth.

Examiners should identify the interest sensitivity of an institution's major holdings. For many instruments, the stated final maturity, coupon interest payment, and repricing frequency are the primary determinants of their interest-rate sensitivity. In general, the shorter the repricing frequency, or maturity for fixed-rate instruments, the greater the impact of a change in rates on the *earnings* of the asset, liability, or OBS instrument employed will be because the cash flows derived, either through repricing or reinvestment, will more quickly reflect market rates. Conversely, the longer the repricing frequency, or maturity for fixed-rate instruments, the more sensitive the *value* of the instrument will be to changes in market interest rates. Accordingly, basic maturity/repricing distributions and gap schedules are important first screens in identifying the interest sensitivity of major holdings from both an earnings and value standpoint.

Efforts should also be made to identify instruments whose value is highly sensitive to rate changes. Even if they do not represent a major position, the rate sensitivity of these holdings may be large enough to have a material effect on the institution's aggregate exposure. Highly interest rate–sensitive instruments generally have fixed-rate coupons with long maturities, significant embedded options, or some elements of both. Identifying explicit options and instruments with embedded options is particularly important. Because of their asymmetrical cash flows under varying scenarios, these holdings may exhibit significantly volatile price and earnings behavior in changing-rate environments. The interest-rate sensitivity of exchange-traded options is usually readily identified due to the standardization of exchange contracts. On the other hand, the interest-rate sensitivity of over-the-counter derivative instruments and the option provisions embedded in other financial instruments, such as the right to prepay a loan without penalty, may be less readily identifiable. Instruments tied to residential mortgages, such as mortgage pass-through securities, collateralized mortgage obligations (CMOs), real estate mortgage investment conduits (REMICs), and various mortgage-derivative products, generally entail some form of embedded optionality. Certain types of CMOs and REMICs constitute high-risk mortgage-derivative products and should be clearly identified. U.S. agency and municipal securities, as well as traditional forms of lending and borrowing arrangements, can often incorporate options into their structures. U.S. agency structured notes and municipal securities with long-dated call provisions are just two examples. Many commercial loans also make use of caps or floors. Over-the-counter OBS instruments, such as swaps, caps, floors, and collars, can involve highly complex structures and, thus, can be quite volatile in the face of changing interest rates.

An evaluation of an institution's funding sources relative to the profile of its assets is fundamental to the assessment of IRR. Reliance on volatile or complex funding structures can significantly increase IRR when asset structures are fixed-rate or long-term in nature. Conversely, long-term liabilities financing shorter-term assets can also increase IRR. The role of nonmaturity or core deposits in an institution's funding base is particularly pertinent to any assessment of IRR. Depending on their composition and the underlying client base, core deposits can provide significant opportunities for institutions to administer and manage the interest rates paid on this funding source. Thus, high levels of stable core deposit funding may provide an institution with significant control over its IRR profile. Examiners should assess the characteristics of an institution's nonmaturity deposit base, including the types of accounts offered, the underlying customer base, and important trends that may influence the rate sensitivity of this funding source.

In general, examiners should evaluate trends and attempt to identify any structural changes in the interest-rate risk profile of an institution's holdings, such as shifts of asset holdings into longer-term instruments or instruments that may have embedded options, changes in funding strategies and core deposit balances, and the use of off-balance-sheet instruments. Significant changes in the composition of an institution's holdings may reduce the usefulness of historical performance as an indicator of future performance.

Examiners should also identify and assess material sources of interest-sensitive fee income. Loan-servicing income, especially when related to residential mortgages, can be an important and highly volatile element in an institution's earnings profile. Servicing income is linked to the size of the servicing portfolio and, thus, can be greatly affected by the rate of prepayment on mortgages in the servicing portfolio. Revenues arising from securitization of other types of loans, including credit card receivables, can also be very sensitive to changes in interest rates.

An analysis of both on- and off-balance-sheet holdings should also consider potential basis risk, that is, whether instruments with adjustable-rate characteristics that reprice in a similar time period will reprice differently than assumed. Consideration of basis risk is particularly pertinent when offsetting positions reprice in the same time period. Typical examples include assets that reprice with three-month Treasury bills paired against liabilities repricing with three-month LIBOR or prime-based assets paired against other short-term funding sources. Analyzing the repricing characteristics of major adjustable-rate positions should help to identify such situations.

Exposure of Earnings to IRR

When evaluating the potential effects of changing rates on an institution's earnings, examiners should assess the key determinants of the net interest margin, the effect that fluctuations in net interest margins can have on overall net income, and the rate sensitivity of non-interest income and expense. Analyzing the historical behavior of the net interest margin, including the yields on major assets, liabilities, and off-balance-sheet positions that make up that margin, can provide useful insights into the relative stability of an institution's earnings. For example, a review of the historical composition of assets and the yields earned on those assets clearly identifies an institution's business mix and revenue-generating strategies and reveals important insights into the potential vulnerabilities of these revenues to changes in rates. Similarly, an assessment of the rates paid on various types of deposits over time can help identify the institution's funding strategies, how the institution competes for deposits, and the potential vulnerability of its funding base to rate changes.

Understanding the effect of potential fluctuations in net interest income on overall operating performance is also important. High overhead structures at some banks may require high net interest margins to generate even moderate levels of income. Accordingly, relatively high net interest margins may not necessarily imply a higher tolerance to changes in interest rates. Examiners should fully consider the potential effects of fluctuating net interest margins when analyzing the exposure of net income to changes in interest rates.

Additionally, examiners should assess the contribution of non-interest income to net income, including its interest-rate sensitivity and how it affects the IRR of the institution. Significant sources of rate-insensitive non-interest income provide stability to net income and can mitigate the effect of fluctuations in net interest margins.

A historical review of changes in an institution's earnings—both net income and net interest income—in relation to changes in market rates is an important step in assessing the rate sensitivity of its earnings. When appropriate, this review should assess the institution's performance during prior periods of volatile rates.

Important tools used to gauge the potential volatility in future earnings include basic maturity and repricing gap calculations and income simulations. Short-term repricing gaps between assets and liabilities in intervals of one year or less can provide useful insights on the exposure of earnings. These can be used to develop rough approximations of the effect of changes in market rates on an institution's profitability. Examiners can develop rough gap estimates using available call report information, as well as the bank's own internally generated gap or other earnings exposure calculations if risk-management and -measurement systems are deemed adequate. When available, a bank's own earnings-simulation model provides a particularly valuable source of information: a formal estimate of future earnings (a "baseline") and an evaluation of how earnings would change under different rate scenarios. Together with historical earnings patterns, an institution's estimate of the IRR sensitivity of its earnings derived from simulation models is an important indication of the exposure of its near-term earnings stability.

As detailed in the preceding subsection, sound risk-management practices require IRR to be measured over a probable range of potential interest-rate changes. At a minimum, an instantaneous shift in the yield curve of plus or minus 200 basis points should be used to assess the potential impact of rate changes on an institution's earnings.

Examiners should evaluate the exposure of earnings to changes in interest rates relative to the institution's overall level of earnings and the potential length of time such exposure might persist. For example, simulation estimates of a small, temporary decline in earnings, while likely an issue for shareholders and directors, may be less of a supervisory concern if the institution has a sound earnings and capital base. On the other hand, exposures that could offset earnings for a significant period (as some thrifts experienced during the 1980s) and even deplete capital would be a great concern to both management and supervisors. Exposures measured by gap or simulation analysis under the minimum 200 basis point scenario that would result in a significant decline in net interest margins or net income should prompt further investigation of the adequacy and stability of earnings and the adequacy of the institution's risk-management process. Specifically, in institutions exhibiting significant earnings exposures, examiners should emphasize the results of the institution's stress tests to determine the extent to which more significant and stressful rate moves might magnify the erosion in earnings identified in the more modest rate scenario. In addition, examiners should emphasize the need for management to understand the magnitude and nature of the institution's IRR and the adequacy of its limits.

While an erosion in net interest margins or net income of more than 25 percent under a 200 basis point scenario should warrant considerable examiner attention, examiners should take into account the absolute level of an institution's earnings both before and after the estimated IRR shock. For example, a 33 percent decline in earnings for a bank with a strong return on assets (ROA) of 1.50 percent would still leave the bank with an ROA of 1.00 percent. In contrast, the same percentage decline in earnings for a bank with a fair ROA of 0.75 percent results in a marginal ROA of 0.50 percent.

Examiners should ensure that their evaluation of the IRR exposure of earnings is incorporated into the rating of earnings under the CAMELS rating system. Institutions receiving an earnings rating of 1 or 2 would typically have minimal exposure to changing interest rates. Conversely, significant exposure of earnings to changes in rates may, in itself, provide a sufficient basis for a lower rating.

Exposure of Capital and Economic Value

As set forth in the capital adequacy guidelines for state member banks, the risk-based capital ratio focuses principally on broad categories of credit risk and does not incorporate other factors, including overall interest-rate exposure and management's ability to monitor and control financial and operating risks. Therefore, the guidelines point out that in addition to evaluating capital ratios, an overall assessment of capital adequacy must take account of " . . . a bank's exposure to declines in economic value of its capital due to changes in interest rates. For this reason, the final supervisory judgement on a bank's capital adequacy may differ significantly from conclusions that might be drawn solely from the level of its risk-based capital ratio."

Banking organizations with low proportions of assets maturing or repricing beyond five years, relatively few assets with volatile market values (such as high-risk CMOs and structured notes or certain off-balance-sheet derivatives), and large and stable sources of nonmaturity deposits are unlikely to face significant economic value exposure. Consequently, an evaluation of their economic value exposure may be limited to reviewing available internal reports showing the asset/liability composition of the institution or the results of internal-gap, earnings-simulation, or economic-value simulation models to confirm that conclusion.

Institutions with fairly significant holdings of longer maturing or repricing assets, concentrations in value-sensitive on- and off-balance-sheet instruments, or a weak base of nonmaturity deposits warrant more formal and quantitative evaluations of economic-value exposures. This includes reviewing the results of the bank's own internal reports for measuring changes in economic value, which should address the adequacy of the institution's risk-management process, reliability of risk-measurement assumptions, integrity of the data, and comprehensiveness of any modeling procedures.

For institutions that appear to have a potentially significant level of IRR and that lack a reliable internal economic-value model, examiners should consider alternative means for quantifying economic-value exposure, such as internal-gap measures or off-site monitoring or surveillance screens that rely on call report data to estimate economic-value exposure. For example, the institution's gap schedules might be used to derive a duration gap by applying duration-based risk weights to the bank's aggregate positions. In estimating changes in economic value using alternative means, the relative crudeness of these techniques and lack of detailed data (such as the absence of coupon or off-balance-sheet data) should be taken into account when drawing conclusions about the institution's exposure and capital adequacy.

An evaluation of an institution's capital adequacy should also consider the extent to which past interest-rate moves may have reduced the economic value of capital through the accumulation of net unrealized losses on financial instruments. To the extent that past rate moves have reduced the economic or market value of a bank's claims more than they have reduced the value of its obligations, the institution's economic value of capital is less than its stated book value.

To evaluate the embedded net loss or gain in an institution's financial structure, fair-value data on the securities portfolio can be used as the starting point; this information should be readily available from the call report or bank internal reports. Other major asset categories that might contain material embedded gains or losses include any assets maturing or repricing in more than five years, such as residential, multifamily, or commercial mortgage loans. By comparing a portfolio's weighted average coupon with current market yields, examiners may get an indication of the magnitude of any potential unrealized gains or losses. For companies with hedging strategies that use derivatives, the current positive or negative market value of these positions should be obtained, if available. For banks with material holdings of originated or purchased mortgage-servicing rights, capitalized amounts should be evaluated to ascertain that they are recorded at the lower of cost or fair value and that management has appropriately written down any values that are impaired pursuant to generally accepted accounting rules.

The presence of significant depreciation in securities, loans, or other assets does not necessarily indicate significant embedded net losses; depreciation may be offset by a decline in the market value of a bank's liabilities. For example, stable, low-cost nonmaturity deposits typically become more profitable to banks as rates rise, and they can add significantly to the bank's financial strength. Similarly, below-market-rate deposits, other borrowings, and subordinated debt may also offset unrealized asset losses caused by past rate hikes.

For banks with substantial depreciation in their securities portfolios, low levels of nonmaturity deposits and retail time deposits, or high levels of IRR exposure, unrealized losses can have important implications for the supervisory assessment of capital adequacy. If stressful conditions require the liquidation or restructuring of the securities portfolio, economic losses could be realized and, thereby, reduce the institution's regulatory capitalization. Therefore, for higher-risk institutions, an evaluation of capital adequacy should consider the potential after-tax effect of the liquidation of available-for-sale and held-to-maturity accounts. Estimates of the effect of securities losses on regulatory capital ratio may be obtained from surveillance screens that use call report data or the bank's internal reports.

Examiners should also consider the potential effect of declines and fluctuations in earnings on an institution's capital adequacy. Using the results of internal model simulations or gap reports, examiners should determine whether capital-impairing losses might result from changes in market interest rates. In cases where potential rate changes are estimated to cause declines in margins that actually result in losses, examiners should assess the effect on capital over a two- or three-year earnings horizon.

When rating capital adequacy in the context of IRR exposure, examiners should consider the effect of changes in market interest rates on the economic value of equity, level of embedded losses in the bank's financial structure, and impact of potential rate changes on the institution's earnings. The IRR of institutions that show material declines in earnings or economic value of capital from a 200 basis point shift should be evaluated fully, especially if that decline would lower an institution's pro forma prompt-corrective-action category. For example, a well-capitalized institution with a 5.5 percent leverage ratio and an estimated change in economic value arising from an appropriate stress scenario amounting to 2.0 percent of assets would have an adjusted leverage ratio of 3.5 percent, causing a pro forma two-tier decline in its prompt-corrective-action category to the undercapitalized category. After considering the level of embedded losses in the balance sheet, the stability of the institution's funding base, its exposure to near-term losses, and the quality of its risk-management process, the examiner may need to give the institution's capital adequacy a relatively low rating. In general, sufficiently adverse effects of market-rate shocks or weak management and control procedures can provide a basis for lowering a bank's rating of capital adequacy. Moreover, even less severe exposures could contribute to a lower rating if combined with exposures from asset concentrations, weak operating controls, or other areas of concern.

Examination Process for Evaluating IRR

As the primary market risk most banks face, IRR should usually receive consideration in full-scope exams. It may also be the topic of targeted examinations. To meet examination objectives efficiently and effectively while remaining sensitive to potential burdens imposed on institutions, the examination of IRR should follow a structured, *risk-focused approach*. Key elements of a risk-focused approach to the examination process for IRR include (1) off-site monitoring and risk assessment of an institution's IRR profile and (2) appropriate planning and scoping of the on-site examination to ensure that it is as efficient and productive as possible. A fundamental tenet of this approach is that supervisory resources are targeted at functions, activities, and holdings that pose the most risk to the safety and soundness of an institution. Accordingly, institutions with low levels of IRR would be expected to receive relatively less supervisory attention than those with more severe IRR exposures.

Many banks have become especially skilled in managing and limiting the exposure of their earnings to changes in interest rates. Accordingly, for most banks and especially for smaller institutions with less complex holdings, the IRR element of the examination may be relatively simple and straightforward. On the other hand, some banks consider IRR an intended consequence of their business strategies and choose to take and manage that risk explicitly—often with complex financial instruments. These banks, along with banks that have a wide array of activities or complex holdings, generally should receive greater supervisory attention.

Off-Site Risk Assessment

Off-site monitoring and analysis involves developing a preliminary view or "risk assessment" before initiating an on-site examination. Both the level of IRR exposure and quality of IRR management should be assessed to the fullest extent possible during the off-site phase of the examination process. The following information can be helpful in this assessment:

- organizational charts and policies identifying authorities and responsibilities for managing IRR
- IRR policies, procedures, and limits
- ALCO committee minutes and reports (from six to twelve months before the examination)
- board of director reports on IRR exposures
- audit reports (both internal and external)
- position reports, including those for investment securities and off-balance-sheet instruments
- other available bank-internal-risk reports, including those detailing key assumptions
- reports outlining key characteristics of concentrations and material holdings of interest-sensitive instruments
- documentation for inputs, assumptions, and methodologies used in measuring risk
- Federal Reserve surveillance reports and supervisory screens

Quantitative IRR exposure can be assessed off-site by conducting as much of the analysis summarized in this subsection as is practicable. This includes assessments of the bank's overall balance-sheet composition and holdings of interest-sensitive instruments. An assessment of the exposure of earnings can be accomplished using supervisory screens, examiner-constructed measures, and internal bank measures obtained from management reports received before the on-site engagement. Similar assessments can be made on the exposure of capital or economic value.

An off-site review of the quality of the risk-management process can significantly improve the efficiency of the on-site engagement. The key to assessing the quality of management is an organized discovery process aimed at determining whether appropriate policies, procedures, limits, reporting systems, and internal controls are in place. This discovery process should, in particular, ascertain whether all the elements of a sound IRR management policy are applied consistently to material concentrations of interest-sensitive instruments. The results and reports of prior examinations provide important information about the adequacy of risk management.

Examination Scope

The off-site risk assessment is an informed hypothesis of both the adequacy of IRR management and the magnitude of the institution's exposure. The scope of the on-site examination of IRR should be designed to confirm or reject that hypothesis and should target specific areas of interest or concern. In this way, examination procedures are tailored to the activities and risk profile of the institution and use flexible and targeted work-documentation programs for the on-site examination. Confirmation of hypotheses on the adequacy of the IRR management process is especially important. In general, if IRR management is identified as adequate, examiners can rely more heavily on the bank's internal IRR measures for assessing quantitative exposures.

The examination scope for assessing IRR should be commensurate with the complexity of the institution and consistent with the off-site risk assessment. For example, only baseline examination procedures would be used for institutions whose off-site risk assessment indicates that they have adequate IRR management processes and low levels of quantitative exposure. Such institutions would include those with noncomplex balance-sheet structures that meet the following criteria:

- Asset structures are principally short-term. Long-term assets constitute less than 25 percent of total assets and the combination of long-term assets and 30 percent of intermediate-term assets constitute less than 30 percent of assets. Long-term assets are considered those that have maturity or repricing intervals greater than five years, and intermediate-term assets are defined as those that have maturity or repricing intervals between one and five years.
- High-risk mortgage securities are less than 5 percent of total assets.
- Structured notes are less than 5 percent of total assets.
- There are no off-balance-sheet positions.
- The capital base is strong, and the institution has a history of stable earnings.

For these and other institutions identified as potentially low risk, the scope of the on-site examination would consist of only those examination procedures necessary to confirm the risk-assessment hypothesis. The adequacy of IRR management could be confirmed through a basic review of the appropriateness of policies, internal reports, and controls and the institution's adherence to them. The integrity and reliability of the information used to assess the quantitative level of risk could be confirmed through limited sampling and testing. In general, if the risk assessment is confirmed by basic examination procedures, the examiner may conclude the IRR examination process.

Institutions assessed to have high levels of IRR exposure and strong IRR management may require more extensive examination scopes to confirm the risk assessment. These procedures may entail more analysis of the institution's IRR measurement system and the IRR characteristics of major holdings. Where high quantitative levels of exposure are found, examiners should focus special attention on the sources of this risk and on significant concentrations of interest-sensitive instruments. Institutions assessed to have high exposure and weak risk-management systems would require an extensive work-documentation program. Internal measures should be used cautiously, if at all.

Regardless of the size or complexity of an institution, care must be taken during the on-site phase of the examination to ensure confirmation of the risk assessment and identification of issues that may have escaped off-site analysis. Accordingly, the examination scope should be adjusted as on-site findings dictate.

Assessing CAMELS Ratings

For most institutions, interest-rate risk is their primary market-risk exposure. Accordingly, the CAMELS market-risk sensitivity or "S" rating for these institutions should be based on assessments of the adequacy of IRR management practices and the quantitative level of IRR exposure.[7] In particular, CAMELS "S" ratings dealing primarily with IRR should be based on, but not limited to, an assessment of the following evaluation factors:

- the sensitivity of the financial institution's earnings or the economic value of its capital to adverse changes in interest rates

7. Section A.5020.1, "Overall Conclusions Regarding Condition of the Bank: Uniform Financial Institutions Rating System," provides guidance on the market-risk sensitivity component of the CAMELS rating system.

- the ability of management to identify, measure, monitor, and control exposure to interest-rate risk given the institution's size, complexity, and risk profile
- the nature and complexity of interest-rate risk exposure arising from nontrading positions
- where appropriate, the nature and complexity of market-risk exposure arising from trading and foreign operations

"S" ratings based primarily on IRR should conform with the following framework:

1 A rating of 1 indicates that interest-rate risk sensitivity is well controlled and that there is minimal potential that the earnings performance or capital position will be adversely affected. Risk-management practices are strong for the size, sophistication, and market risk accepted by the institution. The level of earnings and capital provide substantial support for the degree of interest-rate risk taken by the institution.
2 A rating of 2 indicates that interest-rate risk sensitivity is adequately controlled and that there is only moderate potential that the earnings performance or capital position will be adversely affected. Risk-management practices are satisfactory for the size, sophistication, and interest-rate risk accepted by the institution. The level of earnings and capital provide adequate support for the degree of interest-rate risk taken by the institution.
3 A rating of 3 indicates that control of interest-rate risk sensitivity needs improvement or that there is significant potential that the earnings performance or capital position will be adversely affected. Risk-management practices need to be improved given the size, sophistication, and level of risk accepted by the institution. The level of earnings and capital may not adequately support the degree of interest-rate risk taken by the institution.
4 A rating of 4 indicates that control of interest-rate risk sensitivity is unacceptable or that there is high potential that the earnings performance or capital position will be adversely affected. Risk-management practices are deficient for the size, sophistication, and level of risk accepted by the institution. The level of earnings and capital provide inadequate support for the degree of interest-rate risk taken by the institution.
5 A rating of 5 indicates that control of interest-rate risk sensitivity is unacceptable or that the level of risk taken by the institution is an imminent threat to its viability. Risk-management practices are wholly inadequate for the size, sophistication, and level of interest-rate risk accepted by the institution.

The adequacy of an institution's IRR management is a leading indicator of its potential IRR exposure. Therefore, assessment of IRR management practices should be the basis for the overall assessment of an institution's IRR. Unsafe exposures and management weaknesses should be fully reflected in "S" ratings. Unsafe exposures and unsound management practices that are not resolved during the on-site examination should be addressed through subsequent follow-up actions by the examiner and other supervisory personnel.

1. To evaluate the policies regarding interest-rate risk established by the board of directors and/or senior management, including the limits established for the bank's interest-rate risk profile.
2. To determine if the bank's interest-rate risk profile is within those limits.
3. To evaluate the management of the bank's interest-rate risk, including the adequacy of the methods and assumptions used to measure interest-rate risk.
4. To determine if internal management reporting systems provide the information necessary for informed interest-rate management decisions and for monitoring the results of those decisions.
5. To initiate corrective action when interest-rate management policies, practices, and/or procedures are deficient in controlling and monitoring interest-rate risk.

1. Determine if interest rate risk is managed at the bank level or on a holding company basis.
2. Review the bank's written policies for reasonableness. At a minimum, they should cover—
   a. definition and measurement of acceptable risks, including acceptable levels of interest rate exposure;
   b. net interest margin goals;
   c. sources and uses of funds;
   d. off-balance-sheet activities that affect interest rate exposure;
   e. responsibilities within the bank for interest rate risk management decisions; and
   f. reporting mechanisms.
3. Evaluate the internal controls or the internal audit function. Determine whether internal mechanisms are adequate to ensure compliance with established limits on interest rate risk. If they are determined to be inadequate, complete or update the Internal Control Questionnaire. The examiner should prepare a brief description of the bank's interest rate risk policies and practices, as well as identify areas in need of improvement.
4. Review the UBPR, interim financial reports, and internal management reports, paying particular attention to—
   a. on- and off-balance-sheet mix and trends;
   b. the methodology used by the bank to measure interest rate risk; and
   c. the stability of interest margins under varying economic conditions or simulations (causes of significant fluctuations should be identified).
5. Evaluate the bank's exposure to interest rate risk by:
   a. Obtaining and reviewing any reports regularly prepared by management for controlling and monitoring interest rate risk.
   b. Requesting the appropriate information for determining the level of interest rate risk present in the bank's assets, liabilities, and off-balance-sheet activities, if management does not, at a minimum, regularly prepare rate-sensitivity reports (the circumstances facing the bank and the existing interest rate environment should govern the degree of analysis).
   c. Estimating the effect of an adverse interest rate change on future earnings or economic value by using the bank's gap reports, duration measures, or simulation models (the latter measure is especially useful if the bank's exposure seems large).
   d. Determining the bank's ability to adjust its interest rate position.
6. Evaluate the quality of interest rate risk management. The bank's procedures and controls should be in compliance with the minimum guidelines set forth in SR-90-41. The evaluation should include, but is not limited to, the following:
   a. Assess whether the methods and assumptions used to measure interest risk are adequate relative to the size of the bank and the complexity of its balance sheet.
   b. Assess management's knowledge of interest rate risk in relation to the size and complexity of the bank's balance sheet. In particular, assess their understanding of the methods used by the bank to measure the risk.
   c. Determine whether the level of risk is within the limits set.
   d. Assess the bank's ability to adjust its interest rate position.
   e. Determine if the reporting process provides clear and reliable information on a timely basis (at least quarterly).
   f. Determine if new products or hedging instruments are adequately analyzed before purchase.
7. Determine the adequacy of the net interest margin based on an analysis of the components of the margin (i.e., interest expense and interest income). If the margin or any component is unusually high or low, determine—
   a. if goals have been established for net interest earnings;
   b. management's success in meeting established goals;
   c. the effect of the bank's interest rate risk position on meeting established goals;
   d. the effect of the bank's pricing policies on meeting established goals; and
   e. the effect of the bank's credit risk appetite on the margin.

8. Review the interest rate risk management section of the last report of examination. Determine if there were concerns in this area and if corrective action was required.
9. Write in appropriate report format and discuss with management general remarks on—
   a. the quality of the bank's planning to control and manage interest rate risk;
   b. the level of the bank's interest rate exposure and an assessment of the associated degree of risk;
   c. the quality of the related administrative controls and internal management reporting systems; and
   d. the effect of interest rate risk management decisions on earnings and capital.
10. Update the workpapers with any information that will facilitate future examinations.

Discuss with senior management the bank's policies and practices with regard to the following:

1. Has the board of directors, consistent with its duties and responsibilities, adopted an interest rate risk management policy that includes:
   a. A formal mechanism to coordinate interest rate sensitivity decisions?
   b. Clear lines of responsibility and authority for decisions affecting interest rate sensitivity?
   c. Guidelines for the level of interest rate risk, including that associated with off-balance-sheet products, if any?
   d. Outside limits for the imbalance between balance-sheet and off-balance-sheet positions and for the potential exposure of earnings or equity to changes in interest rates?
2. Have internal management reports been prepared that provide an adequate basis for making interest rate management decisions and for monitoring the results of those decisions? Specifically:
   a. Are reports prepared on the bank's rate sensitivity using an appropriate measurement method?
   b. Is historical information on asset yields, cost of funds, and net interest margins readily available?
   c. Are interest margin variations, both from the prior reporting period and from the budget, regularly monitored?
   d. Is sufficient information available to permit an analysis of the cause of interest margin variations?
3. Does the foregoing information provide an adequate basis for evaluating internal controls in that deficiencies in areas not covered by this questionnaire do not significantly impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.

LITIGATION AND OTHER LEGAL MATTERS

Events or conditions arising from litigation,[1] claims, and assessments are matters within the direct knowledge and, often, control of bank management. Accordingly, management is the primary source of information about these matters.[2] Examiners ordinarily do not possess legal skills and therefore cannot make legal judgments on such information. The examiner should request that bank management send a letter of inquiry to those attorneys with whom it has consulted on litigation, claims, and assessments. The letter of inquiry is the examiner's primary means of corroborating information furnished by management.

When requesting these inquiries, the examiner should consider the scope of counsel's involvement with the bank. Banks frequently engage a number of law firms, so the examiner should have the bank direct requests to both general counsel and counsel whose service is limited to particular matters. Ordinarily, inquiries should be made of all outside counsel.

In certain instances, however, the examiner may be reasonably certain that some of the bank's counsels are handling only routine matters that ultimately won't have a significant effect on the bank's financial condition. In these cases, the examiner-in-charge may decide not to send letters of inquiry to those counsels.

Requests for corroboration from legal counsel should ask for information about litigation, impending litigation, claims, and contingent liabilities. For the purposes of these requests, the terms impending litigation and contingent liabilities have the following meanings:

- *Impending litigation.* Litigation threatened against the bank by a third party but not formally commenced.
- *Contingent liabilities.* Matters other than litigation or claims, which available information indicates have at least a reasonable possibility of impairing assets or increasing liabilities. Contingent liabilities should include unasserted claims or assessments.

A letter of inquiry should ask for a response both as of the examination date and as of the date of counsel's response. That date of response should be as close to the completion of the examination as practicable, yet should allow sufficient time for evaluation of responses and follow-up of nonreplies. In some cases, the examiner may wish to obtain an interim response (in addition to a final response) so that a timely preliminary evaluation of material legal matters may be made. Letters of inquiry should be mailed early enough to allow them to circulate within the law firm because several attorneys may be considering legal matters for the bank. Before completing the examination, the examiner should request that appropriate bank officials contact counsel who have not responded to the initial letter of inquiry.

The examiner should not assume that bank management or counsel will keep him or her informed of developments subsequent to the date of counsel's response. Accordingly, if there is reason to believe that there may be subsequent developments, the examiner should contact bank management again before submitting the report of examination. If bank management is uncooperative or regarded as incapable of supervising matters concerning litigation, or if other sensitivities mandate circumvention of bank management, then the examiner should bring the matter to the attention of Federal Reserve Bank management for further communications with the bank's management and counsel, which could include direct contact with bank counsel.

EXAMINATION-RELATED SUBSEQUENT EVENTS

As a practical matter, the examination, and therefore the report of examination, is as of a

1. Legal or litigation risk is the risk that contracts are not legally enforceable or documented properly. Legal risks should be limited and managed through policies developed by the institution's legal counsel. At a minimum, guidelines and processes should be in place to ensure the enforceability of counterparty agreements.

2. In limited circumstances, a bank director who is not an officer of the bank may have direct knowledge and control of legal information, usually when the director's primary occupation is as an attorney. Management in these rare instances may have limited knowledge and control of legal information.

stated date. However, events or transactions sometimes occur, subsequent to the date of examination, but before the date the report of examination is submitted to the Reserve Bank, that may have a significant effect on the soundness of a bank. Such events and transactions are referred to as ''subsequent events'' and may be of two types.

One type includes those events or transactions that provide additional evidence about conditions that existed at the examination date. Examples of this type are the bankruptcy of a significant borrower or the resolution of outstanding litigation.

The second type includes those events that provide evidence about conditions that did not exist at the date of examination, but that arose subsequently. An example of that type of event would be new litigation arising subsequent to the examination date but before submission of the examination report or a merger agreement signed subsequent to the examination date.

All information that becomes available before the submission of the report of examination should be used by the examiner in his or her evaluations of the bank. Accordingly, all events or transactions that either significantly affect or have the potential to significantly affect the soundness of the bank should be reflected in the report of examination, regardless of whether they occurred before or subsequent to the examination date.

Litigation and Other Legal Matters; Examination-Related Subsequent Events

Examination Objectives

Effective date May 1996

Section 4100.2

1. To determine whether any events or transactions have occurred subsequent to the examination date that have had or may have a significant impact on the present or future soundness of the bank or on the conclusions expressed in the report of examination.
2. To determine the effect of legal counsel's evaluation of litigation, impending litigation, claims, and contingent liabilities on the examiner's overall conclusion regarding the soundness of the bank.

Litigation and Other Legal Matters, Examination-Related Subsequent Events

Examination Procedures

Effective date March 1984

Section 4100.3

1. Obtain from the bank officer responsible for legal matters a listing of impending or threatened litigation. For each item, the following information should be included:
   a. nature of the litigation
   b. progress of case to date
   c. how management is responding or intends to respond to the litigation
   d. an evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss
2. Obtain from the bank officer responsible for legal matters a listing of unasserted claims or assessments management considers will probably be asserted and which, if asserted, would have at least a reasonable possibility of an unfavorable outcome. For each item, the following information should be included:
   a. nature of the matter
   b. how management intends to respond if the claim is asserted
   c. possible exposure if the claim is asserted
3. Obtain from management a listing of attorneys and legal firms to whom litigation and related matters have been referred. Also, obtain a listing of any litigation noted in the newest review done by internal or external auditors from the examiner assigned internal control, and determine that corrections have been accomplished.
4. Review bills supporting major charges to the general ledger expenses account(s) for legal services as a test of the completeness of the list supplied by the bank.
5. Request that management incorporate information obtained in above steps in a letter to the bank's legal counsel for corroboration.
6. Evaluate management's listing of litigation, unasserted claims and assessments, and counsel's replies for the effect on the financial condition of the bank, giving appropriate consideration to any insurance coverage.
7. Obtain and review copies of any subsequent interim financial statements. Examples of such statements are—
   a. published reports sent to shareholders or others
   b. reports submitted to the board of directors by internal auditors, external auditors, or management
   c. statements of condition
   d. income statements
      - Inquire as to whether interim statements obtained were prepared on the same basis as that used for the statements as of the examination date. If not, request proper adjustments to the interim statements.
      - Compare the interim financial statements, especially income statements, with similar statements for the corresponding period in the prior year and to budgets, profit plans, etc., for the current period, if such are available.
      - Obtain from management satisfactory explanations for any unusual items or significant fluctuations noted.
8. Make inquiries of and hold discussions with officers and other executives who have responsibility for the following matters:
   a. changes in credit lines or transactions with officers, directors, controlling shareholders, affiliated bank holding companies, affiliates of an affiliated holding company, or their interests
   b. changes in significant accounting policies
   c. changes in senior officers
   d. any event or combination of events which have had or could have a material adverse effect on the bank's financial condition, including liquidity, or results of operation, such as the default of a bond issue in which the bank has substantial holdings or the filing of bankruptcy by a major borrower
   e. commencement or discontinuance of services not requiring prior approval
   f. execution of significant contracts, such as for employment, leases, pension, or other fringe benefit programs
   g. significant new contingent liabilities or commitments other than those referred to above
   h. significant changes in assets which may not be evident from the review of subsequent interim financial statements, such as a shift in the amount of loans or

investments in special categories, or unusal adjustments made in or after the subsequent interim financial statements reviewed in connection with step 7 above

9. Distribute information obtained in step 8 to the appropriate examiners.
10. Read minutes of all meetings of stockholders, directors, and appropriate committees (investment, loans, etc.).
    a. Ascertain from officials of the bank whether minutes of all such meetings subsequent to the examination date are set forth in the minute book.
    b. As to meetings for which minutes have not been prepared at the date of the review, inquire directly of persons present at the meetings and, preferably, of the person charged with the responsibility of preparing the minutes, concerning matters dealt with at such meetings.
11. If specific violations of law or areas of weakness have been reported to management earlier in the examination, determine the extent to which management has proceeded toward corrective action.
12. Make additional inquiries or perform such procedures as considered necessary and appropriate to dispose of questions that arose in the course of the preceding procedures, inquiries, and discussions.
13. If, as a result of performing the above procedures, information is obtained that has a significant impact on the evaluation of the soundness of the bank, extend the appropriate examination procedures so that sufficient evidence is reviewed and documented in the workpapers to support the conclusions reached.
14. Prepare comments for the examination report on any events or transaction noted which may have a material effect on the soundness of the bank.
15. Update the workpapers with any information that will facilitate future examinations.

INTRODUCTION

Off-balance-sheet credit activities have been one of the fastest growing areas of banking activity. Although these activities may not be reflected on the balance sheet, they must be thoroughly reviewed because they can expose the bank to contingent liabilities. Contingent liabilities are financial obligations of a bank that are dependent on future events or actions of another party.

The purpose of this section is to provide a concise reference for contingent liabilities that arise from off-balance-sheet credit activities (for example, loan commitments and letters of credit). This section will also include some discussion of other contingent liabilities, which arise from asset sales and other off-balance-sheet activities. Activities such as trusts, securities clearance, securities brokerage, and corporate management advisory services involve significant operational and fiduciary risks and require specialized examination procedures. Consult section 6010, ''Other Types of Examinations,'' in this manual for further information about these activities.

Derivatives are also not covered in this section. The acquisition and management of derivatives for the bank's own account are covered in detail in sections 2020 and 4090, ''Acquisition and Management of Nontrading Securities and Derivative Instruments'' and ''Interest-Rate Risk Management'' of this manual. The *Trading Activities Manual* provides more specific guidance for the examination of banks that are involved in derivatives trading and customer accommodation activities.

Risks associated with contingent liabilities may ultimately result in charges against capital. As a result, full-scope examinations will include an analysis of these risks. Each of the major components of the examination—capital, asset quality, management, liquidity, and earnings—incorporates an assessment of the risks associated with off-balance-sheet credit activities. While it is impossible to enumerate all of the types and characteristics of contingent liabilities here, some of the more common ones are discussed in this section. In all cases, the examiner's overall objectives are to assess the potential impact of these contingent liabilities on the financial condition of the bank, to ascertain the likelihood that such contingencies may ultimately result in losses to the bank, to ensure that management has appropriate systems to identify and control contingent liabilities, and to ensure compliance with all applicable laws, regulations, and statements of regulatory policy.

OFF-BALANCE-SHEET LENDING ACTIVITIES

In reviewing individual credit lines, all of a customer's borrowing arrangements with the bank (for example, direct loans, letters of credit, and loan commitments) should be considered. The factors analyzed in evaluating a direct loan (financial performance, ability and willingness to pay, collateral protection, and future prospects) are applicable to the review of off-balance-sheet lending arrangements. When analyzing these activities, however, examiners should evaluate the probability of draws under the bank's off-balance-sheet lending arrangements with its customers and should evaluate whether the allowance for loan and lease losses adequately reflects the associated risks. Consideration should also be given to compliance with laws and regulations. Refer to section 2040, ''Loan Portfolio Management,'' of this manual for further details.

Loan Commitments

A formal loan commitment is a written agreement signed by the borrower and the lender that details the terms and conditions under which a loan, up to a specified amount, will be made. Unlike a standby letter of credit, which commits the bank to satisfying its customer's obligation to a third party, a loan commitment involves only the bank and its customer. The commitment will have an expiration date and, in exchange for agreeing to make the accommodation, the bank often requires the customer to pay a fee and/or maintain a stipulated compensating balance.

Some commitments, such as a working capital line, revolving credit facility, or a term loan facility, are expected to be used. Other commitments, such as back-up lines of credit for commercial paper issuance, involve usage that is not anticipated unless the customer is unable to retire or roll over the issue at maturity.

Lines of Credit

A line of credit expresses to the customer, usually by letter, a bank's willingness to lend up to a certain amount over a specified timeframe. These lines of credit are disclosed to the customer and are referred to as ''advised'' or ''confirmed'' lines. In contrast, ''guidance'' lines (also referred to as internal guidance lines) are not disclosed to the customer. ''Guidance'' lines of credit are formally approved like any other loans or commitments and are established to aid the loan officer who is servicing an account act quickly to an unexpected request for funds. Many lines of credit may be cancelled if the customer's financial condition deteriorates; others are simply subject to cancellation at the option of the issuer, such as ''guidance'' lines and other nonbinding agreements. Lines of credit usually require periodic or annual borrowing cleanups. Not adhering to cleanup provisions is a well-defined weakness.

Disagreements may arise as to what constitutes a legally binding commitment. A bank's own descriptive terminology alone may not always be the best guideline. For example, a credit arrangement could be referred to as a revocable line of credit but, at the same time, it may be a legally binding commitment to lend—especially if consideration has been given by the customer for the bank's promise to lend and if the terms of the agreement between the parties result in a contract. Therefore, management of the bank should properly distinguish its legally binding loan commitments from its revocable loan commitments. Proper documentation will help ensure that the bank's position is defensible if legal action becomes necessary to cancel a loan commitment.

Some lending agreements contain a ''material adverse change'' (MAC) clause, which is intended to allow the bank to terminate the commitment or line of credit if the customer's financial condition deteriorates. This clause may apply to the continuing financial condition of guarantors. The extent to which MAC clauses are enforceable depends on several factors, including whether a legally binding relationship remains despite specific financial covenants that are violated. Some documents make only a vague reference to a borrower's responsibility for maintaining a satisfactory financial condition. Although the enforceability of MAC clauses may be subject to some uncertainty, such clauses may provide the bank with leverage in negotiations with the customer over such issues as requests for additional collateral and/or personal guarantees.

A bank cannot always routinely determine whether funding of a commitment or line of credit will be required; therefore, the examiner must always subject the line of credit to careful analysis. A MAC clause could allow the bank to refuse funding to a financially troubled borrower; a default in other contract covenants could cause the termination of the commitment or line of credit. Some banks might strictly enforce the terms of a credit arrangement and refuse funding if any of the covenants are broken. Other banks take a more accommodating approach and will continue to make advances unless the customer files for bankruptcy. In the final analysis, the procedures normally followed by the bank in honoring or terminating a contingent lending agreement are important in the examiner's overall evaluation of the credit risk.

Risk Management for Loan Commitments and Lines of Credit

The primary risk inherent in any future extension of credit is that the condition of the borrower may change between the issuing of the commitment and its funding. However, commitments may also entail liquidity and interest-rate risk.

Examiners should evaluate anticipated drawdowns of an issuing bank's loan commitments and lines of credit relative to the bank's anticipated funding sources. A draw under lines of credit may be in the form of a letter of credit issued on the borrower's behalf. Such letters of credit share the same collateral as the line of credit, and the issuance of the letter of credit uses availability under the line. At each examination, the draws that are anticipated for unused commitments and advised lines of credit should be estimated. If the amount of unfunded commitments is large relative to the bank's liquidity position, further analysis is suggested to determine whether borrowed funds will have to be used and, if so, the amount and sources of such funds. Concerns and comments should be noted on the Liquidity/Funds Management page in the report of examination. Also, loan commitments are to be reported on the commitments and contingencies schedule in the report of examination. For further information, refer to sections 4020, 4090, and 6000, "Asset/Liability Management," "Interest-Rate Risk Management," and "Instructions for the Report of Examination," in this manual.

LETTERS OF CREDIT

A letter of credit substitutes the credit capacity of a financial institution for that of an individual or a corporation. The concept of substituting one obligor's financial standing for another party's financial standing has been used in financing the international shipment of merchandise for centuries (imports and exports). Today, letters of credit are also used in a wide variety of other commercial financing transactions, such as guaranteeing obligations involving the private placement of securities and ensuring payment in the event of nonperformance of an obligated party. In addition, letters of credit are used to secure the guarantees of principals in real estate development loans. For additional information on letters of credit, see section 7080, "International—Letters of Credit," in this manual.

Elements of a Letter of Credit

A letter of credit should contain the following elements:

- a conspicuous statement that the document is a letter of credit
- a specified expiration date or a definite term and an amount
- an obligation of the issuer to pay that is solely dependent on the presentation of conforming documents as specified in the letter of credit and not on the factual performance or nonperformance by the parties to the underlying transaction
- an unqualified obligation of the account party to reimburse the issuer for payments made under the letter of credit

A letter of credit involves at least three parties and is three separate and distinct contracts:

- a contract between the account party and the beneficiary under which the account party has an obligation of payment or performance
- a contract between the account party and the issuer of the letter of credit (The issuer is the party obligated to pay when the terms of the letter of credit are satisfied. The account party agrees to reimburse the issuer for any payments made.)
- a contract between the issuer and the beneficiary, whereby the issuer agrees to pay the beneficiary in compliance with the terms and conditions of the letter

Policies and Procedures

Maintaining adequate written policies and procedures and monitoring letters of credit activities are part of the fiduciary and oversight responsibilities of the board of directors. Generally, policies and procedures governing the institution's issuance of letters of credit are contained in a section of the loan policy manual.

The letter of credit policy should thoroughly explain the institution's procedures in issuing both commercial letters of credit and standby letters of credit. The policy should outline desirable and undesirable issuances, designate persons authorized to issue letters of credit and their corresponding loan authority, and define the recordkeeping and documentation requirements including the need to establish separate files for each issuance.

If several lending departments issue letters of credit, the policy should explicitly assign responsibility for file maintenance and recordkeeping. A separate file containing an exact copy of each outstanding letter of credit and all the supporting documentation that the underwriter used in deciding to issue the letter should be included in the file. This documentation should be the same as the financial documentation used for originating any other form of credit, which includes current financial statements, current income statements, purpose of the letter of credit, collateral-security documentation, proof-of-lien position, borrowing authorization, all correspondence, and officers' memoranda.

Documentation

In addition, the file must contain the documentation associated with any disbursements or payments made. For a commercial letter of credit, these documents may include—

- the draft (sometimes called the bill of exchange), which is the demand for payment;
- the commercial invoice, a document describing the goods being shipped (prepared by the seller and signed by the buyer);
- the bill of lading, which documents that shipment of the goods has taken place and gives the issuer an interest in the goods in the event the account party defaults;
- customs documentation that verifies that all required duties have been paid;
- the insurance certificate, which provides evidence that the seller has procured insurance;
- the consular documents, which state that the shipment of goods satisfies the import/export regulations; and
- the certificates of origin and inspection, which state that the goods originated in a specified country to guard against the substitution of second-quality merchandise.

The documents associated with standby letters of credit are far less complicated than those for commercial letters of credit. Often no document is necessary to support the beneficiary's draw upon a standby letter of credit. This is what is referred to as a clean standby letter of credit and should be discouraged due to the possible legal expense of defending any action taken in honoring or dishonoring a draw without specific documentary requirements. At a minimum, standby letters of credit should require a beneficiary's certificate asserting that the account party has not performed according to the contract or has defaulted on the obligation, as well as a copy of the contract between the account party and beneficiary.

Accounting Issues

Since letters of credit represent a contingent liability to the issuing institution, they must be disclosed in the financial statements in accordance with generally accepted accounting principles (GAAP). The Financial Accounting Standards Board has stipulated in its Statement of Financial Accounting Standard No. 5 that the nature and the amount of a standby letter of credit must be disclosed in the institution's financial statement. Commercial letters of credit and standby letters of credit should be accounted for on the balance sheet as liabilities if it is probable that the bank will disburse funds, and if the amount of the funding is determinable. Most standby letters of credit will not be recorded as a liability. However, their existence will be disclosed in the footnotes to the financial statements.

Benefits of Letters of Credit

Both the customer and the financial institution can benefit from letters of credit. Through the use of a letter of credit, a customer can often obtain a less expensive source of funds than would be possible through direct financing from the institution. For example, the customer may be able to take advantage of a seller's credit terms with the backing of a letter of credit to substantiate the customer's credit capacity. The institution receives a fee for providing the service. In addition, the institution hopes to build a better working relationship with its customers, who may generate or refer other profitable business.

Revocable or Irrevocable

Letters of credit can be issued as either revocable or irrevocable. The revocable letter of credit is rarely used because it may be amended or canceled by the issuer without the consent of the other parties. Most letters of credit are issued as irrevocable with a stipulation that no changes may be made to the original terms without the full consent of all parties.

Risks in Issuing Letters of Credit

A financial institution must be aware of the credit risks that are associated with letters of credit and must issue letters of credit only when its resources are adequate. Although letters of credit are not originally made as loans, they may lead to loans if the account party cannot meet its obligations. Therefore, the institution must implement the same prudent underwriting guidelines for letters of credit as for other extensions of commercial credit. Refer to section 2080, "Commercial Loans," in this manual for further details.

The importance of adequate documentation cannot be overemphasized. Commercial letters of credit are part of a continuous flow of transactions evolving from letters of credit to sight drafts to acceptances. Repayment may depend on the eventual sale of the goods involved; however, the goods may not provide any collateral protection. Thus, proper handling and accuracy of the required documents are of primary concern. Letters of credit are frequently issued via tested telex, which verifies the authenticity of the sender (usually another bank). No institution should honor a letter of credit presented by a beneficiary without first confirming its authenticity.

Commercial letters of credit involving imports must be considered unsecured until the goods have passed customs, the security documents specified in the letter of credit have been presented, and the goods have been verified and controlled.

Letters of credit are subject to the risk of fraud perpetrated by customers, beneficiaries, or insiders of the issuing institution. Moreover, standby letters of credit can be used by officers or directors as a vehicle for obtaining credit at another institution. It is important to note that Regulation O requirements apply to standby letters of credit.

Consequently, letters of credit should be issued under the same strict internal controls as any other extension of credit. Such controls include a requirement of dual or multilevel authorizations and the segregation of the issuing, recordkeeping, acceptance, and payment functions.

Risks in Honoring Letters of Credit

The honoring of another institution's letter of credit or acceptance requires strict verification procedures as well as dual authorization by the honoring financial institution. Reasons for strict procedures and authorizations are numerous. The issuer may be unable or unwilling to honor a letter of credit or standby letter of credit, claiming that the document is fraudulent or a forgery or that the signer was unauthorized. Before honoring any other institution's letter of credit, a bank should confirm in writing that the letter of credit is valid and will be honored under specified conditions. Agreements with issuers for accepting letters of credit issued by tested telex should provide specific conditions under which they will be honored.

To minimize risks of loss, compliance with the conditions outlined within the letter of credit must be strict—not merely substantial. Testing of LOCs should involve two or more persons through dual authorization or segregation of duties to prevent fraud by employees in this process.

Uniform Commercial Code

Both the issuer and the beneficiary of letters of credit are obligated to conform to a uniform set of rules governed by article 5 of the Uniform Commercial Code (UCC). These rules are referenced in the Uniform Customs and Practice for Documentary Credits (UCP). The UCC is a set of articles governing commercial transactions adopted by various states, whereas the UCP encompasses all of the international guidelines for trading goods and services. Local laws and customs vary and must be followed under advice of counsel.

TYPES OF LETTERS OF CREDIT

There are two major types of letters of credit: the commercial letter of credit, also referred to as a trade letter of credit, and the standby letter of credit. Banks have significantly increased their issuances of letters of credit, particularly standby letters. A contributing factor to this significant increase is that by issuing letters of credit, an institution can increase its earnings without disbursing funds and increasing total assets. The institution charges a fee for the risk of default or nonperformance by the customer, thereby increasing the bank's return on average assets. It is important for examiners to be concerned with the elements of risk that are present in the institution's practices regarding the issuance of letters of credit. Examiners should then assess the institution's system of controls that can mitigate the risks (including staff experience, proper documentation, and the quality of underwriting). The standards for issuing letters of credit should be no less stringent than the standards for making a loan. Likewise, the letter-of-credit portfolio requires a review as thorough as the lending review. A default or nonperformance by the account party of a letter of credit will have the same impact as a default on a loan.

Commercial Letters of Credit

The commercial letter of credit (LOC) is commonly used as a means of financing the sale of goods between a buyer and seller. Generally, a seller will contract with a buyer on an open-account basis, whereby the seller ships the goods to the buyer and submits an invoice. To avoid the risk of nonpayment, the seller may require the buyer to provide a commercial letter of credit. To satisfy the requirement, the buyer applies for a letter of credit at a financial institution. If approved, the letter of credit would contain specified terms and conditions in favor of the seller (beneficiary), and the buyer (account party) would agree to reimburse the financial institution for payments drawn against the letter. The commercial letter of credit can be used to finance one shipment or multiple shipments of goods. Once documents that provide evidence that the goods have been shipped in accordance with the terms of the letter of credit are received, the seller can draw against the issued letter of credit through a documentary draft or a documentary demand for payment. The institution honors the draft, and the buyer incurs an obligation to reimburse the institution.

Letters of credit can be secured by cash deposits, a lien on the shipped goods or other inventory, accounts receivable, or other forms of collateral. Commercial letters of credit ''sold for cash'' (that is, secured by cash deposits) pose very little risk to a bank as long as the bank, before making payment on the draft, ensures that the beneficiary provides the proper documents. If credit is extended to pay for the goods, the subsequent loan presents the same credit risks associated with any other similar loan.

Standby Letters of Credit

The standby letter of credit (SBLOC) is an irrevocable commitment on the part of the issuing institution to make payment to a designated beneficiary if the institution's customer, the account party, defaults on an obligation. The SBLOC differs from the commercial letter of credit because it is not dependent on the movement of goods. While the commercial letter of credit eliminates the beneficiary's risk of nonpayment under the contract of sale, the SBLOC eliminates the financial risks resulting from nonperformance under a contract. The SBLOC, in effect, enhances the credit standing of the bank's customer.

SBLOCs may be financially oriented (financial SBLOCs), whereby an account party agrees to make payment to the beneficiary, or SBLOCs may be service-oriented (performance SBLOCs), whereby the financial institution guarantees to make payment if its customer fails to perform a nonfinancial contractual obligation.

Financial SBLOCs

Financial SBLOCs are often used to back direct financial obligations such as commercial paper, tax-exempt securities, or the margin requirements of exchanges. For example, if the bank's customer issues commercial paper supported by an SBLOC, and the bank's customer is unable to repay the commercial paper at maturity, the holder of the commercial paper may request the bank to make payment. Upon receipt of the request, the bank would repay the holders of the commercial paper and account for the payment as a loan to the customer under the letter of credit. Because of this irrevocable commitment, the bank has, in effect, directly substituted its credit for that of its customer upon the issuance of the SBLOC; consequently, the SBLOC has become a credit enhancement for the customer.

Performance SBLOCs

Performance SBLOCs are generally transaction-specific commitments that the issuer will make payment if the bank's customer fails to perform a nonfinancial contractual obligation, such as to ship a product or provide a service. Performance SBLOCs are often used to guarantee bid or performance bonds. Through a performance SBLOC, the bank provides a guaranty of funds to complete a project if the account party does not perform under the contract. In contrast to the financial SBLOC, the bank's irrevocable commitment provides liquidity to the obligor and not directly to a third-party beneficiary.

Unlike a commercial letter of credit, a demand for payment against an SBLOC is generally an indication that something is wrong. The nonperformance or default that triggers payment under the SBLOC often signals the financial weakness of the customer, whereas payment under a commercial letter of credit suggests that the account party is conducting its business as usual. Standby letters of credit can be either unsecured or secured by a deposit or other form of collateral.

Uses

The uses of standby letters of credit are practically unlimited. The more common areas of use include the following.

Financing Real Estate Development. A mortgagee will condition its loan commitment upon a cash contribution to a project by the developers. Although the lender insists that the developers have some equity in the project, the developer may not have funds available as they are tied up in other projects. The parties often use the letter of credit to satisfy the requirement for equity without the need for a cash deposit.

Fulfilling Municipal Regulations. Most municipalities require some form of a performance bond to ensure that infrastructure improvements, such as buildings, roads, and utility services, are completed. Because the bonding companies generally required a letter of credit as collateral for their bond, developers began offering the SBLOC to the municipality as a substitute. The SBLOC is probably more common than the performance bond. The SBLOC provides the municipality the guaranty of funds to complete necessary improvements if the developer does not perform as required.

Securing Notes. A lender will sometimes ask its obligor to secure the balance of a promissory note with an SBLOC issued by another bank.

Ensuring Performance. The standby letter of credit is similar to a performance bond. Often the seller of goods will have the borrower obtain a commercial letter of credit to ensure payment; simultaneously, the buyer will have the seller obtain a standby letter of credit to ensure that the goods are delivered when agreed and in acceptable condition.

Guaranteeing Securities. The standby letter of credit guarantees obligations involving the private placement of securities, such as revenue and development bonds. If an SBLOC secures against default, such paper will generally have a higher rating and bear a lower rate of interest. An SBLOC could also be used as a credit enhancer for packaging retail loans for public sale. The use of an SBLOC in this situation typically carries minimal overall risk because the packaging institution normally sets aside a contingent reserve for losses. However, if the reserve is inadequate, the SBLOC should be reviewed for possible classification.

SBLOCs Issued as Surety for Revenue Bonds

SBLOCs may be issued in conjunction with the development of a property that is financed with tax-free or general revenue bonds. In these transactions, a municipal agency—typically, a local housing authority or regional development authority—sells bonds to investors in order to finance the development of a specific project. Once the bonds are issued, the proceeds are placed with a trustee and then loaned at less than market rates to the developer of the project. The below-market-rate loan that is granted to the developer enables the municipal agency to encourage development without expending tax dollars. The municipal agency has no liability; the bond investors only have recourse against the specific project. If the bonds are exempt from federal taxation, they will generally carry a below-market interest rate. If the bonds are not tax free—and some municipal bonds are not tax free—they will carry a market rate of interest.

Because the bonds are secured only by the project, an SBLOC is typically obtained by the beneficiary (in this example, the municipal agency) from a financial institution to provide additional security to the bondholders. The SBLOC is usually for an amount greater than the face amount of the bonds, so the bondholders' accrued interest between interest payment dates is usually secured. The bank generally secures its SBLOC with a lien that is subordinate to the authority's or trustees' lien against the property and the personal guarantees of the principal. Underwriting standards and credit analysis for SBLOCs should mirror those employed for direct loans.

The trustee receives periodic payments from the developer and then pays the bondholders their periodic interest payments and also pays the financial institution its letter-of-credit fee. In the event of a default by the developer, the trustee will draw upon the SBLOC to repay the bondholders. If such a default occurs, the issuing financial institution assumes the role of the lender for the project.

The structure of the transaction requires the bank issuing the SBLOC to assume virtually all of the risk. Because the purpose of these bonds is to encourage development, financially marginal projects, which would not be feasible under conventional financing, are often financed in this manner. The primary underwriting consideration is the ability of the securing property to service the debt. The debt-service-coverage calculations should include both the tax-free rate, if applicable, obtained through the revenue bonds and market interest rates. The operations of the securing property should also be monitored on an ongoing basis. If new construction is involved, the progress should be monitored and any cost overruns should be identified and addressed.

Renewal of SBLOCs

Although most SBLOCs contain periodic renewal features, the examiner must be aware that the bank cannot relieve itself from liability simply by choosing not to renew the SBLOC. Virtually all of the bond issues require a notice of nonrenewal before the expiration of the SBLOC. If such notice is received by the trustee, the trustee normally considers the notice an event of default and draws against the existing SBLOC. The bank should protect itself, therefore, by continuously monitoring both the project and the status of the bonds. Documentation should be maintained in the bank's file to substantiate the property's occupancy, its cashflow position, and the status of the bonds. In addition to the current status of interest payments, any requirements for a sinking fund that are contained in the bond indenture should also be monitored.

Some letters of credit are automatically renewable unless the issuing bank gives the beneficiary prior notice (usually 30 days). These letters of credit represent some additional risk because of the notification requirement placed on the bank. As noted above, proper monitoring and timely follow-up are imperative to minimize risk.

Without the benefit of a substantial guarantor or equity in the collateral, these SBLOCs present more than normal risk of loss. If the SBLOC is converted into an extension of credit, the loan will likely be classified substandard or worse. Protection against loss may be provided by a long-term lease from a major tenant of an industrial property or a lease from a housing authority with a governmental funding commitment or guaranty.

Classification of SBLOCs

It may be appropriate to adversely classify an SBLOC if draws under the SBLOC are probable and a well-defined credit weakness exists. For example, deterioration of the financial standing of the account party could jeopardize performance under the letter of credit and result in the requirement of payment to the beneficiary. Such a payment would result in a loan to the account party and could result in a collection problem, especially if the SBLOC was unsecured. If payment is probable and the account party does not have the ability to repay the institution, an adverse classification is warranted. FASB 5 requires that if a loss contingency is probable and can be reasonably estimated, a charge to income must be accrued. Refer to section 2060, "Classification of Credits," in this manual for procedures on SBLOC classification.

BANKER'S ACCEPTANCES

When the beneficiary presents a draft to the issuer in compliance with the terms of a commercial letter of credit, the method of honoring the draft is acceptance. The issuer will stamp the word "accepted" across the face of the draft, which makes the instrument negotiable. Thus, the institution upon which the draft is drawn converts what was originally an order to pay into an unconditional promise to pay. Depending on the terms specified in the letter of credit, payment of the draft can vary from sight to 180 days. There is a ready market for these instruments, because payment must be made at maturity by the accepting institution, whether or not it is reimbursed by its customer. These acceptances are readily negotiable, and a beneficiary may sell accepted time drafts to other financial institutions at a discount. Acceptances are governed by article 3 of the UCC, and any rights the parties have under acceptance are subject to the rules of that article. For further discussion of banker's acceptances, see section 7060, "International—Banker's Acceptances,'' and the Instructions for the Preparation of the Report of Condition and Income.

Participations in Banker's Acceptances

The following discussion refers to the roles of accepting and endorsing banks in banker's acceptances. It does not apply to banks purchasing other banks' acceptances for investment purposes. Banker's acceptances may represent either a direct or contingent liability of the bank. If the acceptance is created by the bank, it constitutes a direct liability that must be paid on a specified future date. The acceptance is also an on-balance-sheet, recognized liability. If a bank participates in the funding risk of an acceptance created by another bank, the liability is contingent and the item is carried off-balance-sheet. The financial strength and repayment ability of the accepting bank should be considered in analyzing the amount of risk associated with these contingent liabilities.

Participations in acceptances conveyed to others by the accepting bank include transactions that provide for the other party to the participation to pay the amount of its participated share to the accepting bank at the maturity of the acceptance, whether or not the account party defaults. Participations in acceptances acquired by the nonaccepting bank include transactions that provide for the nonaccepting bank to pay the amount of its participated share to the accepting bank at the maturity of the acceptance, whether or not the account party defaults.

Call Report Treatment

For regulatory reporting purposes, the existence of such participations is not to be recorded on the balance sheet. Rather, both the accepting bank conveying the participation to others and the bank acquiring the participation from the accepting bank must report the amounts of such participations in the appropriate item in Schedule RC-L, Commitments and Contingencies. (The amount of participations in acceptances reported in Schedule RC-L by a member bank may differ from the amount of such participations that enter into the calculation of the bank's acceptances to be counted toward its acceptance limit imposed by section 13 of the Federal Reserve Act (12 USC 372). These differences are mainly attributable to participations in ineligible acceptances, to participations with ''uncovered'' institutions, and to participations that do not conform to the minimum requirements set forth in 12 CFR 250.163.)

NOTE-ISSUANCE AND REVOLVING UNDERWRITING CREDIT FACILITIES

The first note-issuance facility (NIF) was introduced in 1981. A NIF is a medium-term (five- to seven-year) arrangement under which a borrower can issue short-term paper. The paper is issued on a revolving basis, with maturities ranging from as low as seven days to up to one year. Underwriters are committed either to purchasing any unsold notes or to providing standby credit. Bank borrowing usually involves commercial paper consisting of short-term certificates of deposit and, for nonbank borrowers, generally promissory notes (Euronotes). Although NIF is the most common term used for this type of arrangement, other terms include the revolving underwriting facility (RUF) and the standby note-issuance facility (SNIF).

Another type of facility, a RUF, was introduced in 1982. A RUF is a medium-term revolving commitment to guarantee the overseas sale of short-term negotiable promissory notes (usually a fixed-spread over LIBOR) issued by the borrower at or below a predetermined interest rate. RUFs separate the roles of the medium-term risk-taker from the funding institutions (the short-term investors). RUFs and NIFs allow access to capital sources at interest rates considerably below conventional financing rates. The savings in interest cost are derived because the borrower obtains the lower interest costs prevailing in the short-term markets, while still retaining the security of longer term financing commitments. The notes issued under RUFs are attractive for institutional investors since they permit greater diversification of risk than the certificates of deposit of only one bank. Underwriters favor them because their commitments do not appear on the statement of financial condition. RUFs are usually structured for periods of four to seven years.

A RUF differs from a NIF in that it separates the functions of underwriting and distribution. With a RUF, the lead bank (manager or arranger) acts as the only placing agent. The arranger retains total control over the placing of the notes.

NIFs and RUFs are discussed further in the *Bank Holding Company Supervision Manual.*

GUARANTEES ISSUED

State member banks and foreign branches of U.S. banks are allowed to issue guarantees or sureties under certain circumstances. Such guarantees are to be reported as contingent liabilities in Schedule RC-L. Refer to section 7090, ''International—Guarantees Issued,'' of this manual and to the call report instructions for further information.

ASSET SALES

The term ''asset sales,'' in the following context, encompasses the range of activities from the sale of whole loans to the sale of securities representing interests in pools of loans. Asset-sales programs entail establishing both a portfolio of assets that are structured to be easily salable and a distribution network to sell the assets. Most large banks have expended great effort in developing structures and standard procedures to streamline asset-sale transactions and continue to do so.

Asset sales, if done properly, can have a legitimate role in a bank's overall asset and liability management, and can contribute to the efficient functioning of the financial system. In addition, these activities can assist a bank in diversifying its risks and improving its liquidity.

The benefits of a qualifying sale transaction are numerous. In particular, the sale of a loan reduces capital requirements. The treatment also enhances net income, assuming that the loan was sold for a profit.

Banks' involvement in commercial loan sales and in public issuance of mortgage and asset-backed securities has grown tremendously over the last decade. Banks are important both as buyers and sellers of whole loans, loan participations, and asset-backed securities. Banks also play important roles in servicing consumer receivables and mortgages backing securities and in providing credit enhancement to originators of primarily asset-backed securities.

Both whole loans and portions of loans are sold. Banks sell portions of loans through participation arrangements and syndication agreements.

Participations

A loan participation is a sharing or selling of ownership interests in a loan between two or more financial institutions. Normally, a lead bank originates the loan and sells ownership interests to one or more participating banks at the time the loan is closed. The lead bank (originating bank) normally retains a partial interest in the loan, holds all loan documentation in its own name, services the loan, and deals directly with the customer for the benefit of all participants. Properly structured, loan participations allow selling banks to accommodate large loan requests that would otherwise exceed lending limits, to diversify risk, and to improve liquidity by obtaining additional loanable funds. Participating banks are able to compensate for low local demand for loans or invest in large loans without their servicing burdens and origination costs. If not appropriately structured and documented, however, a loan participation can present unwarranted risks to both the seller and purchaser of the loan. Examiners should determine the nature and adequacy of the participation arrangement and should analyze the credit quality of the loan. For further information on participations, refer to section 2040, ''Loan Portfolio Management,'' in this manual.

Syndication

A syndication is an arrangement in which two or more banks lend directly to the same borrower pursuant to one loan agreement. Each bank in the syndicate is a party to the loan agreement and receives a note from the borrower evidencing the borrower's debt to that bank. Each participant in the syndicate, including the lead bank, records its own share of the participated loan. Consequently, the recourse issues and contingent liabilities encountered in a loan participation involving syndication are not normally an issue. However, many banks involved in syndicated transactions will sell some of their allotment of the facility through subparticipations. These subparticipations should be reviewed in the same manner as any other participation arrangement.

Asset Securitization

Banks have long been involved with asset-backed securities, both as investors in these securities and as sellers of assets within the context of the securitization process. In recent years, banks have increased their participation in the long-established market for those securities that are backed by residential mortgage loans. They have also expanded their securitizing activities to other types of assets, including credit card receivables, automobile loans, boat loans, commercial real estate loans, student loans, nonperforming loans, and lease receivables. See section 4030, ''Asset Securitization,'' for a detailed discussion of the securitization process.

Risks

Assets sold without recourse are generally not a contingent liability, and the bank should reflect on its books only that portion of the assets it has retained. In some instances, however, participations must be repurchased to facilitate ultimate collection. For example, a bank may sell the portion of a loan that is guaranteed by the Small Business Administration (SBA) and retain the unguaranteed portion and the responsibility for servicing the loan. In the event of a default, the holder of the guaranteed portion has the option to request the originating bank to repurchase its portion before presenting the loan to the SBA for ultimate disposition and collection. In addition, some banks may repurchase assets and absorb any loss even when no legal responsibility exists. It is necessary to determine management's practice in order to evaluate the degree of risk involved. If management routinely repurchases assets that were sold without recourse, a contingency liability should be recognized. The amount of the liability should be based on historical data.

Contingent liabilities may also result if the bank, as the seller of a loan without recourse, does not comply with provisions of the agreement. Noncompliance may result from a number of factors, including failure on the part of the selling institution to receive collateral and/or security agreements, obtain required guarantees, or notify the purchasing party of default or adverse financial performance by the borrower. The purchaser of a loan may also assert claims that the financial information, which the purchaser relied on when acquiring the loan, was inaccurate, misleading, or fraudulent and that the selling bank was aware of the deficiencies. Therefore, a certain degree of risk may in fact be evident in assets allegedly sold without recourse. Examiners need to be mindful of this possibility and its possible financial consequences on the bank under examination.

Banks also face credit, liquidity, and interest-rate risk in the period in which they accumulate the assets for sale. Especially in mortgage banking activities, the need to carefully monitor interest-rate risk in the ''pipeline'' represents one of the significant risks of the business. Sellers of participations also face counterparty risk similar to that of a funding desk, because the loan-sales operation depends on the ongoing willingness of purchasers to roll over existing participations and to buy new ones. In addition, many banks sell loans in the secondary market but retain the responsibility for servicing the loans.

Accounting Issues

For regulatory reporting purposes, some transactions involving the ''sale'' of assets must be reported as financing transactions (that is, as borrowings secured by the assets ''sold''), and others must be reported as sales of the assets involved. The treatment required for any particular transfer of assets depends on whether the ''seller'' retains risk in connection with the transfer of the assets. In general, to report the transfer of assets as a sale, the selling institution must retain no risk of loss or obligation for payment of principal or interest.

All recourse arrangements should be documented in writing. If a loan is sold with recourse back to the seller, the selling bank has, in effect, retained the full credit risk of the loan, and its lending limit to the borrower is not reduced by the amount sold. Loans sold with recourse are to be treated as borrowings of the selling bank from the purchasing bank. Examiners should consider asset sales subject to formal or informal repurchase agreements (or understandings) to be sales ‘‘with recourse’’ regardless of other wording in the agreement to the contrary.

In determining the true recourse nature of an asset sale, examiners must determine the extent to which the credit risk has been transferred from the seller to the purchaser. In general, if the risk of loss or obligation for payments of principal or interest is retained by, or may ultimately fall back upon, the seller or lead bank, the transaction must be reported by the seller as a borrowing from the purchaser and by the purchaser as a loan to the seller. Complete details on the treatment of asset sales for purposes of the report of condition and income are found in the glossary of the Instructions for the Preparation of the Report of Condition and Income under the entry ‘‘sales of assets.’’

OTHER OFF-BALANCE-SHEET ACTIVITIES AND CONTINGENT LIABILITIES

Banks often provide a large number of customer services, which normally do not result in transactions subject to entry on the general ledger. These customer services include safekeeping, the rental of safe deposit boxes, the purchase and sale of investments for customers, the sale of traveler’s checks, the sale of U.S. Savings Bonds, collection services, federal funds sold as agent, operating leases, and correspondent bank services. It is the bank’s responsibility to ensure that collateral and other nonledger items are properly recorded and protected by effective custodial controls. Proper insurance must also be obtained to protect against claims arising from mishandling, negligence, mysterious disappearance, or other unforeseen occurrences. Failure to take these protective steps may lead to contingent liabilities. In addition, pending litigation in which the bank is a defendant could expose the bank to substantial risk of loss. Refer to section 4000, ‘‘Other Examination Areas,’’ in this manual for further information.

Banks often enter into operating leases as lessees of buildings and equipment. The arrangements should be governed by a written lease. For a material lease, the examiner must determine whether the lease is truly an operating lease or if it is a capitalized lease pursuant to FASB 13. Capitalized leases and associated obligations must be recorded on the books of the bank in accordance with FASB 13 and the instructions for the preparation of the Report of Condition and Income. Refer to the instructions for the call report and to section 2190, ‘‘Bank Premises and Equipment,’’ in this manual for further information about capitalized leases.

While operating leases do not affect the bank’s capital ratios, the costs of an operating lease may have a material effect upon the earnings of the bank. Moreover, operating leases may involve other responsibilities for the bank, and the bank’s failure to perform these responsibilities may ultimately result in litigation and loss to the bank. The examiner must be cognizant of the requirements imposed on the bank by its leasing arrangements.

Some banks purchase federal funds from smaller correspondent banks as agent. This off-balance-sheet activity is more fully discussed in section 2030, ‘‘Bank Dealer Activities,’’ in this manual.

1. To determine if policies, practices, procedures, and internal controls regarding contingent claims from off-balance-sheet credit activities are adequate.
2. To determine if bank officers are operating in conformance with the established guidelines.
3. To evaluate the off-balance-sheet credit activities for credit quality and collectibility.
4. To determine the scope and adequacy of the audit function.
5. To determine compliance with applicable laws and
6. To initiate corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws or regulations have been noted.

INTRODUCTION

To meet competitive pressures, banks provide a large number of customer services that normally do not result in assets and liabilities subject to entry on the general ledger, but that may involve significant risk. These customer services include fiduciary accounts, investment management, customer safekeeping, rental of safe deposit box facilities, purchase and sale of investments for customers, sale of traveler's checks, and collection department services. The bank is responsible for properly maintaining and safeguarding all consigned items. Banks accomplish the necessary control and review of consigned and collection items through non-ledger control or memorandum accounts. Automated systems, such as a Securities Movements Accounting and Control system (SMAC), can provide proper control for fiduciary, customer safekeeping, custodial, and investment management accounts.

CUSTOMER SAFEKEEPING

Custodial and Investment Management Accounts

Banks may act as custodians for customers' investments such as stocks, bonds, or gold. Custodial responsibilities may involve simple physical storage of the investments, as well as recording sales, purchases, dividends, and interest.[1] On the other hand, responsibilities may be expanded to include actually managing the account. This type of account management includes advising customers when to sell or buy certain investments, as well as meeting their recording requirements. In addition, the bank may lend securities from custodial accounts if authorized by the customer. This transaction allows the bank, as custodian, to charge a fee for lending the securities, thereby reducing its net custody costs. Also, both the bank and the custodial account benefit from interest earned on the transaction. This type of transaction should be governed by a policy that clearly specifies quality and maturity parameters. Additionally, to prevent defaults, borrowers should be subject to minimum credit standards, ongoing financial monitoring, and aggregate borrowing limits. Banks may also indemnify customer accounts against losses from a borrower or collateral default. Such indemnification creates a contingent financial risk to the institution.

Before providing such management and/or lending services, the bank should seek the advice of legal counsel about applicable state and federal laws concerning that type of bank-customer relationship. In addition, the use of signed agreements or contracts that clearly define the services to be performed by the bank is a vitally important first step in limiting the bank's potential liability and risk. The bank must also ensure that a proper control environment, including joint custody and access procedures, is established and maintained in support of custodial and management activities. Clearly, the largest and most active companies take on an increased level of risk. For companies that are aggressively pursuing custodial services or other nontraditional lines of business, the examiner should consider an expanded scope of review for these activities.

Safe Deposit Boxes

When banks maintain safe deposit box facilities, the bank and the customer enter into a contract whereby the bank receives a fee for renting safe deposit boxes. The bank assumes the responsibility of exercising reasonable care and precaution against loss of the box's contents. When a loss does occur, unless the bank can demonstrate it has maintained the required standard of care, it could be held liable for the loss. The required standard of care is defined as that which would be taken by a reasonably prudent and careful person engaged in the same business. Two different keys are required to open the box, and the customer and the bank each have one. Careful verification of a customer's identification is critical to meeting an appropriate standard of care. The customer is not required to disclose the contents of the box to the bank and

1. Collection of interest and dividend income cannot be facilitated by the bank where the securities held are still in the customer's name, unless the paying agent is advised to change the dividend/interest address. Typically, when securities remain in the registered name of the holder, the holder continues to receive the dividend/interest payments. If the securities are re-registered into the name of the bank (or its nominee), then dividends and interest are received by the bank for the credit of the custodial customer.

upon court order the bank may gain access to the box without the presence of the customer.

Safekeeping

In addition to items held as collateral for loans, banks occasionally hold customers' valuables for short periods of time. The bank may or may not charge a fee for the service. Although it is a convenience for bank customers, many banks attempt to discourage the practice by emphasizing the benefits of a safe deposit box. When it is not possible or practical to discourage a customer, the same procedures that are employed in handling collateral must be followed. Items to be stored should be inventoried by two persons and maintained under dual control in the bank's vault. A multicopy, prenumbered, safekeeping receipt should be prepared with a detailed description of the items accepted and it should be signed by the customer. Sealed packages with contents unknown to the bank should never be accepted for safekeeping.

COLLECTION ITEMS

The collection department is one of the most diversified areas in the bank. It engages in receiving, collecting, and liquidating items which generally require special handling and for which credit normally is given only after final payment is received. The bank acts as agent for its customers or correspondents and receives a fee for that service. Even though general ledger accounts rarely are used in the collection process, the importance and value of customer assets under bank control demand the use of accounting procedures adequate to provide a step-by-step historical summary of each item processed. An audit trail must be developed to substantiate the proper handling of all items and to reduce the bank's potential liability.

CONSIGNED ITEMS

The most common items held on consignment by banks are unissued traveler's checks and gold. Traveler's checks have gained widespread popularity because of the possibility that customers can obtain a refund if the checks are lost or stolen. Traveler's checks are issued for a fee or commission shared by the consignor and the issuing bank. Generally, a working supply of the checks is maintained at the teller line or selling station and a reserve supply is maintained under dual control in the bank's vault.

Under paragraph 7 of section 5136 of the Revised Statutes, national banks may exercise their powers "by buying and selling exchange, coin and bullion." This statute is applied to state member banks under section 9, paragraph 20, of the Federal Reserve Act. Consequently, banks may deal only in gold or silver that qualifies as coin or bullion. The term "coin" means coins minted by a government or exact restrikes, minted at a later date by, or under the authority of, the issuing government. The restrictions contained in the Glass-Steagall Act, which prohibit investment in or underwriting of securities, also are applicable to securities of companies involved with gold.

Rarely does a bank receive sufficient revenues from the above transactions to cover the cost of handling them. However, banks must offer a full range of services to be competitive and attract customers. The bank assumes the responsibility and related contingent liability to properly maintain the assets of others and to properly record all transactions involved with the consigned items.

INTERNAL CONTROL CONSIDERATIONS

It is essential that bank policy provides for proper internal controls, operating procedures, and safeguards. In all cases, control totals must be generated and the function balanced periodically by someone not associated with the function. Proper insurance protection must also be obtained to protect against claims arising from mishandling, negligence, mysterious disappearance, or other unforeseen occurrences. If an employee should, by fraud or negligence, permit unauthorized removal of items held for safekeeping or issue traveler's checks improperly, the bank may be held liable for losses. Therefore, banks should maintain adequate bonding for contingent liabilities and the examiner should review applicable insurance policies.

Other Non-Ledger Control Accounts
Examination Objectives
Effective date May 1996

1. To determine if the policies, practices, procedures, and internal controls regarding custodial activities, consigned items, and other non-ledger control accounts are adequate.
2. To determine if bank officers and employees are operating in conformance with the established guidelines.
3. To determine the scope and adequacy of the audit function.
4. To determine compliance with laws and regulations.
5. To initiate corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws or regulations have been noted.

1. If selected for implementation, complete or update the Consigned Items and Other Non-Ledger Control Accounts section of the Internal Control Questionnaire.
2. Based on the evaluation of internal controls and the work performed by internal/external auditors, determine the scope of the examination.
3. Test for compliance with policies, practices, procedures and internal controls in conjunction with performing the remaining examination procedures. Obtain a listing of any deficiencies noted in the latest review done by internal/external auditors from the examiner assigned ‘‘Internal Control’’ and determine if appropriate corrections have been made.
4. Obtain a listing of consigned items and other non-ledger control accounts from the bank.
5. Scan any existing control accounts for any significant fluctuations and determine the cause of fluctuations.
6. Compare bank control records to remittance records for unissued U.S. savings bonds and food stamps.
7. Determine compliance with laws and regulations pertaining to non-ledger control accounts by determining, through observation and discussion with management, that there exist no violation of the prohibition against a bank participating in lotteries (section 9A of the Federal Reserve Act (12 USC 25A)).
8. Prepare in appropriate report form, and discuss with appropriate officer(s):
   a. Violations of laws and regulations.
   b. Recommended corrective action when policies, practices or procedures are deficient.
9. Update the workpapers with any information that will facilitate future examinations.

Review the bank's internal controls, policies, practices and procedures for consigned items and other non-ledger items. The bank's system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used, and other pertinent information. Items marked with an asterisk require substantiation by observation or testing.

SAFE DEPOSIT BOXES

1. Has counsel reviewed and approved the lease contract in use which covers the rental, use and termination of safe deposit boxes?
*2. Is a signed lease contract on file for each safe deposit box in use?
3. Are receipts for keys to the safe deposit box obtained?
4. Are officers or employees of the bank prohibited from acting as a deputy or having the right of access to safe deposit boxes except their own or one rented in the name of a member of their family?
5. Is the guard key to safe deposit boxes maintained under absolute bank control?
6. Does the bank refuse to hold, for renters, any safe deposit box keys?
7. Is each admittance slip signed in the presence of the safe deposit clerk and the time and date of entry noted?
8. Are admittance slips filed numerically?
9. Are vault records noted for joint tenancies and co-rental contracts requiring the presence of two or more persons at each access?
10. Are the safe deposit boxes locked closed when permitting access and the renter's key removed and returned to the customer?
11. Is the safe deposit clerk prohibited from assisting the customer in looking through the contents of a box?
12. Does the safe deposit clerk witness the relocking of the box?
13. Are all coupon booths examined by an attendant after being used but before being assigned to another renter, to be sure the previous person did not leave behind anything of value?
14. Has a standard fee schedule for this service been adopted?
15. Are all collections of rental income recorded when received?
16. Are all safe deposit boxes where lessee is delinquent in rent, flagged or otherwise marked so that access will be withheld until rent is paid?
17. Is there a file maintained of all attachments, notices of bankruptcy, letters of guardianship and letters testamentary served on the bank?
18. Is an acknowledgment of receipt of all property, and a release of liability signed upon termination of occupancy?
19. Are locks changed when boxes are surrendered, whether or not keys are lost?
20. Is drilling of boxes witnessed by two individuals?
21. Are the contents of drilled boxes inventoried, packaged, and placed under dual control?
*22. Are all extra locks and keys maintained under dual control?

Conclusion

23. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
24. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

ITEMS IN SAFEKEEPING

*25. Are such items segregated from bank-owned assets and maintained under dual control?
26. Is there a set charge or schedule of charges for this service?

27. Do bank policies prohibit holding items in safekeeping free of charge?
28. Are duplicate receipts issued to customers for items deposited in safekeeping?
29. Are the receipts prenumbered?
*30. Is a safekeeping register maintained to show details of all items for each customer?
*31. Is a record maintained of all entries to custodial boxes or vaults?
32. Does the bank refuse to accept sealed packages when the contents are unknown?
33. If the bank has accepted sealed packages for safekeeping, the contents of which are not described, has the approval of the bank's counsel been obtained?
34. When safekeeping items are released, are receipts obtained from the customer?

Conclusion

35. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
36. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

CUSTODIAN ACCOUNTS

(Omit this section if the bank's trust department handles such accounts).

*37. Does the bank have written contracts on hand for each account that clearly define the functions to be performed by the bank?
38. Has bank counsel reviewed and approved the type and content of the contracts being used?
39. Does the bank give customers duplicate receipts with detailed descriptions, including dates of coupons attached, if applicable, for all items accepted?
40. Are those receipts prenumbered?
41. Do bank procedures prohibit its holding any investments not covered by a sale or purchase order in this department?
42. Are all orders for the purchase and sale of investments properly authorized in the account contract or signed by customers?
43. For coupon securities held by the bank:
    a. Is a tickler file or other similar system used to ensure prompt coupon redemption on accounts where the bank has been authorized to perform that service?
    b. Are procedures in effect to prevent clipping of coupons where bank is not so authorized?
    c. Have procedures been adopted to insure prompt customer credit when coupon proceeds or other payments are received?
*44. Are all investment items handled in this area maintained under dual control?
45. Have procedures been established for withdrawal and transmittal of items to customers?
*46. Does an officer review and approve all withdrawals prior to the transaction?
47. Has a standard fee schedule for this service been adopted?

Conclusion

48. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
49. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

COLLECTION ITEMS

50. Is access to the collection area controlled (if so, indicate how)?
*51. Are permanent registers kept for incoming and outgoing collection items?
52. Are all collections indexed in the collection register?
53. Do such registers furnish a complete history of the origin and final disposition of each collection item?

54. Are receipts issued to customers for all items received for collection?
55. Are serial numbers or prenumbered forms assigned to each collection item and all related papers?
*56. Are all incoming tracers and inquiries handled by an officer or employee not connected with the processing of collection items?
57. Is a record kept to show the various collection items which have been paid and credited as a part of the day's business?
58. Is an itemized daily summary made of all collection fees, showing collection numbers and amounts?
59. Are employees handling collection items periodically rotated, without advance notification, to other banking duties?
*60. Is the employee handling collection items required to make settlement with the customer on the same business day that payment of the item is received?
61. Does the bank have an established policy of not allowing the customer credit until final payment is received?
*62. Have procedures been established, including supervision by an officer, for sending tracers and inquiries on unpaid collection items in the hands of correspondents?
63. In the event of nonpayment of a collection item, is the customer notified and the item promptly returned?
*64. Are the files of notes entered for collection clearly and distinctly segregated from bank-owned loans and discounts?
*65. Are collection notes above maintained under memorandum control and is the control balanced regularly?
66. Are collection files locked when the employee handling such items is absent?
67. Are vault storage facilities provided for collection items carried over to the next day's business?
*68. Does the collection teller turn over all cash to the paying teller at the close of business each day and start each day with a standard change fund?
69. Has a standard fee schedule for this service been adopted?
70. Is the fee schedule always followed?
71. Is a permanent record maintained for registered mailed?

Conclusion

72. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
73. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

CONSIGNED ITEMS

*74. Is the reserve stock of consigned items maintained under dual control?
75. Are working supplies kept to a reasonable minimum, i.e., two or three days' supply, and adequately protected during banking hours?
*76. Is a memorandum control maintained of consigned items?
77. Are separate accounts with the consignor maintained at each issuing location (branch), if applicable?
*78. Is the working supply put in the vault at night and over weekends or holidays or is it otherwise protected?
79. Are remittances for sales made on a regularly scheduled basis, if not daily?

Conclusion

80. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
81. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

Modern economies require an efficient system for transferring funds between financial institutions and between financial institutions and their customers. Banks and other depository institutions use payment systems both to transfer funds related to their own operations—for example, when engaging in federal-funds transactions—and to transfer funds on behalf of their customers. Depository institutions and the Federal Reserve together provide the basic infrastructure for the nation's payment system.

Commercial banks maintain accounts with each other and with the Federal Reserve Banks; through these accounts, the payments of the general public are recorded and ultimately settled. The demand for electronic funds transfer (EFT) services has increased with improved data communication and computer technology. Community banks that previously executed EFT transactions through a correspondent can now initiate their own same-day settlement transactions nationwide. The need for same-day settlement transactions has precipitated financial institutions' increased reliance on EFT systems. Financial institutions commonly use their EFT operations to make and receive payments, buy and sell securities, and transmit payment instructions to correspondent banks worldwide. In the United States, most of the dollar value of all funds transfers is concentrated in two electronic payment systems: Fedwire, which is a Federal Reserve service, and the Clearing House Interbank Payments System (CHIPS), which is a private-sector multilateral settlement system owned and operated by CHIPCo LLC, a subsidiary of the New York Clearing House Association.

Final settlement occurs when payment obligations between payment-system participants are extinguished with unconditional and irrevocable funds. For transactions settled in physical currency, payment and settlement finality occur simultaneously. On occasion, settlement finality may not occur on the same day a payment is made. Without immediate settlement finality, the recipient of a payment faces the uncertainty of not receiving the value of funds that has been promised. The exposure to this uncertainty is generally referred to as payment system risk (PSR).

Payment system risk refers to the risk of financial loss to the participants in and operators of payment systems due to a variety of exposures, such as counterparty or customer default, operational problems, fraud, or legal uncertainty about the finality of settled payments. A major source of payment system risk arises when participants in or the operator of a payment system extends unsecured, intraday credit to facilitate the smooth and efficient flow of payments. For example, the aggregate value of intraday credit extended by the Federal Reserve, in the form of daylight overdrafts in institutions' Federal Reserve accounts, is substantial and creates significant credit exposure for the Federal Reserve Banks.

A daylight overdraft occurs whenever an institution has a negative account balance during the business day. Such a credit exposure can occur in an account that an institution maintains with a Federal Reserve Bank or with a private-sector financial institution. At a Reserve Bank, a daylight overdraft occurs when an institution has insufficient funds in its Federal Reserve account to cover Fedwire funds transfers, incoming book-entry securities transfers, or other payment activity processed by the Reserve Bank, such as automated clearinghouse or check-clearing transactions. Similarly, banks are exposed to credit risk when they permit their customers to incur daylight overdrafts in their accounts. More specific information about the types of risks involved under the rubric of payment systems risk is discussed later in this section.

When developing an institution's overview, performing annual and quarterly risk assessments, and conducting the institution's examination, examiners should review an instsitution's payment system risk and EFT practices. Supervisory and examination guidance and procedures should be followed to determine the risk assessment, matrix, supervisory plan, and scope of an examination. This guidance should also be used when conducting the examination. An overall initial analysis of an institution's payment system risk practices can provide examiners with quick insight on the adequacy of its current internal controls and risk-management practices, and on whether the institution's payment activity creates intraday exposures that may pose significant risk if not managed properly.

In general, examiners should review the frequency, magnitude, and trend of daylight overdrafts in an institution's Federal Reserve account, as well as any breaches of its net debit cap.

Examiners should analyze the reasons for the daylight overdrafts and cap breaches; the nature of the transactions causing the overdrafts (for example, correspondent check clearings or funds transfers); whether the number of customers, correspondents, and respondents is concentrated among only a few entities; and whether there is a clear pattern of transactions and the types of activities involved. In addition, examiners should review and determine the adequacy of the board-of-directors resolution authorizing the institution's net debit cap and use of Federal Reserve intraday credit (as required by the PSR policy). The examiners' most important goal is to ensure that banks have and use appropriate risk-management policies and procedures that effectively monitor and control their exposure to payment system risk.

TYPES OF PAYMENT SYSTEMS

An understanding of the mechanics of the various payment systems is necessary to evaluate the operational procedures depository institutions use to control payment-processing risks for their own or their customers' accounts.

EFT Systems

Fedwire

The Fedwire funds-transfer system is a real-time gross settlement system in which depository institutions initiate funds transfers that are immediate, final, and irrevocable when processed. Depository institutions that maintain a reserve or clearing account with a Federal Reserve Bank may use Fedwire to send payments to or receive payments from other account holders directly. Depository institutions use Fedwire to handle large-value, time-critical payments, such as payments for the settlement of interbank purchases and sales of federal funds; the purchase, sale, and financing of securities transactions; the disbursement or repayment of loans; and the settlement of real estate transactions.

In the Fedwire funds-transfer system, only the originating financial institution can remove funds from its Federal Reserve account. Originators provide payment instructions to the Federal Reserve either on-line or off-line. On-line participants send instructions through a mainframe or PC connection to Fedwire, and no manual processing by the Federal Reserve Banks is necessary. Off-line participants give instructions to the Reserve Banks by telephone. Once the telephone request is authenticated, the Reserve Bank enters the transfer instruction into the Fedwire system for execution. The manual processing required for off-line requests makes them more costly; thus, they are suitable only for institutions with small, infrequent transfers. (For further information, see http://www.federalreserve.gov/paymentsystems/fedwire.)

CHIPS

The Clearing House Interbank Payments System (CHIPS) is a large-value funds-transfer system for U.S. dollar payments between domestic or foreign banks that have offices located in the United States. CHIPS is a real-time final settlement system that continuously matches, nets, and settles queued payment orders.

All CHIPS payment orders are settled against positive balances, simultaneously offset by incoming payment orders, or some combination of both. To facilitate this process, CHIPCo maintains an account on the books of the Federal Reserve Bank of New York. Each CHIPS participant has a pre-established opening-position requirement, which, once funded by a Fedwire funds transfer, is used to settle payment orders throughout the day.

During the operating day, participants submit payment orders to a centralized queue maintained by CHIPS. Payment orders that do not pass certain settlement conditions are held in the central queue until an opportunity for settlement occurs or until the end-of-day settlement process. The sending and receiving participants are not obligated to settle these queued payment orders.

Each afternoon, each participant with a closing-position requirement must transfer, through Fedwire, its requirement to the CHIPS account at the Federal Reserve Bank of New York.[1] These requirements, when delivered, are credited to participants' balances. After comple-

1. Although CHIPS no longer makes distinctions between settling and nonsettling participants, CHIPS participants can use nostro banks to make transfers on their behalf.

tion of this process, CHIPS will transfer to those participants who have any balances remaining, that is, participants in an overall net positive position for the day, the full amount of those positions. (For further information, see the CHIPS rules at http://www.chips.org.)

Manual Systems

Not all financial institutions employ an EFT system. Some banks execute such a small number of EFT transactions that the cost of a computer-based system such as Fedwire is prohibitive. Instead, these banks will continue to execute EFTs by a telephone call to a correspondent bank. Executing EFT transactions in this way is an acceptable practice as long as the bank has adequate internal-control procedures.

Message Systems

The message systems employed by financial institutions, corporations, or other organizations to originate payment orders—either for their own benefit or for payment to a third party—are indispensable components of funds-transfer activities. Unlike payment systems, which transmit actual debit and credit entries, message systems process administrative messages and instructions to move funds. The actual movement of the funds is then accomplished by initiating the actual entries to debit the originating customer's account and to credit the beneficiary's account at one or more financial institutions. If the beneficiary's account or the beneficiary bank's account is also with the originator's bank, the transaction is normally handled internally through ''book entry.'' If the beneficiary-related accounts are outside the originating customer's bank, the transfer may be completed by use of a payment system such as Fedwire or CHIPS. The means of arranging payment orders ranges from manual methods (for example, memos, letters, telephone calls, fax messages, or standing instructions) to electronic methods using telecommunications networks. These networks may include those operated by the private sector, such as SWIFT or Telex, or other networks operated internally by particular financial institutions.

Even though the transfers initiated through systems such as SWIFT and Telex do not result in the immediate transfer of funds from the issuing bank, they do result in the issuing bank's having an immediate liability, which is payable to the disbursing bank. Therefore, the internal operating controls of these systems should be as stringent as the ones implemented for systems such as Fedwire and CHIPS.

SWIFT

Society for Worldwide Interbank Financial Telecommunications (SWIFT) is a nonprofit cooperative of member banks that serves as a worldwide interbank telecommunications network. Based in Brussels, Belgium, SWIFT is the primary system employed by financial institutions worldwide to transmit either domestic or international payment instructions. (For further information, see http://www.swift.com.)

TELEX

Several private telecommunications companies offer worldwide or interconnected services that provide a printed permanent record of each message transmitted. Telex is the primary message system for institutions that do not have access to SWIFT. The Telex systems do not include built-in security features. Telex users exchange security codes, and senders sequentially number messages sent to another institution.

Automated Clearinghouse and Check Transactions

The automated clearinghouse (ACH) is an electronic payment delivery system most often used to process low-dollar repetitive retail payments. The system is used primarily for preauthorized recurring payments such as payroll, corporate payments to vendors, Social Security payments, insurance premium payments, and utility payments. First introduced in the early 1970s as a more efficient alternative to checks, ACH has evolved into a nationwide mechanism that processes electronically originated credit and debit transfers for any participating institution nationwide. An alternative to paper checks, the ACH handles billions of payments annually.

Financial institutions are encouraged to obtain a copy of the ACH rules of the National Automated Clearing House Association (NACHA): *A Complete Guide to Rules and Regulations Governing the ACH Network.* The ACH rules provide detailed information on the rule changes, their operational impact, and whether any software changes are required. The rulebook is designed to help financial institutions comply with the current NACHA rules, which are applicable to all ACH participants and include a system of national fines. (For further information, see http://www.nacha.org.)

The Federal Reserve ACH is governed by Operating Circular #4, "Automated Clearing House Items." Other important federal legislation concerning the ACH can be found in Regulation E (primarily regarding consumer rights in electronic funds transfers) and Regulation CC (regulations concerning the availability of funds). (For further information, see http://www.frb.services.org.)

There are two types of ACH transactions: ACH credits and ACH debits. A file containing mortgage payments or insurance premiums could be an example of an ACH debit file. In this transaction, funds flow from the receiver to the originator of the transaction. ACH debit transactions are very similar to check transactions. Both receivers of ACH debit files and payers of checks have the right to return transactions for various reasons, such as insufficient funds in the account or a closed account. The major risk facing institutions that originate ACH debit transactions and collect checks for customers is return-item risk. Return-item risk extends from the day funds are made available to the customer until the individual return items are received.

ACH credit transactions are similar to Fedwire funds transfers in that funds flow from the originator of the transaction to the receiver. A company payroll would be an example of an ACH credit transaction: the bank originating payments on behalf of a customer (the employer in this instance) has a binding commitment to make the payments to the ACH processor when the bank deposits its files with the ACH processor. Since the ACH is a value-dated mechanism, that is, transactions may be originated one or two days before the specified settlement day, the bank is exposed to temporal credit risk that can extend from one to three business days, depending on when the customer (the employer) funds the payments it originates. If the customer fails to fund the payments on the settlement day, the potential loss faced by the originating bank is equal to the total value of payments deposited with the processor from the time the payments are deposited until the customer funds these payments.

BOOK-ENTRY SYSTEMS

Fedwire Book-Entry Securities Transfers

The Fedwire book-entry securities system is known as the National Book-Entry System (NBES). It consists of a safekeeping function and a transfer and settlement function. The safekeeping function involves the electronic storage of securities records in custody accounts. The transfer and settlement function involves the transfer of securities between parties.

Transfers of Fedwire book-entry securities are initiated in the same manner as Fedwire funds transfers. Depository institutions that maintain a reserve account with a Federal Reserve Bank can use the NBES to hold and transfer U.S. Treasury and U.S. government agency securities (including mortgage-backed securities), as well as securities issued by certain international organizations such as the World Bank. These securities are held and transferred in electronic (book-entry) form; the U.S. Treasury and international organizations no longer issue physical securities, nor do most federal agencies.

Securities transfers can be made free of payment or against a designated payment. Nonetheless, most securities transfers involve the delivery of securities and the simultaneous exchange of payment for the securities, a transaction called delivery-versus-payment. The transfer of securities ownership and related funds (if any) is final at the time of transfer. Access to the securities service is limited to depository institutions and a few other organizations, such as federal agencies, state government treasurers' offices (which are designated by the Department of the Treasury to hold securities accounts), and limited-purpose trust companies that are members of the Federal Reserve System. Nonbank brokers and dealers typically hold and transfer their securities through depository institutions that are Fedwire participants and that provide specialized government securities clearing services. (For more information, see http://www.federalreserve.gov/paymentsystems/fedwire.)

Private Book-Entry Systems

In addition to U.S. Treasury and government agency securities, major categories of financial instruments commonly traded in the United States include corporate equities and bonds, municipal (state and local) government securities, money market instruments, and derivatives such as swaps and exchange-traded options and futures. These instruments are generally traded through recognized exchanges or over-the-counter dealer markets. The mechanisms for clearance and settlement vary by type of instrument and generally involve specialized financial intermediaries, such as clearing corporations and depositories. Clearing corporations provide trade comparison and multilateral netting of trade obligations. Depositories, in contrast, hold physical securities and provide book-entry transfer and settlement services for their members.

The vast majority of corporate equity and bond trades are cleared through the National Securities Clearing Corporation (NSCC). Most corporate securities, as well as municipal government bonds, are held at the Depository Trust Company (DTC) in New York. Settlement of securities cleared through NSCC is effected by book-entry transfers at DTC. DTC and NSCC are owned by the Depository Trust and Clearing Corporation, an industry-owned holding company. (For more information, see http://www.dtcc.com.)

U.S. Treasury, federal agency, and mortgage-backed securities are generally traded in over-the-counter markets. The Government Securities Clearing Corporation (GSCC) compares and nets its members' trades in most U.S. Treasury and federal agency securities. The GSCC relies on the Fedwire book-entry securities-transfer system, discussed above, to effect final delivery of securities to its participants. GSCC is owned by DTCC. (For more information see http://www.gscc.com.)

The Mortgage-Backed Securities Clearing Corporation (MBSCC) provides automated post-trade comparison, netting, risk-management, and pool-notification services to the mortgage-backed securities market. MBSCC provides its specialized services to major market participants active in various Government National Mortgage Association (GNMA), Federal Home Loan Mortgage Corporation (Freddie Mac or FHLMC), and Federal National Mortgage Association (Fannie Mae or FNMA) mortgage-backed securities programs. The net settlement obligations of MBSCC participants are settled through the Fedwire book-entry securities system. (For further information, see http://www.mbscc.com.)

PAYMENT SYSTEMS RISK POLICY OVERVIEW

The Federal Reserve's Policy Statement on Payment Systems Risk (PSR policy) addresses risks that payment systems present to the Federal Reserve Banks, the banking system, and other sectors of the economy. Section I of the PSR policy focuses on depository institutions' use of Federal Reserve intraday credit.[2] An integral component of the PSR policy is a program to control the use of Federal Reserve intraday credit, commonly referred to as "daylight credit" or "daylight overdrafts." Individual Reserve Banks are responsible for administering the Board's PSR policy and ensuring compliance by depository institutions. A primary objective of examiners when evaluating payment system risk is to ensure that banks using Federal Reserve payment services comply with the Board's PSR policy.

PSR Policy Objectives

Like depository institutions that offer payment services to customers, Federal Reserve Banks may be exposed to risk of loss when they process payments for institutions that hold accounts with them. The Federal Reserve guarantees payment on Fedwire funds and book-entry securities transfers, net settlement service (NSS) entries,[3] and ACH credit originations made by account holders. If an institution were to fail after sending a transaction that placed its account in an overdraft position, the Federal Reserve would be obligated to cover the payment and bear any resulting losses. Risk is present even when an institution overdraws its account at a Reserve Bank for only a few minutes during the day.

2. Sections II and III of the PSR policy address private-sector systems and other policies. The full text of the PSR policies is available on the Internet at http://www.federalreserve.gov/paymentsystems/psr.

3. The Federal Reserve's NSS provides settlement services to various clearinghouses.

Similar types of risk are generated when customers of private financial institutions and participants in some private-sector payment arrangements incur daylight overdrafts. In addition, daylight credit may be a source of systemic risk in the payment system. Systemic risk refers to the potential that the failure of one participant in a payment system, or in the financial markets generally, to meet its required obligations will cause other participants or financial institutions to be unable to meet their settlement obligations when due.

The PSR policy establishes limits on the amount of Federal Reserve daylight credit that a depository institution may use during a single day or over a two-week period. These limits are sufficiently flexible to reflect the overall financial condition and operational capacity of each institution using Federal Reserve payment services. The policy also permits Reserve Banks to protect themselves from the risk of loss by unilaterally reducing net debit caps; imposing collateralization or clearing-balance requirements; rejecting or delaying certain transactions during the day until the institution has collected balances in its Federal Reserve account; or, in extreme cases, taking the institution off-line or prohibiting it from using Fedwire.

Daylight-Overdraft Capacity

Under the Federal Reserve's PSR policy, each institution that maintains an account at a Federal Reserve Bank is assigned or may establish a net debit cap, as outlined below. The net debit cap limits the amount of intraday Federal Reserve credit that the institution may use during a given interval. The policy allows financially healthy depository institutions that have regular access to the discount window to incur daylight overdrafts in their Federal Reserve accounts up to their individual net debit caps. In addition, the policy allows certain institutions to pledge collateral to the Federal Reserve in order to access additional daylight-overdraft capacity above their net debit caps. In these instances, the institution can incur daylight overdrafts up to the value of its net debit cap plus any Reserve Bank–approved collateralized credit.

NET DEBIT CAPS

An institution's net debit cap refers to the maximum dollar amount of uncollateralized daylight overdrafts that the institution may incur in its Federal Reserve account. An institution's cap category and its capital measure determine the dollar amount of its net debit cap.[4] An institution's net debit cap is calculated as its cap multiple, as listed in the table below, times its capital measure:

$$\text{net debit cap} = \text{cap multiple} \times \text{capital measure}$$

4. The capital measure used in calculating an institution's net debit cap depends on its home-country supervisor and chartering authority. For depository institutions chartered in the United States, net debit caps are multiples of ''qualifying'' or similar capital measures, that is, those capital instruments that can be used to satisfy risk-based capital standards, as set forth in the capital adequacy guidelines of the federal financial regulatory agencies.

Table 1—Net Debit Cap Multiples

	Net Debit Cap Multiples	
Cap categories	*Single-day*	*Two-week average*
High	2.25	1.50
Above average	1.875	1.125
Average	1.125	0.75
De minimis	0.40	0.40
Exempt-from-filing*	$10 million or 0.20	$10 million or 0.20
Zero	0	0

* The net debit cap for the exempt-from-filing category is equal to the lesser of $10 million or 0.20 multiplied by a capital measure.

Because a net debit cap is a function of an institution's capital measure, the dollar amount of the cap will vary over time as the institution's capital measure changes. An institution's cap category, however, is normally fixed over a one-year period. Cap categories and their associated cap levels, set as multiples of capital, are listed in table 1.

An institution is expected to avoid incurring daylight overdrafts that, on average over a two-week period, exceed its two-week average cap, and that, on any day, exceed its single-day cap. The two-week average cap provides flexibility, recognizing that fluctuations in payments can occur from day to day. The purpose of the single-day cap is to limit excessive daylight overdrafts on any day and to ensure that institutions develop internal controls that focus on the exposures each day, as well as over time. Institutions in the zero, exempt-from-filing, and de minimis cap categories have one cap that applies to both the single-day peak overdraft and the average overdraft for a two-week period.

Cap Categories

The PSR policy defines six cap categories: high, above average, average, de minimis, exempt-from-filing, and zero. The average, above-average, and high cap categories are referred to as "self-assessed" caps.

Self-Assessed

To establish a net debit cap category of average, above average, or high, an institution must perform a self-assessment of its creditworthiness, intraday funds management and control, customer credit policies and controls, and operating controls and contingency procedures. The assessment of creditworthiness is based on the institution's supervisory rating and prompt-corrective-action designation. An institution may perform a full assessment of its creditworthiness in certain limited circumstances, for example, if its condition has changed significantly since the last examination, or if it possesses additional substantive information on its financial condition. An institution performing a self-assessment must also evaluate its intraday funds-management procedures and its procedures for evaluating the financial condition of and establishing intraday credit limits for its customers. Finally, the institution must evaluate its operating controls and contingency procedures to determine if they are sufficient to prevent losses due to fraud or system failures.

An examiner's review of an institution's assessment is an important part of determining the institution's compliance with the PSR policy. An examiner is responsible for ensuring that the institution's underlying analysis and methodology were reasonable, and that the resulting self-assessment was generally consistent with examination findings. The following discussion is a simplified explanation of the self-assessment factors. A more detailed explanation is provided in the *Guide to the Federal Reserve's Payments System Risk Policy.* (The guide is available on the Internet at http://www.federalreserve.gov/paymentsystems/psr.)

Creditworthiness. Of the four self-assessment factors, creditworthiness is the most influential in determining an overall net debit cap for a given institution. The creditworthiness factor is principally determined by a combination of the institution's capital adequacy and most recent supervisory rating. In the self-assessment, an institution's creditworthiness is assigned one of the following ratings: excellent, very good, adequate, or below standard. An excellent or a very good rating indicates that an institution demonstrates a sustained level of financial performance above its peer-group norm. As a general matter, fundamentally sound depository institutions that experience only modest weaknesses receive a rating of very good.

Most institutions will use the creditworthiness matrix to determine this component's rating. If an institution's creditworthiness rating is adequate or better, it then proceeds to rate the other three factors in the self-assessment process. The institution's assessment of the other three factors determines whether its composite rating will be lower than or equal to that determined by the creditworthiness factor. If the overall creditworthiness is either adequate or below standard, then the institution does not qualify for a positive daylight-overdraft cap. In certain limited circumstances, an institution may conduct a full analysis of this component. The matrix and information regarding the full analysis are available in the *Guide to the Federal Reserve's Payment System Risk Policy.*

Intraday funds management and control. The purpose of analyzing intraday funds management and control is to assess a depository institution's ability to fund its daily settlement obligations across all payment systems in which it participates. The analysis requires a review of funds management, credit, operations personnel, and payment activity over a period of time.

To obtain an accurate understanding of funds movements, an institution must fully understand its daily use of intraday credit as well as its use of intraday credit on average over two-week periods. The analysis covers a sufficient period of time so that an institution can determine its peak demand for intraday credit and establish its average use of such credit. The more volatile an institution's payments activity, the longer the interval that is selected for analysis. The analysis incorporates all operational areas with access to payment systems. In addition to large-dollar funds and book-entry securities-transfer activity, the review should address check clearing, ACH, currency operations, and other payment activity that results in relatively large-value settlement obligations. Thus, the analysis should not be limited to on-line payment systems or to payment systems to which the institution has on-line access. Additionally, institutions with direct access to Fedwire or other payment systems in more than one Federal Reserve District must combine all of these access points into a single integrated analysis.

In performing the analysis, the institution considers both liquidity demands and the potential credit risks associated with participation in each payment system. The institution's capacity to settle its obligations in both routine and nonroutine circumstances must be carefully assessed. In many cases, a complete assessment of an institution's ability to control its intraday obligations extends beyond its ability to control its use of Federal Reserve intraday credit within the constraints of its net debit cap. Rather, the assessment extends to the institution's ability to control its position across all payment systems to a level that permits it to fund its obligations regularly. This type of assurance requires an institution to fully understand the nature of its obligations and to establish systems that permit it to monitor daily activity and respond to unusual circumstances.

Customer credit policies and controls. The assessment of an institution's customer credit policies and controls requires two distinct analyses:

- an analysis of the institution's policies and procedures for assessing the creditworthiness of its customers, counterparties, and correspondents
- an analysis of the institution's ability to monitor the positions of individual customers and to control the amount of intraday and interday credit extended to each customer

The analyses require the involvement of both credit and operations personnel, and they should focus on the creditworthiness of all customers, including corporate and other depository institutions that are active users of payment services. In addition, the creditworthiness of correspondents and all counterparties on privately operated clearing and settlement systems must be assessed.

Operating controls and contingency procedures. The purpose of the analysis of operating controls and contingency procedures is to assess the integrity and the reliability of a depository institution's payment operations to ensure that they are not a source of operating risk. The integrity of operations is of particular concern because operational errors and fraud can increase the cost of payment services and undermine public confidence in the payments mechanism. Similar results can occur if payment systems are unreliable and if parties making and receiving payments do not have confidence that timely payments will be made.

Overall assessment rating. Once the four self-assessment components are analyzed and an overall rating is determined, the results must be reviewed and approved by the institution's board of directors. The directors' approval must be communicated to the Reserve Bank by submission of a board-of-directors resolution. The Reserve Bank then reviews the cap resolution for appropriateness, in conjunction with the institution's primary regulator. If the Reserve Bank determines that the cap resolution is not appropriate, the institution is informed that it must reevaluate its self-assessment and submit another resolution. A resolution to establish a different cap category may be submitted by the institution, or it may be required by the Reserve Bank before the annual renewal date, if circumstances warrant such a change.

De Minimis

Depository institutions that incur daylight overdrafts of up to 40 percent of their capital may qualify for a de minimis net debit cap. To ease the burden of performing a self-assessment for these institutions, the PSR policy allows a financially healthy institution to incur daylight overdrafts of up to 40 percent of its capital if the institution submits a board-of-directors resolution. An institution with a de minimis cap must submit to its Reserve Bank at least once each year a copy of its board-of-directors resolution (or a resolution by its holding company's board) approving the depository institution's use of daylight credit up to the de minimis level. If an institution with a de minimis cap exceeds its cap during a two-week reserve-maintenance period, its Reserve Bank will counsel the institution and decide whether the de minimis cap should be maintained or the institution will be required to perform a self-assessment for a higher cap.

Exempt-from-Filing

The majority of depository institutions that hold Federal Reserve accounts have an exempt-from-filing net debit cap. The exempt-from-filing cap category is granted at the discretion of the Reserve Bank and permits institutions to incur daylight overdrafts in amounts up to the lesser of $10 million or 20 percent of their capital. If a Reserve Bank determines that an institution is eligible for the exempt-from-filing status, it will assign this cap category without requiring any additional documentation. The Reserve Banks will review the status of an exempt depository institution that incurs overdrafts in its Federal Reserve account in excess of $10 million or 20 percent of capital on more than two days in any two consecutive two-week reserve-maintenance periods. The Reserve Bank will decide if the exemption should be maintained or if the institution will be required to file for a higher cap.

Zero

Some financially healthy depository institutions that could obtain positive net debit caps choose to have zero caps. Often these institutions have very conservative internal policies regarding the use of Federal Reserve daylight credit, or they simply want to ensure that they do not incur daylight overdrafts and thus avoid any daylight-overdraft fees. If a depository institution that has adopted a zero cap incurs a daylight overdraft, the Reserve Bank counsels the institution and may monitor the institution's activity in real time and reject or delay certain transactions that would cause an overdraft. If the institution qualifies for a positive cap, the Reserve Bank may suggest that the institution adopt an exempt-from-filing cap or, if the institution believes that it will continue to incur daylight overdrafts, file for a higher cap.

In addition, a Reserve Bank may assign a depository institution a zero net debit cap. Institutions that may pose special risks to the Reserve Banks, such as those without regular access to the discount window, those incurring daylight overdrafts in violation of this policy, or those in weak financial condition, are generally assigned a zero cap. Recently chartered institutions may also be assigned a zero net debit cap.

Additional Daylight-Overdraft Capacity

While net debit caps provide sufficient liquidity to most institutions, some depository institutions experience liquidity pressures. Consequently, certain depository institutions with self-assessed net debit caps may pledge collateral to their administrative Reserve Bank (ARB) to secure daylight-overdraft capacity in excess of their net debit caps, subject to Reserve Bank approval. Depository institutions that request daylight-overdraft capacity beyond the net debit cap must have already explored other alternatives to address their increased liquidity needs.[5] A depository institution that wishes to expand its daylight-overdraft capacity by pledging collateral should consult with its ARB.[6] The ARB will work with a depository institution that requests additional daylight-overdraft capacity to decide on the appropriate level of maximum daylight-overdraft capacity. Institutions are expected to submit the following information

5. Some potential alternatives available to a depository institution to address increased intraday credit needs include (1) filing for a higher net debit cap, (2) shifting funding patterns or delaying the origination of funds transfers, or (3) transferring some payments-processing business to a correspondent bank.

6. The ARB is responsible for the administration of Federal Reserve credit, reserves, and risk-management policies for a given depository institution or other legal entity.

when requesting collateralized capacity:

- the amount of maximum daylight-overdraft capacity requested
- written justification for requesting additional daylight-overdraft capacity
- written approval from the depository institution's board of directors or, in the case of U.S. branches and agencies of foreign banks, written approval from the bank's most senior officer responsible for formulating policy at the foreign bank's U.S. head office
- a principal contact at the depository institution

When deciding whether an institution is eligible for collateralized capacity, the ARB will consider the institution's reasons for applying for additional collateralized capacity; the information related to the institution's condition; and other information, as applicable. If the ARB approves the request for additional daylight-overdraft capacity, the depository institution must submit a board-of-directors resolution for the maximum daylight overdraft capacity at least once in each 12-month period. An institution's maximum daylight-overdraft capacity is defined as follows:

maximum daylight-overdraft capacity =
net debit cap
+ Reserve Bank–approved collateralized credit

Institutions with exempt-from-filing and de minimis net debit caps may not obtain additional daylight-overdraft capacity by pledging collateral. These institutions must first file for a higher cap to obtain additional daylight-overdraft capacity. Institutions with zero net debit caps also may not obtain additional daylight-overdraft capacity by pledging collateral. If an institution has adopted a zero cap voluntarily, but qualifies for a positive cap, it must file for a higher cap to obtain additional daylight-overdraft capacity. Depository institutions that have been assigned a zero net debit cap by their Reserve Bank are not eligible to apply for additional daylight-overdraft capacity.

ROLE OF DIRECTORS

The directors of a depository institution establish and implement policies to ensure that its management follows safe and sound operating practices, complies with applicable banking laws, and prudently manages financial risks. Given these responsibilities, the directors play a vital role in the Federal Reserve's efforts to reduce risks within the payment system. As part of the PSR policy, the Federal Reserve requests that directors, at a minimum, undertake the following responsibilities:

- Understand the depository institution's practices and controls for the risks it assumes when processing large-dollar transactions for both its own account and the accounts of its customers or respondents.
- Establish prudent limits on the daylight overdrafts that the institution incurs in its Federal Reserve account and on its privately operated clearing and settlement systems.
- Periodically review the frequency and dollar levels of daylight overdrafts to ensure that the institution operates within the guidelines established by its board of directors. Directors should be aware that, under the Federal Reserve's PSR policy, repeated policy violations could lead to reductions in the institution's daylight-overdraft capacity, or to the imposition of restrictions on its Federal Reserve account activity, either of which could affect the institution's operations.

Each institution that performs a self-assessment for a net debit cap should establish daylight-overdraft policies and controls after considering its creditworthiness, intraday funds management and control, customer credit policies and controls, and operating controls and contingency procedures.

The directors may appoint a committee of directors to focus on the institution's participation in payment systems and its use of daylight credit. Furthermore, a higher-level board of the same corporate family may conduct a self-assessment review, if necessary, and approve a resolution. The board of directors should be aware that delegating the review process to a committee or higher-level board does not absolve the directors from the responsibilities stated in the Federal Reserve's PSR policy. The directors cannot delegate this responsibility to an outside consultant or third-party service provider.

For resolutions on collateralized capacity, the board of directors must understand the use and purposes of the pledged collateral under the PSR policy. The directors must understand the reasons that the institution is applying for additional daylight-overdraft capacity, the amount of the collateralized capacity, and the total amount of the net debit cap plus Reserve Bank–approved collateralized credit.

The Federal Reserve recognizes that directors of foreign banks do not necessarily serve in the same capacity as directors of banks in the United States. Therefore, individuals who are responsible for formulating policy at the foreign bank's head office may substitute for directors in performing the responsibilities specified in the PSR policy.

Resolutions

A board-of-directors resolution is required to establish a cap in the de minimis or self-assessed cap categories (average, above average, or high). In addition, a separate resolution is required for self-assessed institutions that wish to obtain collateralized capacity above their net debit caps. These resolutions must follow a prescribed format. Specifically, resolutions must include (1) the official name of the institution, (2) the city and state in which the institution is located, (3) the date the board acted, (4) the cap category adopted, (5) the appropriate official signature, (6) the ABA routing number of the institution, and (7) the corporate seal. For a board resolution approving the results of a self-assessment, the resolution must identify the ratings assigned to each of the four components of the assessment as well as the overall rating used to determine the actual net debit cap. In addition, the institution should indicate if it did not use the creditworthiness-matrix approach in determining its creditworthiness rating.

A depository institution's primary supervisor may review resolutions, and any information and materials the institution's directors used to fulfill their responsibilities under the PSR policy must be made available to the bank supervisor's examiners. Supporting documentation used in determining an appropriate cap category must be maintained at the institution. At a minimum, the following items must be maintained in the institution's "cap resolution file":

- an executed copy of the resolution adopting the net debit cap and/or collateralized capacity
- for institutions with self-assessed caps, copies of management's self-assessment of creditworthiness, intraday funds management and control, customer credit policies and controls, and operating controls and contingency procedures
- minutes and other documentation that serve as a formal record of any directors' discussions on the self-assessment and/or request for collateralized capacity
- status reports the board of directors received on the depository institution's compliance with both the resolutions adopted by the directors and the PSR policy
- other materials that provide insight into the directors' involvement in carrying out their responsibilities under the PSR policy, including special studies or presentations made to the directors
- for the collateralized-capacity resolution, the amount and type of collateral pledged and the amount of maximum daylight-overdraft capacity
- for the supplemental securities-in-transit collateralized-capacity resolution, the amount of pledged securities in transit and the amount of other collateral pledged, if applicable[7]

The board-of-directors resolution for de minimis and self-assessed institutions and for collateralized-capacity resolutions is valid for one year after the Reserve Bank approves the net debit cap or the amount of maximum daylight-overdraft capacity. An institution with a de minimis cap must renew its cap resolution annually by submitting a new resolution to its Reserve Bank. An institution with a self-assessed cap must perform a new self-assessment annually and submit an updated cap resolution to its Reserve Bank. An institution that has a self-assessed cap and has obtained additional collateralized capacity above its net debit cap must submit a board-of-directors resolution to its Reserve Bank annually. Procedures for submitting these resolutions are the same as those for establishing the initial cap; however, an institution may submit a resolution for a differ-

7. Depository institutions with self-assessed net debit caps that receive Reserve Bank approval to support a limit on maximum daylight-overdraft capacity with securities in transit must submit a board-of-directors resolution at least once in each 12-month period. The resolution requires the depository institution's board of directors to acknowledge that (1) securities in transit will be used to collateralize daylight-overdraft capacity in a manner consistent with the reasons and purposes submitted to the institution's administrative Reserve Bank, and (2) the value of the securities in transit pledged to the Reserve Bank will fluctuate during the day and over time.

ent cap category or a different amount of collateralized capacity, if appropriate. The Reserve Bank, in conjunction with an institution's primary supervisor, will review the appropriateness of each resolution.

Because the self-assessment process may, in some cases, require considerable time to complete and approve, institutions should be aware of the expiration date of their cap resolutions well in advance. If a new cap resolution is not received by the expiration date, an institution may be assigned a zero cap, which would generally preclude the institution from using any Federal Reserve daylight credit.

Confidentiality

The Federal Reserve considers institutions' daylight-overdraft caps; cap categories; and collateralized capacity, if applicable, to be confidential information and will only share this information with an institution's primary supervisor. Institutions are also expected to treat cap and collateralized-capacity information as confidential. Cap and collateralized-capacity information should not be shared with outside parties or mentioned in any public documents.

DAYLIGHT-OVERDRAFT MONITORING AND CONTROL

All institutions that maintain Federal Reserve accounts are expected to monitor their account balances on an intraday basis. Institutions should be fully aware of payments they are making from their accounts each day and how those payments are funded. Institutions are encouraged to use their own systems and procedures, as well as the Federal Reserve's systems, to monitor their Federal Reserve account balance and payment activity.

Daylight-Overdraft Measurement

To determine whether a daylight overdraft has occurred in a depository institution's account, the Federal Reserve uses a set of transaction-posting rules that define explicitly the time of day that debits and credits for transactions processed by a Reserve Bank will post to the account. All Fedwire funds transfers, book-entry securities transfers, and NSS transactions are posted to an institution's account as they occur throughout the day. For other transactions, quasi-real-time posting rules govern the timing of account debits and credits. These posting rules should help institutions control their use of intraday credit because they allow institutions to monitor the time that each transaction is credited or debited to their account. Note that these posting times affect the calculation of the account balance for daylight-overdraft monitoring and pricing purposes but do not affect the finality or revocability of the entry to the account. An important feature of the posting rules is a choice of posting times for check credits.

Monitoring Daylight Overdrafts

To monitor an institution's overdraft activity and its compliance with the PSR policy and to calculate daylight-overdraft charges, the Federal Reserve uses the Daylight-Overdraft Reporting and Pricing System (DORPS). DORPS captures all debits and credits resulting from an institution's payment activity and calculates end-of-minute account balances using the daylight-overdraft posting rules. As measured by DORPS, an institution's account balance is calculated at the end of each minute, based on its opening balance and all payment transactions posted to the institution's account up until that moment. The daylight-overdraft measurement period begins with the current official opening time of Fedwire and continues until the official closing time. Although DORPS records positive as well as negative account balances, positive balances do not offset negative balances for purposes of determining compliance with net debit caps or for calculating daylight-overdraft fees. In cases of unscheduled extensions of Fedwire hours, the final closing account balance is recorded as if it were the balance at the standard closing time, and balances between the scheduled and actual closing times are not recorded. DORPS generates various reports at the end of each two-week reserve-maintenance period. These reports provide useful information for monitoring daylight overdrafts, such as peak daily overdrafts for the period; overdrafts in excess of net debit cap; end-of-minute account balances for a particular day; and related ratios, such as the peak daily overdraft relative to net debit cap.

Monitoring PSR Policy Compliance

Reserve Banks generally monitor institutions' compliance with the PSR policy over each two-week reserve-maintenance period. In most cases, a policy violation occurs when an institution's account balance for a particular day shows one or more negative end-of-minute account balances in excess of its single-day net debit cap or when an institution's average peak daily overdraft over a reserve-maintenance period exceeds its two-week average cap.[8] The exceptions to this general rule are discussed below.

Institutions in the exempt-from-filing cap category are normally allowed two cap breaches in two consecutive two-week reserve-maintenance periods without violating the PSR policy. For institutions in the de minimis or self-assessed cap categories or for institutions that have been approved for maximum daylight-overdraft capacity, each cap breach is considered a policy violation. A Reserve Bank may waive a violation if it determines that the overdraft resulted from circumstances beyond the institution's control.

An institution with a self-assessed cap that has been approved for maximum daylight-overdraft capacity should avoid incurring daylight overdrafts that, on average over a two-week period, exceed its two-week-average limit, and that, on any day, exceed its single-day limit. The two-week-average limit is equal to the two-week average cap plus the amount of applicable Reserve Bank–approved collateral, averaged over a two-week reserve-maintenance period. The single-day limit is equal to an institution's net debit cap plus the amount of applicable Reserve Bank–approved collateral.

For daylight-overdraft purposes, accounts of U.S. branches and agencies of foreign banks and accounts involved in merger-transitions are monitored on a consolidated basis; that is, a single account balance is derived by adding together the end-of-minute balances of each account. The accounts of affiliated institutions are monitored separately if they are separate legal entities. In addition, for institutions with accounts in more than one Federal Reserve District, an ARB is designated. The ARB coordinates the Federal Reserve's daylight-overdraft monitoring for the consolidated accounts or institutions.

8. An institution's average peak daily overdraft is calculated by adding the largest overdraft incurred for each day during a reserve-maintenance period and dividing that sum by the number of business days in the period.

Consequences of Violations

A PSR policy violation may initiate a series of Reserve Bank actions aimed at deterring an institution's excessive use of Federal Reserve intraday credit. These actions depend on the institution's history of daylight overdrafts and its financial condition. Initially, the Reserve Bank may assess the causes of the overdrafts and review account-management practices. In addition, the Reserve Bank may require an institution to submit documentation specifying the actions it will take to address the overdraft problems. If policy violations continue, the Reserve Bank may take additional actions. For example, if a financially healthy institution in the zero, exempt-from-filing, or de minimis cap category continues to breach its cap, the Reserve Bank may recommend that the institution file a cap resolution or perform a self-assessment to obtain a higher net debit cap.

If an institution continues to violate the PSR policy, and counseling and other Reserve Bank actions have been ineffective, the Reserve Bank may assign the institution a zero cap. In addition, the Reserve Bank may impose other account controls that it deems prudent, such as requiring increased clearing balances; rejecting Fedwire funds transfers, ACH credit originations, or NSS activity in excess of the account balance; or requiring the institution to fund certain transactions in advance. Reserve Banks also keep institutions' primary regulators apprised of any recurring overdraft problems.

Real-Time Monitoring

The Account Balance Monitoring System (ABMS) is the system Reserve Banks use to monitor in real time the payment activity of institutions that potentially expose the Federal Reserve and other payment-system participants to risk of loss. ABMS is both an information source and an account-monitoring and control tool. It allows institutions to obtain intraday balance information for purposes of managing their use of daylight credit and avoiding overnight overdrafts. All institutions that have an electronic connection to the Federal Reserve's Fedwire funds-transfer service, such as a FedLine® terminal or a computer interface connection, are able to review their intraday Federal Reserve account position in ABMS. While ABMS is not a substitute for an institution's own internal tracking and monitoring systems, it does provide real-time account information based on Fedwire funds and securities transfers and NSS transactions. Additionally, ABMS captures debits and credits resulting from other payment activity as those transactions are processed in the Reserve Bank's accounting system. ABMS also provides authorized Federal Reserve Bank personnel with a mechanism to monitor and control account activity for selected institutions.

ABMS has the capability to reject or intercept funds transfers from an institution's account. This capability is called ''real-time monitoring.'' The Federal Reserve Banks use real-time monitoring to prevent selected institutions from transferring funds from their accounts if there are insufficient funds to cover the payments. Institutions are generally notified before a Reserve Bank begins monitoring their account in real time.

If an institution's account is monitored in the ''reject'' mode in ABMS, any outgoing Fedwire funds transfer, NSS transaction, or ACH credit origination that would cause an overdraft above a specified threshold, such as the institution's net debit cap plus any Reserve Bank–approved collateral pledged, would be immediately rejected back to the sending institution. The institution could then initiate the transfer again when sufficient funds became available in its account. If an institution's account is monitored in the ''intercept'' mode, sometimes referred to as the ''pend'' mode, outgoing funds transfers, NSS transactions, or ACH credit originations that would cause an overdraft in excess of the threshold will not be processed but will be held. These intercepted transactions will either be released by the Reserve Bank once funds are available in the institution's account or rejected back to the institution. Reserve Banks will normally be in direct contact with an institution in the event any of its funds transfers are intercepted.

Institutions can view Federal Reserve accounting information on the web through FedLine®. The Account Management Information (AMI) application provides real-time access to intraday account-balance and daylight-overdraft balance information, detailed transaction information, and a variety of reports and inquiry services. Institutions can obtain information on accessing ABMS and AMI from any Federal Reserve Bank.

SPECIAL TYPES OF INSTITUTIONS

U.S. Branches and Agencies of Foreign Banks

Under the PSR policy, U.S. branches and agencies of foreign banks are typically treated the same as domestic institutions. However, several unique considerations affect the way in which the policy is applied to U.S. branches and agencies of foreign banks. In general, net debit caps for foreign banking organizations (FBOs) are calculated in the same manner as for domestic banks, that is, by applying cap multiples for one of the six cap categories to a capital measure. For U.S. branches and agencies of foreign banks, net debit caps on daylight overdrafts in Federal Reserve accounts are calculated by applying the cap multiples for each cap category to the FBO's U.S. capital equivalency measure. U.S. capital equivalency is equal to the following:

- 35 percent of capital for FBOs that are financial holding companies (FHCs)
- 25 percent of capital for FBOs that are not FHCs and have a strength-of-support assessment (SOSA) ranking of 1
- 10 percent of capital for FBOs that are not FHCs and are ranked a SOSA 2
- 5 percent of ''net due to related depository institutions'' for FBOs that are not FHCs and are ranked a SOSA 3

U.S. branches and agencies of foreign banks that (1) wish to establish a non-zero net debit cap, (2) are an FHC, and/or (3) are ranked SOSA 1 or 2 are required to file the Annual Daylight Overdraft Capital Report for U.S. Branches and Agencies of Foreign Banks (FR 2225). Granting a net debit cap or any extension of intraday credit to a depository institution is at the discretion of the Reserve Bank. In the event a Reserve Bank grants a net debit cap or extends intraday credit to a financially healthy FBO ranked a SOSA 3, the Reserve Bank may require such credit to be fully collateralized, given the heightened supervisory concerns with these FBOs.

As in the case of U.S. institutions, the ARB must have the ability to assess regularly the financial condition of a foreign bank in order to grant the institution a daylight-overdraft cap other than zero. The ARB will generally require information regarding tier 1 and total risk-based capital ratios for the consolidated foreign bank. Accordingly, U.S. branches and agencies of foreign banks seeking a positive daylight-overdraft cap (exempt, de minimis, or self-assessment cap categories) should provide the ARB with capital ratios at the time the cap is established and annually thereafter. U.S. branches and agencies of foreign banks that are based in countries that do not adhere to the Basel Capital Accord should provide information comparable to the accord format. Workpapers for capital ratios need to be maintained at a designated U.S. branch or agency and are subject to review by the institution's primary supervisor. The Federal Reserve considers capital information provided to the ARB in connection with an institution's daylight-overdraft cap to be confidential.

Allocation of Caps

The Federal Reserve monitors the daylight overdrafts of U.S. branches and agencies of foreign banks on a consolidated basis; that is, each foreign-bank family, consisting of all of the U.S. branches and agencies of a particular foreign bank, has a single daylight-overdraft cap. Like other institutions with accounts in more than one Federal Reserve District, intraday account balances of all the U.S. branches and agencies in a foreign-bank family are added together for purposes of monitoring against its daylight-overdraft cap.

For purposes of real-time monitoring, however, a foreign bank that has offices in more than one District may choose to allocate a portion of its net debit cap to branches or agencies in Districts other than that of the ARB. Unless a foreign-bank family instructs otherwise, the Federal Reserve will assign the dollar value of the family's single-day daylight-overdraft cap to the branch or agency located in the District of the ARB. The foreign-bank family may indicate to the ARB the dollar amount of cap to be allocated to offices in other Districts. Any dollar amount of the cap that is not allocated to offices in other Districts will be assigned to the branch or agency in the District of the ARB. A foreign bank may revise its cap allocation from time to time by communicating the revision to its ARB, but such revisions should be infrequent.

Nonbank Banks and Industrial Banks

Institutions subject to the Competitive Equality Banking Act of 1987 (CEBA), such as nonbank banks or certain industrial banks, may not incur daylight overdrafts on behalf of affiliates, except in three circumstances. First, the prohibition does not extend to overdrafts that are a result of inadvertent computer or accounting errors beyond the control of both the nonbank bank or industrial bank and its affiliate. Second, nonbank banks are permitted to incur overdrafts on behalf of affiliates that are primary U.S. government securities dealers, provided such overdrafts are fully collateralized. Third, overdrafts incurred in connection with an activity that is financial in nature are also permitted. A nonbank bank or industrial bank loses its exemption from the definition of bank under the Bank Holding Company Act if it permits or incurs prohibited overdrafts. In enforcing these restrictions, the Federal Reserve uses a separate formula for calculating intraday Federal Reserve account positions for these institutions.

Institutions with Federal Reserve Accounts and No Access to the Federal Reserve Discount Window

Under the PSR policy, institutions that have Federal Reserve accounts but lack regular access to the discount window are not eligible for a positive daylight-overdraft cap. These institutions are strongly discouraged from incurring any daylight overdrafts. If such an institution were to incur an overdraft, however, the Reserve Bank would generally require it to pledge collateral sufficient to cover the peak amount of the overdraft for an appropriate period.

In addition to the pledge of collateral, the institutions discussed below are subject to a penalty fee on any daylight overdrafts incurred in their Federal Reserve accounts. The penalty fee is intended to provide a strong incentive for these institutions to avoid incurring any daylight overdrafts in their Federal Reserve accounts. The penalty fee is assessed at a rate equal to the regular daylight-overdraft fee plus 100 basis points (annualized, 24-hour rate). The penalty fee is calculated and assessed in the same manner as the daylight-overdraft fee charged to other institutions.

Edge Act and Agreement Corporations

Edge Act and agreement corporations[9] do not have regular access to the discount window and should refrain from incurring daylight overdrafts in their reserve or clearing accounts. If any daylight overdrafts occur, the Edge Act or agreement corporation will be required to pledge collateral to cover them. Like foreign banks, Edge Act and agreement corporations that have branches in more than one Federal Reserve District are monitored on a consolidated basis.

Bankers' Banks

Bankers' banks,[10] including corporate credit unions, are exempt from reserve requirements and do not have regular access to the discount window. Bankers' banks may voluntarily waive their exemption from reserve requirements, thus gaining access to the discount window. These bankers' banks would then be free to establish caps and would be subject to the PSR policy in the same manner as other depository institutions. Bankers' banks that have not waived their exemption from reserve requirements should refrain from incurring overdrafts and must pledge collateral to cover any daylight overdrafts that they incur.

9. These institutions are organized under section 25A of the Federal Reserve Act (12 USC 611–631) or have an agreement or undertaking with the Board of Governors under section 25 of the Federal Reserve Act (12 USC 601–604a).

10. For the purposes of the PSR policy, a bankers' bank is a financial institution that is not required to maintain reserves under the Federal Reserve's Regulation D (12 CFR 204) because it is organized solely to do business with other financial institutions, is owned primarily by the financial institutions with which it does business, and does not do business with the general public and is not a depository institution as defined in the Federal Reserve's Regulation A (12 CFR 201.2(a)).

Limited-Purpose Trust Companies

The Federal Reserve Act (FRA) permits the Board to grant Federal Reserve membership to limited-purpose trust companies[11] subject to conditions the Board may prescribe pursuant to the FRA. Limited-purpose trust companies that maintain Federal Reserve accounts should refrain from incurring overdrafts and should pledge collateral to cover any daylight overdrafts that they incur.

EFT MANAGEMENT

Economic and financial considerations have led financial institutions and their customers to recognize the need to manage cash resources more efficiently. The PSR policy calls on private networks and depository institutions to reduce their own credit and operational risks. It also depends on the role of the Federal Reserve and other financial institution regulators in examining, monitoring, and counseling institutions. To ensure that banking institutions are following prudent banking practices in their funds-transfer activities, examinations should focus equally on the evaluation of both credit and operational risks.

The bank should establish guidelines for types of allowable transfers. Procedures should be in effect to prevent transfers drawn against uncollected funds. Thus, banks should not transfer funds against simple ledger balances unless preauthorized credit lines have been established for that account.

Errors and omissions or fraudulent alteration of the amount of a transfer or of the account number to which funds are to be deposited could result in losses to the bank. Losses may include total loss of the transferred funds, loss of availability of funds, interest charges, and administrative expenses associated with the recovery of the funds or correction of the problem.

Management is responsible for assessing the inherent risks in the EFT system, establishing policies and controls to protect the institution against unreasonable exposures, and monitoring

11. For the purposes of the PSR policy, a limited-purpose trust company is a trust company that, because of limitations on its activities, does not meet the definition of "depository institution" in section 19(b)(1)(A) of the Federal Reserve Act (12 USC 461(b)(1)(A)).

the effectiveness of safeguards. Regulatory agencies will ensure that each financial institution has evaluated its own risks realistically and has adequate accounting records and internal controls to keep exposures within reasonable, established limits.

The risks associated with any computerized EFT system can be reduced if management implements the controls that are available on the system. For example, the authority to enter, verify, and send transfers can be segregated, and the dollar amount of transactions can be limited. Effective risk management requires that management establish and maintain—

- reasonable credit limits (payments in excess of these limits that involve significant credit risk must be properly approved by appropriate lending authorities),
- adequate recordkeeping to determine the extent of any intraday overdrafts and potential overnight overdrafts before releasing payments, and
- proper monitoring of respondents' accounts when the institution sets the positions of others. Responsibility for this function should be assigned to an appropriate supervisory level of management that will ensure the use of adequate internal controls.

Authentication or Verification Methods

The same due care that financial institutions use when executing EFT transactions must be used when accepting EFT requests from customers. Management must implement security procedures for ensuring that the transfer requests are authentic. As stated in Uniform Commercial Code (UCC) section 4A-201, "Authorized and Verified Payment Orders," security procedures may require the use of algorithms or other codes, identifying words, or numbers; encryption; callback procedures; or similar security devices. An explanation of authorized and verified payment orders is detailed in UCC section 4A-202.

Signature Verification

One method to verify the authenticity of a customer's EFT request is to verify the customer's signature. Unfortunately, this procedure cannot be performed when the customer requests the transaction by telephone. Some financial institutions have implemented policies whereby the customer completes and signs a transfer request, and then faxes the request to the bank. However, this is not a safe EFT procedure because, although the bank can verify the signature on the faxed request, it cannot be certain that the transfer request is legitimate. Any document that is transmitted electronically can be altered (for example, by changing the amount or account number). The alteration can occur before the document is digitalized (that is, before being fed into the fax machine) or after. In most instances, these alterations cannot be detected by the receiving entity. If there is any question about a document's authenticity, the transaction should be reconfirmed through other sources.

Personal Identification Numbers

One way for financial institutions to authenticate transfers initiated over the telephone is through the use of personal identification numbers (PINs) issued to each customer. When a customer requests a transfer, his or her identity is verified by comparing the supplied PIN with the customer's PIN-request form that is on file. At a minimum, the following safeguards should be implemented for these types of transfers:

- All nonretail customers should be requested to sign an agreement whereby the bank is held harmless in the event of an unauthorized transfer if the bank follows routine authentication procedures. The customer is responsible for informing the bank about changes in who is authorized to execute EFTs. These procedures should minimize the risk to the bank if someone is able to execute a fraudulent transaction. (These procedures are described in detail in UCC section 4A-202.)
- All transactions over a specific dollar amount should be re-verified by a callback routine. The bank should require that the person being called for re-verification is someone other than the person who initially requested the transaction.
- Whenever new PINs are issued, they should be mailed in sealed, confidential envelopes (preferably computer-generated) by someone who does not have the ability to execute wire transfers.

- The number of bank employees with access to the PINs should be very limited.

Tape Recording

The tape recording of EFT requests made over the telephone is another internal-control practice. When possible, verifying and recording the incoming telephone number (that is, using a ‘‘caller-ID’’ system) is also a good practice. The laws addressing telephone recording vary by state. Some states require that the caller be informed that the conversation is being recorded; others do not have this requirement. Regardless of the state’s law, the bank should inform callers that, for their protection, conversations are being recorded. Moreover, banks should have in place a policy for archiving the taped telephone records and should retain them for a specified period of time, at least until the statements from the Federal Reserve or correspondent banks have been received and reconciled.

Statements of Activity

Some larger banks have implemented a procedure whereby customers are electronically sent a summary statement at the end of each day that lists the transfers executed and received on their behalf. The statement can be sent through a fax machine, a personal computer, or a remote printer. This procedure quickly identifies any transfers the customer did not authorize.

Test Keys

EFT requests can be authenticated using ‘‘test keys.’’ A test key is a calculated number that is derived from a series of codes that are contained in a ‘‘test-key book.’’ The codes in a test-key book represent such variables as the current date, hour of the day, receiving institution, receiving account number, and amount of the transfer. The value derived from these variables equals the test key. The financial institution or corporate customer initiating the transfer will give its EFT information, along with the test-key value. The receiving bank will recalculate the test key and, if the two test keys equal the same amount, the EFT request is considered authenticated. Test-key code books should be properly secured to prevent unauthorized access or fraudulent use. The use of test keys has declined in recent years as more and more institutions implement personal computer–based EFT systems.

Blanket Bond

Although computer-related employee misappropriations are normally covered, financial institution blanket bond policies generally exclude certain types of EFT activities from standard coverage. Separate coverage for EFT systems is available and should be suggested to management, particularly if a significant risk exposure exists. A bank’s fidelity bond insurance could be declared null and void by the carrier if a fraudulent transfer were to occur and the loss was directly attributable to weak internal controls. (See section 4040.1, ‘‘Management of Insurable Risks.’’)

SUPERVISORY RISK EVALUATION

Bank management is responsible for assessing the inherent risks in the EFT system (or systems) it uses. Management should establish policies and controls to protect the institution against unreasonable exposures, as well as monitor the effectiveness of the established safeguards.

Examiner Responsibilities

Examiners are responsible for ensuring that financial institutions have assessed and evaluated their risks realistically and have adopted internal controls that are adequate to keep those risks within acceptable limits. The types of risks involved in EFT systems, as well as payment systems generally, are discussed below.

Credit Risk

Credit risk is the risk that a counterparty will not settle an obligation for full value when due, nor at any time subsequently. Any time an institution extends credit to a customer or permits a customer to use provisional funds to make a payment, the institution is exposed to the risk that the customer will not be able to meet its payment obligation. If the customer is unable or unwilling to repay the credit extension, the institution could incur a financial loss. Similarly, an institution that receives a payment in provisional funds has a credit exposure to the sender until such time as the payment is settled with finality; that is, until the payment becomes unconditional and irrevocable. If an institution permits a customer to withdraw or make a payment with provisional funds received, then the institution incurs credit exposure to both the sender of the provisional funds and the customer. Those credit exposures are not extinguished until the provisional funds received are settled with finality. With respect to payment systems risk, overall credit risk consists of (1) direct-credit risk to the Federal Reserve, that is, a borrowing institution may be unable to cover its intraday overdraft arising from a transfer of funds or receipt of book-entry securities, thus causing a Federal Reserve Bank to incur a loss; (2) private direct-credit risk, or the possibility of loss to institutions extending credit; and (3) systemic risk, which is the possibility of loss to multiple creditors when borrowing institutions fail to cover their obligations to creditor institutions. Variants of credit risk include sender risk, receiver risk, and return-item risk.

Systemic risk. Stated more clearly, systemic risk occurs when one participant in a payment system, or in the financial markets generally, fails to repay its required obligation when due, and this failure prevents other private or market participants or financial institutions from meeting their settlement obligations when due. Systemic risk may result from extraneous events, actions, or reasons that are independent of the institution, or from developments in the payment system. Changes in the capital markets, domestic political or government announcements or actions, unplanned events, or soverign actions of other countries are examples of events that may cause systemic risk.

Sender risk. Sender risk is the risk that results if a depository institution uses an extension of credit to make an irrevocable payment on behalf of a customer. This credit can be a loan or an extension of payment against uncollected or provisional funds or against insufficient balances.

Receiver risk. Receiver risk arises when an institution accepts funds from a sender who may be a customer, another institution, or the payment system. As the receiver of funds, the institution relies on the sender's ability to settle its obligations. The risk exists while payments are revocable within the system and remains until final settlement.

Return-item risk. The major risk in originating ACH debit transactions and collecting checks for customers is return-item risk. Return-item risk extends from the day funds are made available to customers until the individual items can no longer legally be returned. The receiver of ACH debit transactions, or the payer of checks, has the right to return transactions for various reasons, including insufficient funds in its customer's account. To minimize its exposure, an institution should perform credit assessments of all customers that originate large dollar volumes of ACH debit transactions, and for all customers for which the institution collects large volumes of checks. Such assessments ensure that if ACH or check items are returned after the customer has been granted use of the funds, the customer will be able to return the funds to the institution.

Liquidity Risk

Liquidity risk (or settlement risk) is the risk that a counterparty will not settle an obligation for full value when due, even though the counterparty may later settle the obligation. Liquidity risk may result from unexpected market or operational disruptions or from catastrophic or unplanned events. It may also result from sovereign actions; therefore, sovereign risk can give rise to liquidity risk.

Sovereign risk refers to the financial capacity of governments to generate foreign-currency revenues to repay their obligations. This capacity is generally limited because government assets are predominantly the discounted value of future taxes denominated in the local currency. Governments have direct access to foreign-currency revenues only when the economy is dominated by a public sector that derives most of its revenues from exports (for example, oil or gold). Sovereign risk is not limited to the country's federal government debt. It also includes debt contracted by all public and publicly guaranteed entities (such as provincial, state, or local governments and all other debt with a government's guarantee).

Actions taken by nondomestic governments can affect the payments of certain participants in a payment system, and these actions can be detrimental to other participants in the system. Soverign risk can include the imposition of exchange-control regulations on a bank participating in international foreign-exchange activities. While the bank itself may be both willing and able to settle its position, government intervention may prevent it from doing so. The risk can be controlled by regularly monitoring the payment-system laws of other countries and by taking specific alternative actions to lessen the risk. Alertness to a bank's sovereign-risk exposure to its counterparties located in other nations, and to possible alternative actions, can considerably lessen this risk.

Legal Risk

Any transaction occurring in a payment system is subject to the interpretation of courts in different countries and legal systems. This issue is normally addressed by adopting "governing law" provisions in the rules of the systems themselves. These provisions provide for all disputes between members to be settled under the laws of a specific jurisdiction. However, if a local court refuses to recognize the jurisdiction of a foreign court, the rules may be of limited use. This risk is difficult to address because there is no binding system of international commercial law for electronic payments. Banks should seek a legal opinion regarding the enforceability of transactions settled through a particular system.

Operational Risk

Operational risk may arise from—

- a system failure caused by a breakdown in the hardware or software supporting the system, possibly resulting from design defects, insufficient system capacity to handle transaction volumes, or a mechanical breakdown, including telecommunications;
- a system disruption if the system is unavailable to process transactions, possibly due to system failure, destruction of the facility (from natural disasters, fires, or terrorism), or operational shutdown (from employee actions, a business failure, or government action); or
- the system being compromised as a result of fraud, malicious damage to data, or error.

Whatever the source, the loss of availability of a payment system can adversely affect major participants, their correspondents, markets, and interdependent payment mechanisms.

Banks should control operational risk through a sound system of internal controls, including physical security, data security, systems testing, segregation of duties, backup systems, and contingency planning. In addition, a comprehensive audit program is essential to assess the risks, adequacy of controls, and compliance with bank policies.

Risk-Control Issues

Bank management should consider and develop risk-management policies and procedures to address the variety of credit, liquidity, operational, and other risks that can arise in the normal course of conducting its payment business—regardless of the clearing and settlement method of the particular payment systems in which the bank participates. EFT systems differ widely in form, function, scale, and scope of activities. Consequently, the specific risk-management measures an institution employs for a particular EFT system will differ depending on the inherent risks in the system. As a general matter, an institution should adopt risk-management controls commensurate with the nature and magnitude of risks involved in a particular EFT system.

In addition to assessing the adequacy of an institution's risk-management procedures for measuring, monitoring, and controlling its risks from participating in a payment system (or systems) and from providing payment services to its customers, examiners should consider the following internal-control guidelines when they review policies and procedures covering EFT activities:

- Job descriptions for personnel responsible for a bank's EFT activities should be well defined, providing for the logical flow of work and adequate segregation of duties.
- No single person in an EFT operation should be responsible for all phases of the transaction (that is, for data input, verification, and transmission or posting).

- All funds transfers should be reconciled at the end of each business day. The daily balancing process should include a reconciliation of both the number and dollar amount of messages transmitted.
- All adjustments required in the processing of a transfer request should be approved by a bank's supervisory personnel, with the reasons for the adjustment documented. Transfer requests ''as of'' a past or future date should require the supervisor's approval with well-defined reasons for those requests.
- Only authorized persons should have access to EFT equipment.

Considerable documentation is necessary to maintain adequate accounting records and auditing control. Many banks maintain transfer-request logs, assign sequence numbers to incoming and outgoing messages, and keep an unbroken electronic copy of all EFT messages. At the end of each business day, employees who are independent of the transfer function should compare request forms with the actual transfers to ensure that all EFT documents are accounted for. When reviewing the adequacy of internal controls, examiners should review the funds-transfer operations to determine that recordkeeping systems are accurate and reliable, all transactions are handled promptly and efficiently, duties are separated appropriately, audit coverage is adequate, and management recognizes the risks associated with these activities.

1. To determine if the bank's electronic funds transfer (EFT) objectives, policies, practices, procedures, and internal controls are adequate to control its exposure to acceptable limits of payment systems risk.
2. To determine if bank officers and other wire-transfer personnel are operating in conformance with established guidelines.
3. To determine the scope and adequacy of the audit function for the risks associated with payment and wire-transfer systems.
4. To ascertain whether senior management is informed of the current status, nature, and magnitude of risks associated with the bank's EFT operations, as well as any changes to these risks.
5. To assess the bank's ability to monitor its payment-systems position, as well as to limit its credit and other risk exposures in the system and from its customers or correspondents.
6. To determine that the board of directors has reviewed and approved the institution's use of Federal Reserve intraday credit, self-assessment (if applicable), and net debit cap, and to determine if the institution is complying with the Federal Reserve Policy Statement on Payments System Risk.
7. If the bank has a self-assessed net debit cap, to review the bank's self-assessment file and determine if the underlying analyses and methodologies are reasonable, adequate, and consistent with the institution's supervisory overview, risk assessments, and risk matrix.
8. To evaluate the quality of the bank's operational controls and determine the extent of compliance with applicable laws and regulations.
9. To initiate corrective action when objectives, policies, procedures, or internal controls are deficient or when violations of law or regulations exist.

1. Review and determine the bank's compliance with the electronic funds transfer (EFT) risk-assessment standards of the examination module, recognizing the associated risks for each. Answer the pertinent questions that refer to EFT in the internal control questionnaire.
2. Review and evaluate the work of internal or external auditors and the compliance officer as it relates to the risks associated with payment systems and EFT activities. Determine if payment system risk is reviewed and whether the independence, scope, coverage, and frequency of internal or external reviews is adequate.
3. Based on an evaluation of internal controls and the work performed by internal or external auditors, determine the scope of the examination.
4. Test for compliance with policies, practices, procedures, and internal controls. Determine whether the management information systems and reports for the institution's payment systems and funds-transfer activities provide timely and accurate data that are sufficient for personnel to make informed and accurate decisions. From the examiner assigned to review ''Internal Control,'' obtain a listing of any deficiencies noted in the latest review by internal or external auditors. Determine if bank management has taken the appropriate corrective actions for the deficiencies.
5. Obtain or construct an organizational chart and flowchart for the EFT area, and determine the job responsibilities and flow of work through that department.
6. Review the bank's standard form of agreement or other written agreements with its customers, correspondent banks, and vendors. Determine whether those agreements are current and clearly define the liabilities and responsibilities, including responsibilities during emergencies, of all parties. Agreements with the Federal Reserve Bank should refer specifically to the operating circular (or circulars) on the electronic funds transfers pursuant to subpart B of Regulation J (12 CFR 210.25 et seq.).
7. Review the bank's board of directors and senior management policies and procedures for payment-systems and EFT activities, including third-party transactions. Perform tests to determine the existence, reasonableness, and adequacy of these policies and procedures. Determine whether the policies and procedures have been disseminated to the employees who are actively responsible for and involved in performing payment-systems and EFT activities. Ascertain whether there is an active employee-training program that ensures employees have the knowledge necessary to comply with the bank's policies and procedures for payment-systems and EFT activities.
8. For transactions involving the Federal Reserve Bank, other private funds-transfer systems, and other due from bank accounts, confer with the examiner who is assigned ''Due from Banks'' and determine the propriety of any outstanding funds-transfer items.
9. If the bank is a CHIPS or other clearing-agency participant, determine the bank's basis for accepting customers for CHIPS-payments activity.
   a. If the examined institution is a funding participant on CHIPS, determine the criteria for accepting a nonfunding participant as a respondent.
   b. Determine that the criteria are reviewed periodically.
10. Coordinate the review of the credit exposures arising from payment-systems and EFT activities with the examiners' review of loan programs or loan portfolios. Determine whether credit personnel make and adequately document, independent of account and operations officers, periodic credit reviews of funds-transfer customers.
11. Determine if appropriate intraday credit limits are imposed and monitored for those customers and counterparties with which the bank has intraday credit exposures.
12. Determine if the bank monitors and controls any intraday credit exposures to affiliates.[1]

1. An insured depository institution must establish and maintain policies and procedures reasonably designed to manage the credit exposure arising from its intraday extensions of credit to affiliates in a safe and sound manner. The policies and procedures must at a minimum provide for

13. Determine whether the institution periodically reviews its ability to fund its closing-position requirement on private multilateral settlement systems, such as CHIPS.
14. Determine that the board of directors has reviewed and approved the institution's use of Federal Reserve intraday credit.
15. If the institution incurs daylight overdrafts in its Federal Reserve account, determine that the institution has selected an appropriate net debit cap.
16. If the institution has selected a de minimis or self-assessed net debit cap, determine that the board-of-directors resolution follows the prescribed format and contains all of the required elements.
17. If the institution has selected a self-assessed net debit cap, review the contents of the self-assessment file to determine that the institution has applied the guidelines seriously and diligently, that the underlying analysis and method were reasonable, and that the resulting self-assessment is generally consistent with the examination findings. Inform the appropriate Reserve Bank of any concerns about the institution's net-debit-cap level, self-assessment, or use of Federal Reserve intraday credit.
18. Review the institutions cap-resolution file and ascertain that it includes all the items and information required.
19. Determine where suspense items or adjustment accounts are posted and accounted for, as well as who is responsible for reviewing, resolving, and clearing out suspense items.
    a. Scan accounts for unusual or old items or abnormal fluctuations.
    b. Reconcile accounts to departmental control totals and to the general ledger.
    c. Review management reports on suspense items and unusual activity.
20. Review the income and expense accounts related to EFT operations for the frequency of entries caused by late or inaccurate execution-of-transfer requests.
21. Observe the space and personnel allocated to the EFT area and the location of communications terminals, and determine whether existing conditions are adequate to provide appropriate physical security.
22. Discuss the following items with the appropriate officer (or officers) and prepare summaries in the appropriate section of the examination report:
    a. internal-control exceptions, as well as deficiencies in or noncompliance with written policies, practices, and procedures
    b. uncorrected audit deficiencies
    c. violations of laws and regulations
    d. the level of understanding of the bank's supervisory officers regarding the definitions, terminology, operating arrangements, accounting procedures, and time limitations of EFT operations
    e. the operating efficiency and physical security of the bank's EFT operation
    f. the adequacy of controls over settlement- and credit-risk exposure
    g. recommended corrective action when policies, practices, or procedures are deficient
23. Update the examination workpapers to include the bank examination activities and procedures performed and any information gathered to support the completed work, including any information that will facilitate future examinations.

monitoring and control of the credit exposure arising from the institution's intraday extensions of credit to each affiliate and all affiliates in the aggregate, and must ensure that the institution's intraday extensions of credit to affiliates comply with section 23B of the Federal Reserve Act. (See 12 CFR 250.248.)

For the preliminary review and assessment, review the bank's internal controls, policies, practices, and procedures for payment systems risk and electronic funds transfer (EFT) activities. The following procedures should be used:

1. Review previous examination reports, earlier workpapers, and correspondence exchanged with the institution to get an overview of previously identified EFT concerns.
2. Review the most recent audits and internal reviews to identify the scope and noted deficiencies.
3. Review management's actions to correct examination and audit deficiencies.
4. Discuss with management recent or planned changes in EFT activities.
5. Review management reports to determine the nature and volume of current activity.
6. Review the minutes of management committees that oversee EFT activity to determine their content and follow-up on material matters.

The bank's payment and EFT systems should be further reviewed and documented completely and concisely. Where appropriate, the preliminary review and assessment should include narrative descriptions, flowcharts, copies of forms used, and other pertinent information.

During the examination, the review of operations and internal controls of all institutions involved in funds-transfer or EFT activities should use the following procedures. Items below that are marked with an asterisk (*) require substantiation by observation or testing.

ORGANIZATION

1. Is there a current organization plan detailing the structure of the funds-transfer function?
2. Is senior management responsible for administering the operations of the funds-transfer function?
3. Does management maintain a current list of bank personnel who are authorized to initiate EFT requests?
4. Are there regular management reviews of staff compliance with the credit and personnel procedures, operating instructions, and internal controls?
5. Are activity and quality-control reports received and reviewed by management?
6. Are major new system designs and newly available hardware for the payment and EFT systems brought to the attention of and reviewed by management?

SUPERVISION BY DIRECTORS AND SENIOR MANAGEMENT

1. Are the directors and senior management kept informed about the nature and volume of transactions and the magnitude of the risks involved in the funds-transfer activity?
2. Has the board of directors or senior management reviewed and approved any limits on the risks in the funds-transfer activities? If so, when were the limits last reviewed?
3. Is senior management or the board of directors advised of any customers with—
   a. large intraday and overnight overdrafts? If so, are other extensions of credit to the same customers combined to show the total credit exposures?
   b. large drawings against uncollected funds?
4. Are management's responses to audit exceptions and recommendations adequate and timely?
5. Is there adequate insurance coverage for EFT risks? Does senior management conduct adequate reviews of insurance coverage and insurance riders for EFT operations and the overall EFT environment?

CREDIT MANAGEMENT, EVALUATION, AND APPROVAL

1. Under the bank's established board-of-directors policies and procedures, is senior management or the credit committee (or credit officers) required to review at predetermined frequencies—

  a. the volume of transactions, the creditworthiness of customers, and the risks involved in the funds-transfer activity?
  b. credit and other exposures as they relate to safe and sound banking practices?
  c. staff capabilities and the adequacy of equipment relative to current and expected volume?
2. Are procedures in place to prohibit transfers of funds against accounts that do not have collected balances or preauthorized credit availability?
3. Have counterparty and customer credit limits been established for all payment system risk exposures, including those relating to Fedwire, CHIPS, ACH, foreign exchange, and other types of payments? Do credit limits take into account intraday and overnight overdrafts?
   a. Are groups of affiliated customers included in such limits?
   b. Are limits set according to a clear and consistent methodology for credit-risk assessment?
   c. How often are the limits reviewed and updated?
   d. Does senior management monitor and review the customer limits? How frequently?
4. Are other types of credit facilities considered when establishing intraday-overdraft limits for the same customer?
5. Is an intraday-posting record kept for each customer, showing opening collected and uncollected balances, transfers in, transfers out, and the collected balances at the time payments are released?
6. If payments exceed the established limits, are steps taken in a timely manner to obtain covering funds?
7. Are there fully documented, periodic credit reviews of funds-transfer customers?
8. Are credit reviews conducted by competent credit personnel who are independent of account and operations officers?
9. Does the institution make payments in anticipation of receiving covering funds? If so, are such payments approved by officers who have the appropriate credit authority?
10. Are intraday exposures limited to amounts that are expected to be received the same day?
11. Do the limits on intraday and overnight overdrafts appear to be reasonable in view of the institution's capital position and the creditworthiness of the respective customers?
12. Does a staff supervisor approve payments in excess of established limits, following verification that the covering funds are in transit to the bank?
13. Before releasing payments, are payments against uncollected funds and intraday overdrafts in excess of established limits referred to a person with appropriate credit authority for approval, and is the reason for the overdraft determined?

PERSONNEL

1. Has the bank taken steps to ensure that screening procedures are applied to personnel that are hired for sensitive positions in the EFT departments?
2. Does the bank prohibit new or temporary employees from working in sensitive areas of the payment-systems and EFT operation?
3. Are statements of indebtedness required from employees who work in sensitive positions of the payment-systems and EFT function?
4. Does supervisory staff give special attention to employees newly assigned to work in the EFT functions?
5. Are employees subject to unannounced rotation of responsibilities, regardless of the size of the institution?
6. Are relatives of employees in the payment-systems and EFT function precluded from working in the same institution's bookkeeping or data processing departments?
7. Does the bank's policy require that employees take a minimum number of consecutive days as part of their annual vacation? Is this policy being enforced?
8. If employees have given notice of resignation or received termination notices, does management reassign them away from sensitive areas of the payment-systems and EFT function?
9. Are personnel informed of the current trends in transfer activities, including necessary internal controls, as part of a regular training program?

SIGNATURE CARDS

1. Does the bank maintain a current list or card file of authorized signers for customers who use the bank's funds-transfer services?
2. Are customer signature cards maintained under dual control or otherwise protected?
3. Do customer signature cards limit the number of authorized persons and the amount of funds that an individual is authorized to transfer?
4. Do bank personnel compare the signature on an original mail request with the authorized signature on file?

TEST KEYS

1. Do telephone requests and EFT transactions use test codes, and are the codes verified by a person other than the person receiving the request?
2. Are test codes restricted to authorized personnel?

*3. Are the files containing test-key formulas maintained under dual control or otherwise protected?

4. Are only authorized personnel permitted in the test-key area or allowed access to computers, teletapes, or terminals?
5. Does the bank maintain an up-to-date test-key file?
6. Does management maintain a list of those authorized persons who have access to test-key files?
7. Are all messages and transfer requests that require testing authenticated by the use of a test key?

*8. Are test codes verified by someone other than the person receiving the initial transfer request?

9. Are callback or other authentication procedures performed on all transfers that do not have a test key or signature card on file?
10. Do mail transfer requests include a test word as an authentication procedure?
11. Does the bank's test-key formula incorporate a sequence number resulting from an agreement between the bank and the customer?
12. Does the bank have procedures in operation for the issuance and cancellation of test keys?

*13. Is the responsibility for issuing and canceling test keys assigned to someone who is not responsible for testing the authenticity of transfer requests?

14. Are test codes maintained in a secure environment when they are not in use?
15. Is the testing area physically separated from other operations?

TELEPHONE TRANSFER REQUESTS

1. Has the bank established guidelines for what information should be obtained from a person making a funds-transfer request by telephone?
2. Does the above information include a test-word authentication code?
3. Does the bank use a callback procedure that includes a test-code authentication to verify telephone transfer requests?
4. Does the bank limit callbacks to transactions over a certain dollar amount?
5. Does the bank maintain a current list of persons who are authorized to initiate telephone funds transfers and messages?

*6. Does the bank have procedures in place to prohibit persons who receive telephone transfer requests from transmitting those requests?

7. Does the bank use devices that record all incoming and outgoing transfer requests?
8. Are prenumbered or sequentially numbered (at a central location after initiation) transfer-request forms used?
9. Is the log or record of transfer requests reviewed daily by supervisory personnel?
10. Do the records of transfer requests contain—
    a. a sequence number?
    b. an amount transferred?
    c. the person, firm, or bank making the request (also the specific transferor)?
    d. the date?
    e. the test-code authentication?
    f. paying instructions?
    g. authorizing signatures for certain types and dollar-amount transfers?

EFT REQUESTS

*1. Do different employees perform the functions of receipt, testing, and transmission of funds-transfer requests?
2. Do incoming and outgoing messages record the time, or are they sequentially numbered for control?
3. Do incoming and outgoing messages include a test word as a means of message authentication?
4. Is an unbroken copy of all messages kept throughout the business day?
5. Is the above copy reviewed and controlled by someone not connected with operations in the EFT area?

AGREEMENTS

1. With respect to EFT and payment-systems transfer operations between the bank and its hardware and software vendors, maintenance companies, customers, correspondent banks, the Federal Reserve, and other providers, are the agreements in effect and current? (The agreements with the appropriate Federal Reserve Bank should refer to the operating circulars regarding the transfer of funds pursuant to subpart B of Regulation J.)
2. Do the written agreements state the responsibilities of each party involved in the agreement?
3. Do the agreements state the vendors' liabilities for their employees' actions?

OPERATING AND PROCESSING PROCEDURES

1. Do written procedures exist for the EFT functions, and are they updated for employees in the incoming, preparation, data entry, balance-verification, transmission, accounting, reconciling, and security areas? Do these procedures include—
   a. control over test words, signature lists, and opening and closing messages?
   b. computer-terminal security and password controls?
   c. access to the funds-transfer and EFT areas and user files?
   d. origination, modification, deletion, or rejection of order transactions or messages?
   e. verification of the sequence numbers of orders?
   f. accounting for all transfer requests and message traffic at the end of the day?
   g. bank supervisory review of all adjustments, reversals, and the reasons therefor, as well as open items?
   h. planning for contingencies?
2. Are all incoming and outgoing payment orders and message requests in the EFT and funds-transfer area—
   a. time-recorded or sequentially numbered for control?
   b. logged?
   c. reviewed for test verification?
   d. reviewed for signature authenticity?
   e. reviewed to verify that the person who initiated the funds-transfer request was authorized to do so?
   f. authorized or reviewed by bank supervisory personnel?
3. Does the EFT department of the bank prepare a daily reconcilement of funds-transfer activity by dollar amount and number of messages?
4. Are all rejects or exceptions reviewed by someone who is not involved in the receipt, preparation, or transmittal of funds?
5. If the institution accepts transfer requests after the close of business or accepts transfer requests with a future value date, are they properly controlled and processed?
6. Are Federal Reserve Bank statements reviewed and reconciled daily with the bank's internal funds-transfer log to determine if there are "open" funds-transfer items and the reasons for the outstanding items?
7. Does an officer review corrections, overrides, open items, reversals, and other adjustments?
8. Does a person other than the receipt clerk review message requests and payment orders for—
   a. the propriety of the transactions?
   b. future dates, especially those for multiple transactions?
9. When reasonably feasible, does a supervisor check all transactions before the release of funds to a customer or before initiating a payment message over the EFT system?

10. At the end of a day, are all message requests and payment orders accounted for in an end-of-the-day proof to ensure that all requests have been processed?
11. Are internally rejected customer transfer requests and message requests controlled, and are they sequentially numbered for accountability?
12. Does an officer review and approve as-of adjustments, open items, reversals, and other adjustments?
13. Are key fields re-verified before transmission, and are messages released by someone other than the individual who originally entered the message?
14. Does the work flow in a one-way direction to provide adequate internal controls?
15. Are audit trails maintained from receipt through posting to a customer's account?
16. Are EFT activities adequately documented, and is there an adequate and active records-retention program?

ACCOUNTING, RECORDKEEPING, AND CONTROLS

1. Are Federal Reserve Bank, correspondent bank, and clearinghouse statements used for funds transfers reconciled daily in another area of the bank (for example, accounting or correspondent banking or by a person who is separate from any money-transfer operations) to ensure that they agree with the funds-transfer records?
2. Are all prenumbered forms, including cancellations, accounted for in the daily reconcilement, and do they include the account number and account title?
3. Is the daily reconcilement of funds-transfer and message-request activity reviewed by supervisory personnel?

*4. Is the balancing of daily activity conducted separately from the receiving, processing, and sending functions?

5. Does the EFT department verify that work sent to other bank departments agrees with its totals?
6. Are general-ledger entries, adjustments, automated transactions, or other supporting documents initialed by authorized persons?
7. Does the institution receive cables or other written communications from its customers that indicate amounts to be paid and received and the source of covering funds?
8. If the above detail of receipts is not received, do the institution's customers inform it of the total amount to be received for the day?
9. Is the information in items 7 and 8 maintained and followed for exceptions?
10. Is an intraday-posting record kept for each customer, showing opening collected and uncollected balances, transfers in, transfers out, and the collected balance at the time payments are released?
11. Are significant CHIPs or Fedwire customer payments and receipts communicated to a monitoring unit promptly during the day to provide adequate information on each customer's overall exposure?
12. Does the accounting system for demand deposits give an accurate collected-funds position?
13. Have limits been established within which a designated person may authorize release of payments after reviewing the customer's activity? Does the institution maintain a record of approvals of these releases?
14. When an overnight overdraft occurs, is a determination made as to whether a fail caused the overdraft? If so, is this determination properly documented? Are follow-up actions to obtain the covering funds in a timely manner adequate?
15. Does the institution have a record of payments it failed to make?
16. Is the above record reviewed to evaluate the efficiency of the department?
17. Is corrective action initiated when appropriate?
18. Are investigations and follow-ups for failed payments conducted by personnel who are independent of the operating unit?
19. Are customer advices issued in a timely manner? Do credit advices sent to customers clearly indicate that credits to their accounts that are received through CHIPS are conditional upon final settlement?
20. For the settling institutions on CHIPS, are the net debit positions of the nonsettling participants relayed to appropriate personnel as soon as the positions become known?
21. Are designated supervisory staff responsible for verifying that respondents' net debit positions are covered the same day?
22. Are the follow-up procedures adequate to facilitate the receipt of funds?

23. Are open-statement items, suspense accounts, receivables, or payables and interoffice accounts related to EFT activity controlled outside of the funds-transfer operations?
24. Do the following controls exist?
    a. Management prepares periodic reports on open-statement items, suspense items, and interoffice accounts.
    b. Reports include agings of open items, the status of significant items, and the resolution of prior significant items.
25. Do general-ledger tickets or other supporting documents include the initials of the originator and designated supervisory personnel?
26. Is senior management required to decide whether to refuse to cover a net debit settlement position of a respondent?
27. Has the institution devised and maintained an adequate system of internal accounting controls, as required by the Foreign Corrupt Practices Act?

AUDIT

1. Does management or the audit department undertake a periodic review to ensure that work is being performed in accordance with policy and guidelines established by the board of directors and senior management?
2. Is the audit department promptly informed when a change is made in systems or the method of operation?
3. Does the audit or independent-review program provide sufficient coverage relative to the magnitude (volume) and nature of EFT activities? Are independent reviews conducted, and do they address all areas of EFT business, including—
    a. payment-order origination (funds-transfer requests);
    b. message testing;
    c. credit evaluation;
    d. customer agreements;
    e. payment processing and accounting;
    f. personnel policies;
    g. physical and data security;
    h. contingency plans;
    i. credit evaluation and approval;
    j. incoming funds transfers;
    k. bank secrecy and foreign assets control, if applicable; and
    l. Federal Reserve payment system risk program and policy issues.

PHYSICAL SECURITY

1. Is access to the EFT area restricted to authorized personnel who have proper bank identification? In limited circumstances when visitors are necessary (such as for repairs of equipment), are they restricted, properly identified, required to sign in, and accompanied by authorized personnel at all times?
2. Is written authorization given to those employees who remain in the EFT area after normal working hours? Who gives such authority? Are security guards informed?
3. Are bank terminal operators or others in EFT operations denied access to computer areas or programs?
4. Do procedures prohibit computer personnel from gaining access to bank terminals or test-key information?
5. Does EFT equipment have physical or software locks to prohibit access by unauthorized personnel at all times?
6. Are terminals and other hardware in the EFT area shut down after normal working hours? Are they regulated by automatic time-out controls or time-of-day controls?
7. Are passwords suppressed when they are entered in terminals?
8. Are operator passwords frequently changed? If so, how often?
9. Is supervisory approval required to access terminals at other than authorized times?
10. Are passwords restricted to different levels of access, such as data files and transactions that can be initiated?
11. Are employees prohibited from taking access keys for sensitive equipment or software test keys out of the EFT area?

CONTINGENCY PLANS

1. Has management properly planned for contingencies, and has it developed a reasonable contingency plan and safeguards that are commensurate with the volume of EFT activity?

2. Does the bank maintain backup communications systems, and is supervisory approval required for their use?
3. Are procedures in place for sending and receiving transfers if the bank is forced to operate at a different site?
4. Are backup systems and equipment periodically tested by bank personnel?
5. Are there adequate procedures to ensure that data is recovered by the opening of the next business day's processing?
6. Have written contingency plans been developed and regularly tested in case of partial or complete failure of the bank's systems or of communication lines between the bank and the New York Clearing House, the Federal Reserve Bank, data centers, critical customers, or servicer companies?
7. Are contingency plans reviewed regularly and tested at least annually?
8. Has management distributed contingency plans to all personnel and stored appropriate copies off-site or in a central database?
9. If the bank processes a large volume of payments, does it maintain a backup facility that provides real-time recovery in case of a disaster or other disruption of the primary data center?
10. Are procedures in place for backup, off-site storage of critical information and for inventory control on hardware and software?
11. Do procedures exist to prevent the inadvertent release of test data into the production environment?
12. Are primary and backup telecommunication lines performance-tested frequently by authorized supervisory personnel?

For guidance and listed procedures on Fedline, EFT, and information technology standards, see chapters 18 and 19 of the *FFIEC Information Systems Examination Handbook.*

CONCLUSION

1. Is the foregoing information an adequate basis for evaluating internal control; that is, there are no significant internal-auditing procedures, accounting controls, administrative controls, or other deficiencies or circumstances in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
2. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).
3. If intraday credit is granted to any affiliates, has the bank established policies and procedures to monitor and control such exposures and ensure compliance with section 23B of the Federal Reserve Act, as required by Regulation H? (See 12 CFR 250.248.)
4. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (good, medium, or bad).
5. Will the credit risk resulting from funds transfers have an adverse impact on overall asset quality?
6. Does the allowance for loan and lease losses adequately include significant adverse credit risk that is derived from EFT activities?
7. Will the weaknesses identified from the review of payment systems risk and EFT activity have a negative impact on overall liquidity, earnings, or capital?

The role of bank regulators in supervising private-banking activities is (1) to evaluate management's ability to measure and control the risks associated with such activities and (2) to determine if the proper internal control and audit infrastructures are in place to support effective compliance with relevant laws and regulations. In this regard, the supervisors may determine that certain risks have not been identified or adequately managed by the institution, a potentially unsafe and unsound banking practice.

Private-banking functions may be performed in a specific department of a commercial bank, an Edge corporation or its foreign subsidiaries, a nonbank subsidiary, or a branch or agency of a foreign banking organization or in multiple areas of the institution. They may also be the sole business of an institution. Regardless of how an institution is organized or where it is located, the results of the private-banking review should be reflected in the entity's overall supervisory assessment.[1]

This section provides examiners with guidance for reviewing private-banking activities at all types and sizes of financial institutions. It is intended to supplement, not replace, existing guidance on the examination of private-banking activities and to broaden the examiner's review of general risk-management policies and practices governing private-banking activities. In addition to providing an overview of private banking, the general types of customers, and the various products and services typically provided, the Functional Review subsection describes the critical functions that constitute a private-banking operation and identifies certain safe and sound banking practices. These critical functions are Supervision and Organization, Risk Management, Fiduciary Standards, Operational Controls, Management Information Systems, Audit, and Compliance. Included in the risk-management portion is a description of the basic ''know-your-customer'' (KYC) principle that is the foundation for the safe and sound operation of a private-banking business. A self-explanatory Preparation for Examination subsection assists in defining the examination scope and provides a list of core requests to be made in the first-day letter. References also are made throughout this section to additional examination guidance in this manual and in the Federal Reserve System's *Bank Secrecy Act Manual, Trust Examination Manual, EDP Examination Manual*, and *Trading and Capital-Markets Activities Manual*.

In reviewing specific functional and product-examination procedures (found in the private-banking activities module that is part of the framework for risk-focused supervision of large complex institutions), all aspects of the private-banking review should be coordinated with the rest of the examination to eliminate unnecessary duplication of effort. Furthermore, this section has introduced the review of trust activities and fiduciary services, critical components of most private-banking operations, as part of the overall private-banking review. Although the product nature of these activities differs from that of other banking activities, such as lending and deposit taking, the functional components of private banking (supervision and organization, risk management, operational controls and management information systems, audit, compliance, and financial condition/business profile) should be reviewed across product lines.

OVERVIEW

Private banking offers the personal and discrete delivery of a wide variety of financial services and products to the affluent market, primarily to high net worth individuals and their corporate interests. A private-banking operation typically offers its customers an all-inclusive money-management relationship, including investment portfolio management, financial-planning advice, offshore facilities, custodial services, funds transfer, lending services, overdraft privileges, hold mail, letter-of-credit financing, and bill-paying services. As the affluent market grows, both in the United States and globally, competition to serve it is becoming more intense. Consequently, new entrants in the private-banking marketplace include banks and nonbank financial institutions, and private-banking products, services, technologies, and distribution channels are still evolving. A range of private-banking products and services may be offered to customers throughout an institution's global network of

1. Throughout this section, the word ''bank'' will be used to describe all types of financial institutions, and the term ''board of directors'' will be interchangeable with ''senior management'' of branches and agencies of foreign banks.

affiliated entities—including branches, subsidiaries, and representative offices—in many different regions of the world, including offshore secrecy jurisdictions.

Typically, private-banking customers are high net worth individuals who have minimum investible assets of $1 million. Institutions often differentiate domestic from international private banking, and they may further segregate the international function based on the geographic location of their international client base. International private-banking clients may be wealthy individuals who live in politically unstable nations and are seeking a safe haven for their capital. Therefore, obtaining detailed background information and documentation about the international client may be more difficult than it is for the domestic customer. Private-banking accounts may, for example, be opened in the name of an individual, a commercial business, a law firm, an investment advisor, a trust, a personal investment company (PIC), or an offshore mutual fund.

Private-banking accounts are usually generated on a referral basis. Every client of a private-banking operation is assigned a salesperson or marketer, commonly known as a relationship manager (RM), as the primary point of contact with the institution. The RM is generally charged with understanding and anticipating the needs of his or her wealthy clients, and then recommending services and products for them. The number of accounts an RM handles can vary, depending on the portfolio size or net worth of the particular accounts. RMs strive to provide a high level of support, service, and investment opportunities for their clients and tend to maintain strong, long-term client relationships. Frequently, RMs take accounts with them to other private-banking institutions if they change employment. Historically, initial and ongoing due diligence of private-banking clients is not always well documented in the institution's files because of RM turnover and confidentiality concerns.

Clients may choose to delegate a great deal of authority and discretion over their financial affairs to RMs. Given the close relationship between clients and their account officers, an integral part of the examination process is assessing the adequacy of managerial oversight of the nature and volume of transactions conducted within the private-banking department or with other departments of the financial institution, as well as determining the adequacy and integrity of the RM's procedures. Policy guidelines and management supervision should provide parameters for evaluating the appropriateness of all products, especially those involving market risk. Moreover, because of the discretion given to RMs, management should develop effective procedures to review client-account activity to protect the client from any unauthorized activity. In addition, ongoing monitoring of account activity should be conducted to detect activity that is inconsistent with the client profile (for example, frequent or sizeable unexplained transfers flowing through the account).

Finally, as clients develop a return-on-assets (ROA) outlook to enhance their returns, the use of leveraging and arbitrage is becoming more evident in the private-banking business. Examiners should be alert to the totality of the client relationship product by product, in light of increasing client awareness and use of derivatives, emerging-market products, foreign exchange, and margined accounts.

Products and Services

Personal Investment Companies, Offshore Trusts, and Token Name Accounts

Private-banking services almost always involve a high level of confidentiality regarding client-account information. Consequently, it is not unusual for private bankers to help their clients achieve their financial planning, estate planning, and confidentiality goals through offshore vehicles such as PICs, trusts, or more exotic arrangements, such as hedge-fund partnerships. While these vehicles may be used for legitimate reasons, without careful scrutiny, they may camouflage illegal activities. Private bankers should be committed to using sound judgment and enforcing prudent banking practices, especially when they are assisting clients in establishing offshore vehicles or token name accounts.

Through their global network of affiliated entities, private banks often form PICs for their clients. These "shell" companies, which are incorporated in offshore secrecy jurisdictions such as the Cayman Islands, Channel Islands, Bahamas, British Virgin Islands, and Netherlands Antilles, are formed to hold the customer's assets as well as offer confidentiality by opening accounts in the PIC's name. The "beneficial owners" of the shell corporations are typically foreign nationals. The banking institution should know and be able to document that it knows the beneficial owners of such corporations and that it has performed the appropriate due diligence to support these efforts. Emphasis should be placed on verifying the source or origin of the customer's wealth. Similarly, offshore trusts established in these jurisdictions should identify grantors of the trusts and sources of the grantors' wealth. *Anonymous relationships or relationships in which the RM does not know and document the beneficial owner should not be permitted.*

Deposit Taking

A client's private-banking relationship frequently begins with a deposit account, and then expands into other products. In fact, many institutions require private-banking customers to establish a deposit account before maintaining any other accounts. Deposit accounts serve as conduits for a client's money flows. To distinguish private-banking accounts from retail accounts, institutions usually require significantly higher minimum account balances and assess higher fees. The private-banking function or institution should have account-opening procedures and documentation requirements that must be fulfilled before a depository account can be opened. (These standards are described in detail in the Functional Review subsection.)

Most private banks offer a broad spectrum of deposit products, including multicurrency deposit accounts that are used by clients who engage in foreign-exchange, securities, and derivatives transactions. The client's transaction activity, such as wire transfers, check writing, and cash deposits and withdrawals, is conducted through deposit accounts (including current accounts). It is very important that the transaction activity into and out of these deposit accounts be closely monitored for suspicious transactions that are inconsistent with the client's profile of usual transactions. Suspicious transactions could warrant the filing of a suspicious-activity report.

Investment Management

In private banking, investment management usually consists of two types of accounts: (1) discretionary accounts in which portfolio managers make the investment decisions based on recommendations from the bank's investment research resources and (2) nondiscretionary (investment advisory) accounts in which clients make their own investment decisions when conducting trades. For nondiscretionary clients, the banks typically offer investment recommendations subject to the client's written approval. Discretionary accounts consist of a mixture of instruments bearing varying degrees of market, credit, and liquidity risk that should be appropriate to the client's investment objectives and risk appetite. Both account types are governed under separate agreements between the client and the institution.

Unlike depository accounts, securities and other instruments held in the client's investment accounts are not reflected on the balance sheet of the institution because they belong to the client. These managed assets are usually accounted for on a separate ledger that is segregated by the customer who owns the assets. For regulatory reporting, domestic trust departments and foreign trust departments of U.S. banks are required to report trust assets annually using FFIEC Form 001 (Annual Report of Trust Assets) and FFIEC Form 006 (Annual Report of International Fiduciary Activities). On the other hand, the fiduciary activities of foreign banking organizations operating in the United States currently are not reported on any FFIEC regulatory report.

Credit

Private-banking clients may request extensions of credit either on a secured or unsecured basis. Loans backed by cash collateral or managed assets held by the private-banking function are quite common, especially in international private banking. Private-banking clients may pledge a wide range of their assets, including cash, mortgages, marketable securities, land, or buildings, to securitize their loans. Management should demonstrate an understanding of the purpose of the credit, the source of repayment, and loan tenor as well as the collateral used in the financing. When lending to individuals with high net worths, whether on a secured or unsecured basis, the creditworthiness determination is bolstered by a thorough and well-structured KYC process. If that process is not thorough, collateral derived from illicit activities may be subject to government forfeiture.

Payable-Through Accounts

Another product that may be seen in private-banking operations is payable-through accounts (PTAs). PTAs are transaction deposit accounts through which U.S. banking entities (''payable-through banks'') extend check-writing privileges to the customers of a foreign bank. The foreign bank (''master account holder'') opens a master checking account with the U.S. bank and uses this account to provide its customers access to the U.S. banking system. The master account is divided into ''subaccounts,'' each in the name of one of the foreign bank's customers. The foreign bank extends signature authority on its master account to its own customers, who may not be known to the U.S. bank. Consequently, the U.S. bank may have customers who have not been subject to the same account-opening requirements imposed on its U.S. account holders. These subaccount customers are able to write checks and make deposits at the U.S. banking entity. The number of subaccounts permitted under this arrangement may be virtually unlimited.

U.S. banking entities engage in PTAs primarily because they attract dollar deposits from the domestic market of their foreign correspondents without changing the primary bank/customer relationship; PTAs also provide substantial fee income. Generally, PTAs at U.S. banking entities have the following characteristics: they are carried out on the U.S. banking entity's books as a correspondent bank account, their transaction volume is high, checks passing through the account contain wording similar to ''payable through XYZ bank,'' and the signatures appearing on checks are not those of authorized officers of the foreign bank.

Personal Trust and Estates

Trust and estate accounts offer management services for assets. When dealing with trusts under will, or ''testamentary trusts,'' the institution may receive an estate appointment (executor) and a trustee appointment if the will provided for the trust from the probate. These accounts are fully funded at origination with no opportunity for an outside party to add to the account, and all activities are subject to review by the probate or surrogates' court. On the other hand, with living trusts, or ''grantor trusts,'' the customer (grantor) may continually add to and, in some instances, has control over the corpus of the account. Trusts and estates require experienced attorneys, money managers, and generally well-rounded professionals to set up and maintain the accounts. In certain cases, bankers may need to manage a customer's closely held business or sole proprietorship. In the case of offshore trust facilities, recent changes in U.S. law have imposed additional obligations on those banks who function as trustees or corporate management for offshore trusts and PICs.

A critical element in offering personal trust and estate services is the fiduciary responsibility of the institutions to their customers. This responsibility requires that institutions always act in the best interest of the clients pursuant to the trust documentation, perhaps even to the detriment of the bank. In these accounts, the bank is the fiduciary and the trust officer serves as a representative of the institution. Fiduciaries are held to higher standards of conduct than other bankers. Proper administration of trusts and estates includes strict controls over assets, prudent investment and management of assets, and meticulous recordkeeping.

Custody Services

Custodial services offered to private-banking customers include securities safekeeping, receipts and disbursements of dividends and interest, recordkeeping, and accounting. Custody relationships can be established in many ways, including by referrals from other departments in the bank or from outside investment advisors. The customer, or a designated financial advisor, retains full control of the investment management of the property subject to the custodianship. Sales and purchases of assets are made by instruction from the customer, and cash disbursements are prearranged or as instructed. Custody accounts involve no investment supervision and no discretion. However, the custodian may be responsible for certain losses if it fails to act properly according to the custody agreement. Therefore, procedures for proper administration should be established and reviewed.

An escrow account is a form of custody account in which the institution agrees to hold cash or securities as a middleman, or third party. The customer, who may be an attorney or travel agency, gives the institution funds to hold until the ultimate receiver of the funds ‘‘performs’’ in accordance with the written escrow agreement, at which time the institution releases the funds to the designated party.

Funds Transfer

Funds transfer, another service offered by private-banking functions, may involve the transfer of funds between third parties as part of bill-paying and investment services on the basis of customer instructions. The adequacy of controls over funds-transfer instructions that are initiated electronically or telephonically, such as by facsimile machine, telex, telegram, and telephone, are extremely important. Funds-transfer requests are quickly processed and, as required by law, funds-transfer personnel may have limited knowledge of the customers or the purpose of the transactions. Therefore, strong controls and adequate supervision over this area are critical.

Hold Mail

Hold-mail, or no-mail, accounts are often provided to private-banking customers who elect to have bank statements and other documents maintained at the institution rather than mailed to their residence. Agreements for all hold-mail accounts should be in place, and they should indicate that it was the customer’s choice to have the statements retained at the bank and that the customer will pick up his or her mail at least annually. Variations of hold-mail services include delivery of mail to a prearranged location (such as another branch of the bank) by special courier or the bank’s pouch system.

Bill-Paying Services

Bill-paying services are often provided to private-banking customers for a fee. If this service is provided, an agreement between the bank and the customer should exist. Typically, a customer might request that the bank debit a deposit account for credit card bills, utilities, rent, mortgage payments, or other monthly consumer charges.

FUNCTIONAL REVIEW

When discussing the functional aspects of a private-banking operation, ‘‘functional’’ refers to managerial processes and procedures, such as reporting lines, quality of supervision (including involvement of the board of directors), information flows, policies and procedures, risk-management policies and methodologies, segregation of duties, management information systems, operational controls, and audit coverage. The examiner should be able to draw sound conclusions about the quality and culture of management and stated private-banking policies after reviewing the functional areas described below. Specifically, the institution’s risk-identification process and risk appetite should be carefully defined and assessed. Additionally, the effectiveness of the overall control environment maintained by management should be evaluated by an internal or external audit. The effectiveness of the following functional areas is critical to any private-banking operation, regardless of its size or product offerings.

Supervision and Organization

As part of the examiner’s appraisal of an organization, the quality of supervision of private-banking activities is evaluated. The appraisal of management covers the full range of functions and activities related to the operation of the private bank. The discharge of responsibilities by bank directors should be effected through an organizational plan that accommodates the volume and business services handled, local business practices and the bank’s competition, and the growth and development of the institution’s private-banking business. Organizational planning is the joint responsibility of senior bank and private-bank management and should be integrated with the long-range plan for the institution.

Both the directors and management have important roles in formulating policies and establishing programs for private-banking products, operations, internal controls, and audits. However, management alone must implement policies and programs within the organizational framework instituted by the board of directors.

Risk Management

Sound risk-management processes and strong internal controls are critical to safe and sound banking generally and to private-banking activities in particular. Management's role in ensuring the integrity of these processes has become increasingly important as new products and technologies are introduced. Similarly, the client-selection, documentation, approval, and account-monitoring processes should adhere to sound and well-identified practices.

The quality of risk-management practices and internal controls is given significant weight in the evaluation of management and the overall condition of private-banking operations. A bank's failure to establish and maintain a risk-management framework that effectively identifies, measures, monitors, and controls the risks associated with products and services should be considered unsafe and unsound conduct. Furthermore, well-defined management practices should indicate the types of clients that the institution will accept and not accept and should establish multiple and segregated levels of authorization for accepting new clients. Institutions that follow sound practices will be better positioned to design and deliver products and services that match their clients' legitimate needs, while reducing the likelihood that unsuitable clients might enter their client account base. Deficiencies noted in this area are weighted in context of the relative risk they pose to the institution and are appropriately reflected in the appraisal of management.

The private-banking function is exposed to a number of risks, including reputational, fiduciary, legal, credit, operational, and market. A brief description of some of the different types of risks follows:

- *Reputational risk* is the potential that negative publicity regarding an institution's business practices and clients, whether true or not, could cause a decline in the customer base, costly litigation, or revenue reductions.
- *Fiduciary risk* refers to the risk of loss due to the institution's failure to exercise loyalty; safeguard assets; and, for trusts, to use assets productively and according to the appropriate standard of care. This risk generally exists in an institution to the extent that it exercises discretion in managing assets on behalf of a customer.
- *Legal risk* arises from the potential of unenforceable contracts, client lawsuits, or adverse judgments to disrupt or otherwise negatively affect the operations or condition of a banking organization. One key dimension of legal risk is supervisory action that could result in costly fines or other punitive measures being levied against an institution for compliance breakdowns.
- *Credit risk* arises from the potential that a borrower or counterparty will fail to perform on an obligation.
- *Operational risk* arises from the potential that inadequate information systems, operational problems, breaches in internal controls, fraud, or unforeseen catastrophes will result in unexpected losses.

Although effective management of all of the above risks is critical for an institution, certain aspects of reputational, legal, and fiduciary risks are often unique to a private-banking function. In this regard, the following KYC policies and practices are essential in the management of reputational and legal risks in the private-banking functions. (In addition, sound fiduciary practices and conflicts-of-interest issues that a private-banking operation may face in acting as fiduciary are described in the subsection on fiduciary standards.)

Know-Your-Customer Policy and Procedures

Sound KYC policies and procedures are essential to minimize the risks inherent in private banking. They should clearly describe the target client base in terms such as minimum investable net worth and types of products sought, as well as specifically indicate the type of clientele the institution will or will not accept. They should be designed to ensure that effective due diligence is performed on all potential clients, that client files are bolstered with additional KYC information on an ongoing basis, and that client-account activity is monitored for transactions that are inconsistent with the client profile and may constitute unlawful activities, such as money laundering. The client's identity, background, and the nature of his or her transactions should be documented and approved by the back office before opening an account or accepting client monies. Certain high-risk clients like foreign politicians or money exchange houses should have additional documentation to mitigate their higher risk.

Money laundering is associated with a broad range of illicit activities: the ultimate intention is to disguise the money's true source—from the initial placement of illegally derived cash proceeds to the layers of financial transactions that disguise the audit trail—and make the funds appear legitimate. Under U.S. money-laundering statutes, a bank employee can be held personally liable if he or she is deemed to engage in ''willful blindness.'' This condition occurs when the employee fails to make reasonable inquiries to satisfy suspicions about client-account activities.

Since the key element of an effective KYC policy is a comprehensive knowledge of the client, the bank's policies and procedures should clearly reflect the controls needed to ensure the policy is fully implemented. KYC policies should clearly delineate the accountability and authority for opening accounts and for determining if effective KYC practices and due diligence have been performed on each client. In addition, policies should delineate due diligence, documentation standards, and accountability for gathering client information from referrals among departments or areas within the institution as well as from accounts brought to the institution by new RMs.

In carrying out prudent KYC practices and due-diligence efforts on potential private-banking customers, management should document efforts to obtain and corroborate critical background information. Private-banking employees abroad often have local contacts who can assist in corroborating information received from the customer. The information listed below should be corroborated by a reliable independent source, when possible:

- The customer's current address and telephone number for his or her primary residence, which should be corroborated at regular intervals, can be verified through a variety of methods, such as—
  - — visiting the residence, office, factory, or farm (with the RM recording the results of the visit or conversations in a memorandum);
  - — checking the information against the telephone directory; the client's residence, as indicated on his or her national ID card; a mortgage or bank statement or utility or property tax bill; or the electoral or tax rolls;
  - — obtaining a reference from the client's government or known employer or from another bank;
  - — checking with a credit bureau or professional corroboration organization; or
  - — any other method verified by the RM.
- Sufficient business information about the customer should be gathered so that the RM understands the profile of the customer's commercial transactions. This information should include a description of the nature of the customer's business operations or means of generating income, primary trade or business areas, and major clients and their geographic locations, as well as the primary business address and telephone number. These items can be obtained through a combination of any of the following sources:
  - — a visit to the office, factory or farm
  - — a reliable third party who has a business relationship with the customer
  - — financial statements
  - — Dun and Bradstreet reports
  - — newspaper or magazine articles
  - — Lexis/Nexis reports on the customer or customer's business
  - — ''Who's Who'' reports from the home country
  - — private investigations
- Although it is often not possible to get proof of a client's wealth, an RM can use his or her good judgment to derive a reasonable estimate of the individual's net worth.
- As part of the ongoing KYC process, the RM should document in ''call reports'' the substance of discussions that take place during frequent visits with the client. Additional information about a client's wealth, business, or other interests provides insight into potential marketing opportunities for the RM and the bank, and updates and strengthens the KYC profile.

As a rule, most private banks make it a policy not to accept ''walk-ins.'' If an exception is made, procedures for the necessary documentation and approvals supporting the exception should be in place. Similarly, other exceptions to policy and procedures should readily identify the specific exception and the required due-diligence and approval process to override existing procedures.

In most instances, all KYC information and documentation should be maintained and available for examination and inspection at the location where the account is located or where the financial services are rendered. If the bank maintains centralized customer files in locations other than where the account is located or the financial services are rendered, complete customer information, identification, and documentation must be made available at the location where the account is located or where the financial services are rendered within 48 hours of a Federal Reserve examiner's request. Off-site storage of KYC information will be allowed only if the bank has adopted, as part of its ''Know Your Customer Program,'' specific procedures designed to ensure that (1) the accounts are subject to ongoing Office of Foreign Assets Control screening that is equivalent to the screening afforded other accounts, (2) the accounts are subject to the same degree of review for suspicious activity, and (3) the bank demonstrates that the appropriate review of the information and documentation is being performed by personnel at the offshore location.

KYC procedures should be no different when the institution deals with a financial advisor or other type of intermediary acting on behalf of a client. To perform its KYC responsibilities when dealing with a financial advisor, the institution should identify the beneficial owner of the account (usually the intermediary's client, but in rare cases, it is the intermediary itself) and perform its KYC analysis with respect to that beneficial owner. The imposition of an intermediary between the institution and counterparty should not lessen the institution's KYC responsibilities.

The purpose of all private-banking relationships should also be readily identified. Incoming customer funds may be used for various purposes such as establishing deposit accounts, funding investments, or establishing trusts. The bank's KYC procedures should allow for the collection of sufficient information to develop a ''transaction/client profile'' for each customer to be used in analyzing client transactions. Internal systems should be developed for monitoring and identifying transactions that may be inconsistent with the customer's transaction/client profile and may thus constitute suspicious activity.

Suspicious-activity reports. The proper and timely filing of suspicious-activity reports (SARs) is an important component of the bank's KYC program. Under the SAR regulations, banks must report any suspicious transaction relevant to a possible violation of law or regulation if the transaction is—

> conducted or attempted, by, at or through a bank, involves $5,000 or more, and, the bank knows, suspects or has reason to suspect either: the transaction involves funds from illegal activities or is conducted in order to hide or disguise assets; is designed to evade Bank Secrecy Act (''BSA'') record keeping or reporting requirements; or the transaction has no business or apparent lawful purpose or is not the sort in which the particular customer would normally be expected to engage, and the bank knows of no reasonable explanation for the transaction after examining the available facts, including the background and possible purpose of the transaction.

The concept of ''reason to suspect'' implies that bank liability is incurred for failing to file an SAR if it did not exercise due diligence in monitoring the account or in determining the true identity of the customer. The bank's internal systems for capturing suspicious activities should provide essential information about the nature and volume of activities passing through customer accounts. It is important that any information suggesting that suspicious activity has occurred be pursued, and, if an explanation is not forthcoming, the matter should be reported to bank management. Examiners should ensure that the bank's approach to SARs is proactive and that well-established procedures cover the SAR process. Accountability should exist within the organization for the analysis and follow-up of internally identified suspicious activity, which concludes with a decision on the appropriateness of filing an SAR. Examiners should see sections 902 and 1002 of the *Bank Secrecy Act Manual* for specific procedures on identifying suspicious activities related to teller and wire-transfer functions.

Credit

The underwriting standards for private-banking loans to high net worth individuals should be consistent with prudent lending standards. The same credit policies and procedures that are applicable to any other type of lending arrangement should extend to these loans. At a minimum, sound policies and procedures should address the following: all approved credit products and services offered by the institution, lending limits, acceptable forms of collateral, geographic and other limitations, conditions under which credit is granted, repayment terms, maximum tenor, loan authority, collections and charge-offs, and prohibition against capitalization of interest.

An extension of credit based solely on collateral, even if the collateral is cash, does not ensure repayment. While the collateral enhances the bank's position, it should not substitute for regular credit analyses and prudent lending practices. If collateral is derived from illegal activities, it is subject to forfeiture through the seizure of assets by a government agency. The bank should perform its due diligence by adequately and reasonably ascertaining and documenting that the funds of its private-banking customers were derived from legitimate means. Banks should also verify that the use of the loan proceeds is for legitimate purposes.

In addition, bank policies should explicitly describe the terms under which ‘‘margin loans,’’ loans collateralized by securities, are made and should ensure that they conform to applicable regulations. Management should review and approve daily MIS reports. The risk of market deterioration in the value of the underlying collateral may subject the lender to loss if the collateral must be liquidated to repay the loan. In the event of a ‘‘margin call,’’ any shortage should be paid for promptly by the customer from other sources pursuant to the terms of the margin agreement.

In addition, policies should address the acceptance of collateral held at another location, such as an affiliated entity, but pledged to the private-banking function. Under these circumstances, management of the private-banking function should, at a minimum, receive frequent reports detailing the collateral type and current valuation. In addition, management of the private-banking function should be informed of any changes or substitutions in collateral.

Fiduciary Standards

Fiduciary risk is managed through the maintenance of an effective and accountable committee structure; retention of technically proficient staff; and the development of effective policies, procedures, and controls. In managing its fiduciary risk, the bank must ensure that it carries out the following fiduciary duties:

- *Duty of loyalty.* Trustees are obligated to make all decisions based exclusively on the best interests of trust customers. Except as permitted by law, trustees cannot place themselves in a position in which their interests might conflict with those of the trust beneficiaries.
- *Avoidance of conflicts of interest.* Conflicts of interest arise in any transaction in which the fiduciary simultaneously represents the interests of multiple parties (including its own interests) which may be adverse to one another. Institutions should have detailed policies and procedures regarding potential conflicts of interests. All potential conflicts identified should be brought to the attention of management and the trust committee, with appropriate action taken. Conflicts of interest may exist in any part of the institution but are most prevalent in trust or investment management departments. Consequently, management throughout the institution should receive training in these matters.
- *Duty to prudently manage discretionary trust and agency assets.* Since 1994, the majority of states have adopted laws concerning the prudent investor rule (PIR) with respect to the investment of funds in a fiduciary capacity. PIR is a standard of review that imposes an obligation to prudently manage the portfolio as a whole, focusing on the process of portfolio management, rather than on the outcome of individual investment decisions. Although this rule only governs trusts, this standard is traditionally applied to all accounts for which the institution is managing funds.

Operational Controls

To minimize any operational risks associated with private-banking activities, management is responsible for establishing an effective internal control infrastructure and reliable management information systems. Critical operational controls over any private-banking activity include the establishment of written policies and procedures, segregation of duties, and comprehensive management reporting. Throughout this manual, specific guidelines and examination procedures for assessing internal controls over different private-banking activities are provided. Listed below are some of those guidelines which cover specific private-banking services.

Segregation of Duties

Banking organizations should have guidelines on the segregation of employees' duties to prevent the unauthorized waiver of documentation requirements, poorly documented referrals, and overlooked suspicious activities. Independent oversight by the back office helps to ensure compliance with account-opening procedures and KYC documentation. Control-conscious institutions may use independent units such as compliance, risk management, or senior management to fill this function in lieu of the back office. The audit and compliance functions of the private bank should be similarly independent so that they can operate autonomously from line management.

Inactive and Dormant Accounts

Management should be aware that banking laws in most states prohibit banks from offering services that allow deposit accounts to be inactive for prolonged periods of time (12 or more months with no externally generated account-balance activity). These regulations are based on the presumption that inactive and dormant accounts may be subject to manipulation and abuse by insiders. Policies and procedures should delineate when inactivity occurs and when inactive accounts should be converted to dormant status. Effective controls over dormant accounts should include a specified time between the last customer-originated activity and its classification as dormant, segregation of signature cards for dormant accounts, dual controls of records, and blocking of the account so that entries cannot be posted to the account without review by more than one member of senior management.

Pass-Through Accounts and Omnibus Accounts

Pass-through accounts (PTAs) extend checking-account privileges to the customers of a foreign bank; several risks are involved in providing these accounts. In particular, if the U.S. banking entity does not exercise the same due diligence and customer vetting for PTAs as it does for domestic account relationships, the use of PTAs may facilitate unsafe and unsound banking practices or illegal activities, including money laundering. Additionally, if accounts at U.S. banking entities are used for illegal purposes, the entities could be exposed to reputational risk and risk of financial loss due to asset seizures and forfeitures brought by law enforcement authorities. As stated in SR-95-10, it is recommended that U.S. banking entities terminate a payable-through arrangement with a foreign bank in situations in which (1) adequate information about the ultimate users of PTAs cannot be obtained, (2) the foreign bank cannot be relied on to identify and monitor the transactions of its own customers, or (3) the U.S. banking entity is unable to ensure that its payable-through accounts are not being used for money-laundering or other illicit purposes.

"Omnibus," or general clearing, accounts may also exist in the private-banking system. They may be used to accommodate client funds before an account opening to expedite a new relationship, or they may fund products such as mutual funds in which client deposit accounts may not be required. However, these accounts could circumvent an audit trail of client transactions. Examiners should carefully review a bank's use of such accounts and the adequacy of its controls surrounding their appropriate use. Generally, client monies should flow through client deposit accounts, which should function as the sole conduit and paper trail for client transactions.

Hold Mail

Controls over hold mail are critical because the clients have relinquished their ability to detect unauthorized transactions in their accounts in a timely manner. Accounts with high volume or significant losses warrant further inquiry. Hold-mail operations should ensure that client accounts are subject to dual control and are reviewed by an independent party.

Funds Transfer

One way that institutions can improve their customer knowledge is by tracking the transaction flows into and out of customer accounts and payable-through subaccounts. Tracking should include funds-transfer activities. Policies and procedures to detect unusual or suspicious activities should identify the types of activities that would prompt staff to investigate the customer's activities, and provide guidance on the appropriate action required for suspicious activity. The following is a checklist to guide bank personnel in identifying some potential abuses:

- indications of frequent overrides of established approval authority or other internal controls
- intentional circumvention of approval authority by splitting transactions
- wire transfers to and from known secrecy jurisdictions
- frequent or large wire transfers for persons who have no account relationship with the bank, or funds being transferred into and out of an omnibus or general clearing account instead of the client's deposit account
- wire transfers involving cash amounts in excess of $10,000
- inadequate control of password access
- customer complaints or frequent error conditions

Custody

Custody departments should monitor account activity to detect instances of ‘‘free-riding,’’ the practice of offering the purchase of securities without sufficient capital and then using the proceeds of the sale of the same securities to cover the initial purchase. Free-riding poses significant risk to the institution and typically occurs without the bank's prior knowledge. Free-riding also violates margin rules (Regulations T, U, and X) governing the extension of credit in connection with securities transactions.

Management Information Systems

Management information systems (MIS) should accumulate, interpret, and communicate information on (1) the private-banking assets under management, (2) profitability, (3) business and transaction activities, and (4) inherent risks. The form and content of MIS for private-banking activities will be a function of the size and complexity of the private-banking organization. Accurate, informative, and timely reports that perform the following functions may be prepared and reviewed by RMs and senior management:

- aggregate the assets under management according to customer, product or service, geographic area, and business unit
- attribute revenue according to customer and product type
- identify customer accounts that are related or affiliated with one another through common ownership or common control
- identify and aggregate customer accounts by source of referral
- identify beneficial ownership of trust, PIC, and similar accounts

To monitor and report transaction activity and to detect suspicious transactions, management reports may be developed to—

- monitor a specific transaction criterion, such as a minimum dollar amount or volume or activity level;
- monitor a certain type of transaction, such as one with a particular pattern;
- monitor individual customer accounts for variations from established transaction and activity profiles based on what is usual or expected for that customer; and
- monitor specific transactions for BSA and SAR compliance.

In addition, reports prepared for private-banking customers should be accurate, timely, and informative. Regular reports and statements prepared for private-banking customers should adequately and accurately describe the application of their funds and detail all transactions and activity that pertain to the customers' accounts.

Furthermore, MIS and technology play a role in building new and more direct channels of information between the institution and its private-banking customers. Active and sophisticated customers are increasing their demand for data relevant to their investment needs, which is fostering the creation of on-line information services. Such on-line information can satisfy customers' desire for convenience, real-time access to information, and a seamless delivery of information.

Audit

An effective audit function is vital to ensuring the strength of a private bank's internal controls. As a matter of practice, internal and external auditors should be independently verifying and confirming that the framework of internal controls is being maintained and operated in a manner that adequately addresses the risks associated with the activities of the organization. Critical elements of an effective internal audit function are the strong qualifications and expertise of the internal audit staff and a sound risk-assessment process for determining the scope and frequency of specific audits. The audit process should be risk-focused and should ultimately determine the risk rating of business lines and client KYC procedures. Compliance with KYC policies and procedures and the detailed testing of files for KYC documentation are also key elements of the audit function. Finally, examiners should review and evaluate management's responsiveness to criticisms by the audit function.

Compliance

The responsibility for ensuring effective compliance with relevant laws and regulations may vary among different forms of institutions, depending on their size, complexity, and availability of resources. Some institutions may have a distinct compliance department with the centralized role of ensuring compliance institution-wide, including private-banking activities. This arrangement is strongly preferable to a situation in which an institution delegates compliance to specific functions, which may result in the management of private-banking operations being responsible for its own internal review. Compliance has a critical role in monitoring private-banking activities; the function should be independent of line management. In addition to ensuring compliance with various laws and regulations such as the Bank Secrecy Act and those promulgated by the Office of Foreign Assets Control, compliance may perform its own internal investigations and due diligence on employees, customers, and third parties with whom the bank has contracted in a consulting or referral capacity and whose behavior, activities, and transactions appear to be unusual or suspicious. Institutions may also find it beneficial for compliance to review and authorize account-opening documentation and KYC adequacy for new accounts. The role of compliance is a control function, but it should not be a substitute for regular and frequent internal audit coverage of the private-banking function. Following is a description of certain regulations that may be monitored by the compliance function.

Office of Foreign Assets Control

The function of the Office of Foreign Assets Control (OFAC) in the U.S. Department of the Treasury is to promulgate and administer regulations dealing with the economic sanctions that the U.S. government imposes against certain foreign countries and the ''specially designated nationals'' of those countries. Under the International Emergency Economic Powers Act, the president can impose sanctions such as trade embargoes, freezing of assets, and import surcharges on these entities.

A ''specially designated national'' is a person or entity who acts on behalf of one of the countries under economic sanction by the United States. Dealing with such nationals is prohibited. Moreover, their assets or accounts in the United States are frozen. In certain cases, the Treasury Department can issue a license to a designated national. This license can then be presented by the customer to the institution, allowing the institution to debit his or her account. The license can be either general or specific.

OFAC screening may be difficult when transactions are conducted through PICs, token names, numbered accounts, or other vehicles that shield true identities. Management must ensure that accounts maintained in a name other than that of the beneficial owner are subject to the same level of filtering for OFAC specially designated nationals and blocked foreign countries as other accounts. That is, the OFAC screening process must include the account's beneficial ownership as well as the official account name.

Any violation of regulations implementing designated national sanctions subjects the violator to criminal prosecution, including up to 12 years in prison and $1 million in corporate fines and $250,000 in individual fines, per incident. Any funds frozen because of OFAC orders should be placed in a blocked account. Release of those funds cannot occur without a license from the Treasury Department.

Bank Secrecy Act

Guidelines for compliance with the Bank Secrecy Act (BSA) can be found in the Federal Reserve System's *Bank Secrecy Act Examination Manual*. In addition, the procedures for conducting BSA examinations of foreign offices of U.S. banks are detailed in SR-96-5.

PREPARATION FOR EXAMINATION

The following subsections provide examiners with guidance on preparing for the on-site examination of private-banking operations, including determination of the examination scope and drafting of the first-day-letter questionnaire that is provided to the institution.

Pre-Examination Review

To prepare the examiners for their assignments, and to determine the appropriate staffing and scope of the examination, the following guidelines should be followed during the pre-examination planning process:

- Review the prior report of examination and workpapers for the exam scope; structure and type of private-banking activities conducted; and findings, conclusions, and recommendations of the prior examination. The prior examination report and examination plan should also provide insight to key contacts at the institution and to the timeframe of the prior private-banking review.
- Obtain relevant correspondence sent since the prior examination, such as management's response to the report of examination, any applications submitted to the Federal Reserve, and any supervisory action.
- Research press releases and published news stories about the institution and its private-banking activities.
- Review internal and external audit reports and any internal risk assessments performed by the institution on its private-banking activities. Such reports should include an assessment of the internal controls and risk profile of the private-banking function.
- Contact management at the institution to ascertain what changes have occurred since the last exam or are planned in the near future. For example, have there been changes to the strategic plan; senior management; or the level and type of private-banking activities, products, and services offered? If there is no mention of private banking in the prior examination report, management should be asked at this time if they have commenced or plan to commence any private-banking activities.

Examination Staffing and Scope

Once the exam scope has been established and before beginning the new examination, the examiner-in-charge and key administrators of the examination team should meet to discuss the private-banking examination scope, the assignments of the functional areas of private banking, and the supplemental reviews of specific private-banking products and services. If the bank's business lines and services overlap, and its customer base and personnel are shared throughout the organization, examiners may be forced to go beyond a rudimentary review of private-banking operations. They will probably need to focus on the policies, practices, and risks within the different divisions of a particular institution and throughout the institution's global network of affiliated entities.

Reflection of Organizational Structure

The review of private-banking activities should be conducted on the basis of the financial institution's organizational structure. These structures may vary considerably depending on the size and sophistication of the institution, its country of origin and the other geographic markets in which it competes, and the objectives and strategies of its management and board of directors. To the extent possible, examiners should understand the level of consolidated private-banking activities an institution conducts in the United States and abroad. This broad view is needed to maintain the ‘‘big picture’’ impact of private banking for a particular institution.

Risk-Focused Approach

Examiners reviewing the private-banking operations should implement the ‘‘risk-focused’’ examination approach. The exam scope and degree of testing of private-banking practices should reflect the degree of risk assumed, prior exam findings on the implementation of policies and procedures, the effectiveness of controls, and an assessment of the adequacy of the internal audit and compliance functions. If initial inquiries into the institution’s internal audit and other assessment practices raise doubts about the internal system’s effectiveness, expanded analysis and review are required—and examiners should perform more transaction testing.

First-Day Letter

As part of the examination preparation, examiners should customize the first-day-letter (FDL) questionnaire to reflect the structure and type of private-banking activities of the institution and the scope of the exam. The following is a list of requests regarding private banking that examiners should consider including in the FDL. Responses to these items should be reviewed in conjunction with responses to the BSA, fiduciary, audit, and internal control inquiries:

- organizational chart for the private bank on both a functional and legal-entity basis
- business and/or strategic plan
- income and expense statements for the prior fiscal year and current year to date, with projections for the remainder of the current and the next fiscal year, and income by product division and marketing region
- balance sheet and total assets under management (list the most active and profitable accounts by type, customer domicile, and responsible account officer)
- most recent audits for private-banking activities
- copies of audit committee minutes
- copy of the KYC and SAR policies and procedures
- list of all new business initiatives introduced last year and this year, relevant new-product-approval documentation that addresses the evaluation of the unique characteristics and risk associated with the new activity and/or product, and an assessment of the risk-management oversight and control infrastructures in place to manage the risks
- list of all accounts in which an intermediary is acting on behalf of clients of the private bank, for example, as financial advisors or money managers
- explanation of the methodology for following up on outstanding account documentation and a sample report
- description of the method for aggregating client holdings and activities across business units throughout the organization
- explanation of how related accounts, such as common control and family link, are identified
- name of a contact person for information on compensation, training, and recruiting programs for relationship managers
- list of all personal investment company accounts
- list of reports that senior management receives regularly on private-banking activities
- description and sample of the management information reports that monitor account activity
- description of how senior management monitors compliance with global policies for worldwide operations, particularly for offices operating in secrecy jurisdictions
- copies of any SARs filed since the last examination

1. To determine if the policies, practices, procedures, and internal controls regarding private-banking activities are adequate.
2. To determine if bank officers and employees are operating in conformance with the bank's established guidelines.
3. To assess the financial condition of the private-banking activities.
4. To determine the scope and adequacy of the audit function.
5. To determine compliance with applicable laws and regulations.
6. To initiate corrective action when policies, practices, procedures, or internal controls are deficient, or when violations of laws or regulations are noted.

INTRODUCTION

The Securities Act of 1933 requires that adequate and reliable information be made available about securities originally offered for sale to the public. The act requires registration of any sale with the Securities and Exchange Commission (SEC) unless it is specifically exempted. Section 4(2) of the act exempts ''transactions by an issuer not involving any public offering.'' That exemption created a type of business in the securities industry known as ''private placements.''

Securities placed privately have certain advantages and disadvantages for both investor and issuer. Through negotiation, both parties may tailor the offering to meet their needs. The issuer saves securities registration costs and obtains alternative financing. The investor makes an investment for a specified length of time at a stated rate of return. Both investor and issuer complete the transaction without being subject to regulatory and public scrutiny.

The major disadvantage of private placements to the investor is the general lack of a secondary market. Thus, the investor may be unable to liquidate the holding until maturity. Additionally, the investor must rely on her or his own expertise when deciding on a purchase. Unlike registered securities, private placements are not reviewed by the SEC. A disadvantage to the issuer is the limitation on the amount of capital that may be raised since the number of investors is usually small. Moreover, advisory fees may be high relative to the size of the issue.

The matching of issuers with investors is usually done by an individual or firm acting as either an agent or an advisor. In the agent relationship, the firm has authority to commit the issuer. An advisor has no such power. Regardless of whether the firm is agent or advisor, it must act prudently and disclose all pertinent information to the investor. Furthermore, the firm must avoid possible conflicts of interest. Agents, usually investment bankers, participate in negotiations between the issuer and investor, and their fee is dependent on their involvement. Agreements between the firm and all other parties should specifically state whom the firm represents as agent.

In 1974, the SEC classified what constitutes an offering exempted from its registration requirements through the issuance of Rule 146. An offering may be a private placement, under that rule, if the following minimum criteria are met:

- The securities are purchased by no more than 35 persons. A person purchasing at least $150,000 of an offering need not be counted in the number of purchasers.
- There is no general advertising and no oral or written solicitation of persons other than eligible offerees.
- The securities are offered and sold only to those persons who the issuer believes are (1) sufficiently experienced to evaluate the merits and risks of the investment or (2) able to bear the risk of the investment. Before the sale, purchasers should have the services of an experienced representative.
- Each offeree either has access to or is furnished with the type of information that would be supplied in a registration statement.
- The issuer takes certain specified steps to ensure that the securities are not resold by the purchasers, except according to the rules governing resales.

When all requirements of Rule 146 are met, an offering may still be subject to registration if it is part of a plan to evade SEC registration provisions. The restrictions placed on commercial banks for the private placement of commercial paper are discussed in ''Bank Dealer Activities,'' section 2030.

PRIVATE-PLACEMENT ACTIVITIES BY BANKS

A commercial bank's board of directors assumes additional responsibilities when private-placement services are offered. Private-placement activities, like any other banking function, should be subject to adequate safeguards and policy considerations. When drafting a policy, the board of directors should ensure that self-dealing practices or conflict-of-interest charges cannot develop. Procedures should be developed to monitor private-placement activity whenever such services are provided by the bank or a subsidiary. Moreover, procedures should be in effect to detect any transactions that could have an adverse effect on the bank's other functions, such as loan or trust department activities.

A bank acting as advisor or agent assumes the risk of a potential conflict-of-interest charge whenever the proceeds from the placement are used to reduce a criticized loan at the bank. Furthermore, the bank must exercise due diligence to disclose relevant information, especially if the issuer is borrowing from the bank and is experiencing financial difficulty. Although the bank may not commit funds in a private-placement transaction, the potential for financial loss or damage to its reputation does exist if the bank does not prudently deal with all parties to the transaction by disclosing all relevant facts.

The examiner should evaluate the bank's involvement and expertise in private-placement activities by reviewing policies, practices, and procedures. The examiner should also check for compliance with applicable laws and regulations and determine if any significant loss exposure or risk could result from the bank's involvement in private placement.

1. To determine if policies, practices, procedures, and internal controls for private placements are adequate and prudent.
2. To determine if bank officers and employees are operating in conformance with established guidelines.
3. To determine the scope and adequacy of the audit function.
4. To evaluate the overall effectiveness and quality of bank management in advising and completing private placements.
5. To initiate corrective action when policies, practices, procedures, or internal controls are deficient.

1. If selected for implementation, complete or update the Private Placements section of the Internal Control Questionnaire.
2. Based upon the evaluation of internal controls and the work performed by internal/external auditors, determine the scope of the examination.
3. Test for compliance with policies, practices, procedures and internal controls in conjunction with performing the remaining examination procedures. Also, obtain a listing of any deficiencies noted in the latest review done by internal/external auditors and determine if corrections have been accomplished.
4. Request the following information from appropriate personnel:
   a. A list of all private placements advised by the bank since the last examination to include:
      - Name of issuer.
      - Name of investor(s), including banks.
      - Fee and how it was determined.
      - Amount, rate, maturity of issue.
   b. A list of any funds managed by the bank or its trust department, subsidiaries or affilates that have been used to purchase private placements advised by the bank or an affiliate.
   c. A letter from bank counsel regarding legality of the bank's involvement in private placement activities.
   d. A list of the person(s) performing private placement advisory services and their previous experience.
   e. A list of investors that the bank normally deals with in placing private offerings and their stated investment requirements.
   f. A copy of the bank's standard form agreements used in private placement transactions.
   g. A list of any borrowers whose loans were partially or fully repaid from the sale of private placements advised by the bank since the last examination.
   h. A list of participations purchased or sold in loans used to fund private placements advised by the bank.
5. Review pertinent information received in performing step 4 and compare it to the list of criticized assets from the previous examination.
6. Forward list of placements to the examiner assigned loan portfolio management and request that he or she determine if any loans were made to fund the investment in the private placement.
7. Review opinions of legal counsel regarding private placements and determine if there are any material deficiencies.
8. Determine if former banking relationships exist for both issuer and investor and determine if fees charged for loans or paid on deposits are within normal bank policy.
9. Review files related to a representative sample of all placement transactions and determine if the bank evaluates both the issuer and investor in a private placement transaction, including the suitability of the investment to the stated investment requirements of the investor.
10. Confer with examiner assigned ''Duties and Responsibilities of Directors'' and determine if potential conflicts of interest exist between bank-advised placements and interests of directors and principal officers.
11. Discuss with appropriate officer(s) and prepare summaries in appropriate report form of:
    a. Deficiencies in policies, practices and internal controls.
    b. Any hazardous or potentially hazardous placement activities.
    c. Recommended corrective action.
12. Update the workpapers with any information that will facilitate future examinations.

Review the bank's internal controls, policies, practices and procedures for private placement activities. The bank's system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used and other pertinent information.

POLICIES

1. Does the bank, bank subsidiary(s) or affiliate(s) provide private placement advisory services?
2. Has the board of directors adopted written policies for private placement activities that:
   a. Define objectives?
   b. Provide guidelines for fee determinations based on:
      - Size of transaction?
      - Anticipated degree of difficulty or time involved?
      - Payment of negotiated fees at various stages of the transaction?

      and not solely on:
      - Deposits on balances or the profitabity of the client's other banking relationships?
      - Successful completion of the transaction?

   c. Require that bank officers act in an advisory rather than agent capacity in all negotiations?

      (An advisor will advise and assist a client, an agent has the authority to commit a client.)
   d. Recognize possible conflicts of interest and establish appropriate procedures regarding:
      - The purchase of bank-advised private placements with funds managed by the bank or an advisory affiliate?
      - Loans to investors to purchase private placements?
      - Use of proceeds of an advised placement to repay the issuer's debts to the bank?
      - Dealings with unsophisticated or non-institutional investors who have other business relationships with the bank?

   e. Require legal review of each placement prior to completion?
   f. Direct officers to obtain certified financial statements from the seller?
   g. Require distribution of certified financial statements to interested investors?
   h. Require officers to request a written statement of investment objectives or requirements from interested investors?
   i. Provide for a supervisory management review to determine if a placement is suitable for the investor?

CONCLUSION

3. Is the foregoing information considered adequate as the basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly and indicate any additional examination procedures deemed necessary.
4. Based on a composite evaluation as evidenced by answers to the foregoing questions, the degree of control by main office management is considered (adequate/inadequate).

INTRODUCTION

The bank failures of the late 1980s caused a rapid depletion of the deposit insurance fund, and despite the poor financial condition of the banking industry during that time, there was a prevailing belief that at least a portion of the cost of resolving bank failures could have been avoided if troubled depository institutions had been dealt with in a more efficient, timely, and consistent manner. Because of this belief, Congress developed a new regulatory framework in 1991 with the intent of minimizing the long-term cost to the deposit insurance fund. This legislation led to the enactment of the prompt-corrective-action statute, which is contained in section 131 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) and added section 38 to the Federal Deposit Insurance Act (FDIA), as amended (12 USC 1831*o*).

Section 38 requires regulators to administer timely corrective action to banks when their capital position declines or is deemed to have declined below certain threshold levels as a result of an unsafe or unsound condition or practice. The prompt-corrective-action (PCA) framework specifies mandatory actions that regulators must take, as well as discretionary actions they must consider taking.

In order to implement PCA as it applies to state member banks, the Federal Reserve added a new subpart B to its Regulation H (12 CFR 208). The Federal Reserve also revised its Rules of Practice for Hearings (12 CFR 263) to establish procedures for the issuance of notices, directives, and other actions authorized under section 38 of the FDIA and Regulation H.

PCA utilizes capital ratios to trigger specific actions that are designed to restore a bank to financial health. One of the primary sources of these ratios is the Consolidated Reports of Condition and Income (call report), which gives added importance to the review of a bank's records for accuracy during an examination. Under the PCA statute a bank is assigned to one of five capital categories: (1) well capitalized, (2) adequately capitalized, (3) undercapitalized, (4) significantly undercapitalized, and (5) critically undercapitalized. The law provides for increasingly stringent corrective provisions as a bank is placed in progressively lower capital categories.

PCA CATEGORIES

PCA uses the total risk-based capital, tier 1 risk-based capital, leverage, and tangible equity ratios for assigning state member banks to the five capital categories.[1] These ratios are defined in the Federal Reserve's Capital Adequacy Guidelines for State Member Banks, appendix A (Risk-Based Measure) and appendix B (Tier 1 Leverage Measure) (12 CFR 208). Determining a bank's PCA category is based upon capital ratios derived from the following: (1) the filing of a quarterly call report, (2) receipt of a Federal Reserve or state examination report, (3) information obtained in the application process, or (4) other reports filed by the bank under banking or securities laws.

In general, a bank is deemed to be notified of its PCA category based upon the time of its submission or receipt of—

- the call report, as of the date the call report is required to be filed,
- the Federal Reserve or state examination report, as of the third day following the date of the transmittal letter accompanying the examination report, and
- other information, upon the bank's receipt of written notice that its category has been changed.

Notifying a bank of its PCA category is important since any bank falling in the undercapitalized or lower categories is subject to certain mandatory provisions, and may be subject to certain discretionary provisions, immediately upon notification that it is undercapitalized, significantly undercapitalized, or critically undercapitalized. These mandatory and discretionary provisions are described in detail later.

Each PCA category is described below. See the table at the end of this section for a summary of framework definitions. A bank is—

1. The total risk-based capital ratio is defined as total capital to risk-weighted assets; the tier 1 capital ratio is the ratio of tier 1 capital to risk-weighted assets; the leverage ratio is the ratio of tier 1 capital to total average assets; and the tangible equity ratio is defined as core capital elements plus cumulative perpetual preferred stock, net of all intangible assets except those amounts of purchased mortgage servicing rights allowable in tier 1 capital. See the manual section on Assessment of Capital Adequacy for additional information.

- *well capitalized* if the bank has a total risk-based capital ratio of 10.0 percent or greater, a tier 1 risk-based capital ratio of 6.0 percent or greater, and a leverage ratio of 5.0 percent or greater, and the bank is not subject to an order, written agreement, capital directive, or prompt-corrective-action directive to meet and maintain a specific capital level for any of the prompt-corrective-action measures.
- *adequately capitalized* if the bank has a total risk-based capital ratio of 8.0 percent or greater, a tier 1 risk-based capital ratio of 4.0 percent or greater, and a leverage ratio of 4.0 percent or greater (or a leverage ratio of 3.0 percent or greater if the bank is rated composite 1 in its most recent report of examination), and the bank does not qualify as well capitalized.
- *undercapitalized* if the bank has a total risk-based capital ratio that is less than 8.0 percent, a tier 1 risk-based capital ratio that is less than 4.0 percent, or a leverage ratio that is less than 4.0 percent (or a leverage ratio that is less than 3.0 percent if the bank is rated composite 1 in its most recent report of examination).
- *significantly undercapitalized* if the bank has a total risk-based capital ratio that is less than 6.0 percent, a tier 1 risk-based capital ratio that is less than 3.0 percent, or a leverage ratio that is less than 3.0 percent.
- *critically undercapitalized* if the bank has a ratio of tangible equity to total assets that is equal to or less than 2.0 percent.

EXAMINATION CONSIDERATIONS

If it is determined a bank is undercapitalized, significantly undercapitalized, or critically undercapitalized, examiners should discuss the PCA provisions with management during the examination. Additionally, examiners should caution banks when their capital ratios approach those found in the undercapitalized category to ensure that proposed dividend or management fee payments do not cause the bank to violate the statute. Any PCA-related comments should be noted on the Examination Comments and Conclusions page of the examination report and in the Summary to Directors of Examination Findings report. The comments should be limited to the mandatory provisions of the statute, reflect the immediacy of these provisions, and clearly indicate that the receipt of the report of examination serves as notification that the bank is subject to PCA provisions.

Capital Adequacy Page

In the report of examination, the PCA capital ratios appear on the Capital Adequacy page and are generally calculated using the bank's most recent call report. In situations where the impact of examination findings (for example, loan loss reserve adjustments or other losses) cause the bank to fall into a lower PCA category, the narrative portion of this page should explicitly state the adjusted PCA ratios and reconcile the adjustments that were made.

RECLASSIFICATION

A bank's PCA category is normally defined by its capital ratios indicated in the preceding definitions. The finding of an unsafe or unsound *condition or practice*, however, may lead to a bank's reclassification to the next lower category than it would otherwise qualify for based solely on its capital ratios. In these circumstances, the Federal Reserve may—

- reclassify a well-capitalized bank to the adequately capitalized category.
- require an adequately capitalized bank to comply with one or more supervisory provisions specified by PCA for an undercapitalized bank.
- impose on an undercapitalized bank one or more supervisory actions authorized for a significantly undercapitalized bank.

While the latter two actions do not strictly represent reclassifications from one category to another, they are nonetheless collectively referred to as ''reclassifications'' for PCA purposes.

Thus, section 38 does not make a bank that has been reclassified to the next lower capital category automatically subject to the mandatory restrictions of the lower category. These mandatory restrictions can only be imposed through the use of a directive and only those mandatory and discretionary provisions deemed appropriate by the Federal Reserve will be imposed. *A bank can only be reclassified to the next lower capital category and cannot be classified as critically undercapitalized on any basis other than its tangible equity ratio.*

The reclassification of a bank for PCA purposes may affect the bank's ability to accept brokered deposits. If a well- or adequately capitalized bank is reclassified, the bank must obtain an FDIC waiver to accept brokered deposits, regardless of its actual capital level. (The manual section on Deposit Accounts contains a detailed discussion on the capital requirements relating to brokered deposit activities.)

An ''unsafe or unsound condition'' is not defined in the PCA statute and assessment thereof is left to the discretion of the Federal Reserve. Banks determined to be in an unsafe or unsound condition based on the results of the most recent report of examination or call report will be reclassified. On the other hand, an ''unsafe or unsound practice'' is defined as a less-than-satisfactory rating for any of the AMEL (asset quality, management, earnings, or liquidity) components in the bank's most recent examination report that have not been corrected since the examination. In particular, a bank should be considered for reclassification if the imposition of the available PCA provisions would assist the return of the bank to a safe or sound condition or institute safe or sound practices.

The Federal Reserve recognizes that certain banks that are candidates for reclassification may have taken favorable actions that are consistent with the purposes of PCA. In these cases, reclassification may not be warranted—

- if the bank has raised or can demonstrate current efforts to raise enough capital to become and remain well capitalized for the foreseeable future; and
- if the bank has attempted to be in substantial compliance with all provisions of any outstanding informal or formal enforcement action; if management is addressing existing problems and is considered satisfactory; and if the bank's condition is stable and shows signs of improvement.

In those instances where reclassification is determined to be appropriate, the Federal Reserve will provide the bank with a written notice specifying its intention to reclassify the bank, along with an explanation of the reasons for the downgrade. The date of the reclassification and the required PCA provisions can be made effective either at a specified future date or, under certain circumstances, immediately, at the discretion of the Federal Reserve. An appeals process exists in both situations; it is described in greater detail in the subsection on Issuance of PCA Directives.

PCA PROVISIONS

Provisions Applicable to All Banks

While well-capitalized and adequately capitalized banks are generally not subject to any restrictions, they are subject to *two provisions that are applicable to all banks:*

- A bank may not pay dividends or make any other capital distributions that would leave it undercapitalized.[2]
- A bank may not pay a management fee to a controlling person if, after paying the fee, the bank would be undercapitalized. Management fees subject to this restriction are those relating to overhead expenses and managerial, supervisory, executive, or policymaking functions, other than compensation to an individual in the individual's capacity as an officer or employee of the bank. This does not include fees relating to nonmanagerial services provided by the controlling person, such as data processing, trust activities, mortgage services, audit and accounting, property management, or similar services.

Restrictions on Advertising

The Federal Reserve prohibits a bank from advertising its PCA category. A bank may not describe itself in an advertisement or in promotional material as falling within the well-capitalized category, nor may the bank advertise that the Federal Reserve has determined it to be well capitalized. However, a bank is not restricted from advertising its capital levels or financial condition.

2. Section 38 contains a limited exception to the dividend restriction for certain types of stock redemptions that (1) the Federal Reserve has approved, (2) are made in connection with an equivalent issue of additional shares or obligations, and (3) will improve the bank s financial condition. The Federal Reserve may also impose dividend restrictions on any company that controls a significantly undercapitalized bank.

Provisions Applicable to Undercapitalized Banks

A bank categorized as undercapitalized is subject to several *mandatory* provisions that become effective upon notification of the bank. Under the mandatory provisions, an undercapitalized bank—

- must cease paying dividends.
- is prohibited from paying management fees to a controlling person (see the previous subsection for exceptions).
- is subject to increased monitoring by the Federal Reserve and periodic review of the bank's efforts to restore its capital.
- must file and implement a capital restoration plan generally within 45 days. Undercapitalized banks that fail to submit or implement a capital restoration plan are also subject to the provisions applicable to significantly undercapitalized banks.
- may acquire interest in a company, open any new branch offices, or engage in a new line of business only if the following three requirements are met:
  - — the Federal Reserve has accepted its capital restoration plan,
  - — any increase in total assets is consistent with the capital restoration plan, and
  - — the bank's ratio of tangible equity to assets increases during the calendar quarter at a rate sufficient to enable the bank to become adequately capitalized within a reasonable time.
- may not make any acquisition, acquire any company or depository institution, establish new branches, or engage in any new line of business unless the Federal Reserve determines that such action is consistent with its capital plan or the FDIC determines that such action will further the purposes of PCA.

In addition to the mandatory provisions, a number of *discretionary* provisions may be imposed on an undercapitalized bank. These include—

- requiring one or more of the following:
  - — That the bank sell enough additional capital or debt to ensure that it would be adequately capitalized after the sale.
  - — That the aforementioned additional capital be voting shares.
  - — That the bank accept an offer to be acquired by another institution or company, or that any company that controls the bank be required to divest itself of the bank.
- restricting transactions between the bank and its affiliates.
- restricting the interest rates paid on deposits collected by the bank to the prevailing rates paid on comparable amounts in the region where the bank is located.
- restricting the bank's asset growth or requiring the bank to reduce its total assets.
- requiring the bank or any of its subsidiaries to terminate, reduce, or alter any activity determined by the Federal Reserve to pose excessive risk to the bank.
- ordering a new election of the board of directors, dismissing certain senior executive officers, or hiring new officers.
- prohibiting the acceptance, renewal, and rollover of deposits from correspondent depository institutions.
- prohibiting any bank holding company that controls the bank from making any capital distribution, including but not limited to dividend payment, without the prior approval of the Federal Reserve.
- requiring the bank to divest or liquidate any subsidiary that is in danger of becoming insolvent and that poses a significant risk to the bank, or is likely to cause significant dissipation of its assets or earnings.
- requiring any company that controls the bank to divest or liquidate any affiliate of the bank (other than another insured depository institution) if the Federal Reserve determines that the affiliate is in danger of becoming insolvent and poses a significant risk to the bank, or is likely to cause significant dissipation of the bank's assets or earnings.
- requiring the bank to take any other action that would more effectively carry out the purpose of PCA than the above actions.

Provisions Applicable to Significantly Undercapitalized Banks

The mandatory restrictions applicable to undercapitalized banks also apply to banks that are significantly undercapitalized. In addition, a significantly undercapitalized bank is restricted in paying bonuses or raises to senior executive officers of the bank unless it receives prior written approval from the Federal Reserve. If a bank fails to submit an acceptable capital restoration plan, however, no such bonuses or raises may be paid until an acceptable plan has been submitted.

The Federal Reserve, as directed by the PCA statute, must take the following actions unless it is determined that these actions would not further the purpose of PCA:

- Require one or more of the following:
  - That the bank sell enough additional capital or debt to ensure that it would be adequately capitalized after the sale.
  - That the aforementioned additional capital be voting shares.
  - That the bank accept an offer to be acquired by another institution or company, or that any company that controls the bank be required to divest itself of the bank.
- Restrict the bank's transactions with affiliates.
- Restrict the interest rates paid on deposits collected by the bank to the prevailing rates paid on comparable amounts in the region where the bank is located.

In addition to these mandatory provisions, one or more of the discretionary provisions for undercapitalized banks must be imposed on a significantly undercapitalized bank. Moreover, other measures (including the provisions for critically undercapitalized banks) may be required if the Federal Reserve determines that such actions will advance the purposes of PCA.

Provisions Applicable to Critically Undercapitalized Banks

A critically undercapitalized bank must be placed in conservatorship (with the concurrence of the FDIC) or receivership within 90 days, unless the Federal Reserve and the FDIC concur that other action would better achieve the purposes of PCA. The decision to defer placing a critically undercapitalized bank in conservatorship or receivership must be reviewed every 90 days, and an explanation must be provided about why deferring this decision would better achieve the purposes of the statute (preventing losses to the bank insurance fund).

A bank must be placed in receivership if it continues to be critically undercapitalized on average[3] during the fourth calendar quarter following the period that it initially became critically undercapitalized, unless the following specific requirements are met:

- The bank has a positive net worth.
- The bank has been in substantial compliance with its capital restoration plan since the date of the plan's approval.
- The bank is profitable or has a sustainable upward trend in earnings.
- The bank has reduced its ratio of nonperforming loans to total loans.
- The Chairman of the Federal Reserve and the chairperson of the FDIC both certify that the bank is viable and not expected to fail.

Critically undercapitalized banks are also prohibited, beginning 60 days after becoming critically undercapitalized, from making any payment of principal or interest on subordinated debt issued by the bank without the prior approval of the FDIC. Unpaid interest, however, may continue to accrue on subordinated debt under the terms of the debt instrument. The FDIC is also required, at a minimum, to prohibit a critically undercapitalized bank from doing any of the following without the prior written approval of the FDIC:

- Entering into any material transaction not in the usual course of business. Such activities include any investment, expansion, acquisition, sale of assets, or other similar action where the bank would have to notify the Federal Reserve.
- Extending credit for any highly leveraged transaction.
- Amending the bank's charter or bylaws, except to the extent necessary to carry out any other requirement of any law, regulation, or order.
- Making any material change in accounting methods.
- Engaging in any covered transaction under section 23A(b) of the Federal Reserve Act.
- Paying excessive compensation or bonuses.
- Paying interest on new or renewed liabilities that would increase the bank's weighted average cost of funds to a level significantly exceeding the prevailing rates of interest paid

3. This is determined by adding the sum of the total tangible equity ratio at the close of business on each day during this quarter and dividing that sum by the number of business days in that quarter.

on insured deposits in the bank's normal market area.

Capital Restoration Plans

A bank that is undercapitalized, significantly undercapitalized, or critically undercapitalized must submit a capital restoration plan to the Federal Reserve. The plan should aim to restore the bank's capital to at least the minimum capital levels required for adequately capitalized banks. This plan must be submitted in writing and specify—

- the steps the bank will take to become adequately capitalized.
- the levels of capital the bank expects to attain in each year that the plan is in effect.
- how the bank will comply with the restrictions and requirements imposed on it under section 38.
- the types and levels of activities in which the bank will engage.
- any other information required by the Federal Reserve.

A capital restoration plan *cannot be accepted unless* the plan—

- contains the information required in the preceding five points.
- is based on realistic assumptions and is likely to succeed in restoring the bank's capital.
- would not appreciably increase the risk (including credit risk, interest-rate risk, and other types of risk) to which the bank is exposed.
- contains a guarantee from each company that controls the bank, specifying that the bank will comply with the plan until it has been adequately capitalized on average during each of four consecutive calendar quarters, and each company has provided appropriate assurances of performance. (See the subsequent subsection, Capital Restoration Plan Guarantee, for additional information.)

Submission and Review of Capital Plans

The Federal Reserve has established rules regarding a uniform schedule for the filing and review of capital restoration plans. These rules require a bank to submit a capital restoration plan within 45 days after the bank has received notice, or has been deemed to have been notified, that it is undercapitalized, significantly undercapitalized, or critically undercapitalized. The Federal Reserve may change this period in individual cases, provided it notifies the bank that a different schedule has been adopted. PCA also requires the Federal Reserve to—

- review each capital restoration plan within 60 days of submission of the plan unless it extends the review time.
- provide written notice to the bank about whether it has approved or rejected the capital plan.
- provide a copy of each acceptable capital restoration plan, and amendments thereto, to the FDIC within 45 days of accepting the plan.

There are two cases where a capital restoration plan may not be required:

- When a bank has capital ratios consistent with those corresponding to the adequately capitalized category but, due to unsafe or unsound conditions or practices, has been reclassified to the undercapitalized category.
- When a bank s capital category changes, but the bank is already operating under a capital restoration plan accepted by the Federal Reserve.

The Federal Reserve will examine the circumstances of each of the above cases to determine whether a revised plan must be submitted.

Capital Restoration Plan Guarantee

The Federal Reserve cannot approve a capital restoration plan unless each company that controls the bank has guaranteed the bank's compliance with the plan and has provided reasonable assurances of performance. The Federal Reserve will consider on a case-by-case basis the appropriate type of guarantee for multi-tier holding companies, or parent holding companies that are shell companies or that have limited resources. A guarantee that is backed by a contractual pledge of resources from a parent company may satisfy the requirements of section 38, particularly in situations involving the ownership of an insured bank by a foreign company through a wholly owned domestic shell holding. In other situations, a third-party guarantee made by a party with adequate financial resources may be satisfactory.

PCA also contains several provisions that clarify the capital restoration plan guarantee:

- Limitation on liability. The aggregate amount of liability under the guarantee for all companies that control a specific bank is limited to the lesser of (1) an amount equal to 5 percent of the bank's total assets, or (2) the amount necessary to restore the relevant capital ratios of the bank to the level required for the bank to be categorized as adequately capitalized.
- Limitation on duration. The guarantee and limit on liability expires after the Federal Reserve notifies the bank that it has remained adequately capitalized for each of the previous four consecutive calendar quarters.
- Collection of guarantee. Each company that controls a given bank is jointly and severally liable for the guarantee.
- Failure to provide a guarantee. A bank will be treated as if it had not submitted an acceptable capital restoration plan if its capital plan does not contain the required guarantee.
- Failure to perform under a guarantee. A bank will be treated as if it failed to implement the capital restoration plan if any company that controls the bank fails to perform its guarantee.

Failure to Submit an Acceptable Capital Plan

An undercapitalized bank that fails to submit or implement, in any material respect, an acceptable capital restoration plan within the required period is subject to the same provisions applicable to a bank that is significantly undercapitalized. If a bank's capital restoration plan is rejected, the bank is required to submit a new capital plan within the time period specified by the Federal Reserve. During the period following notice of the rejection, and before Federal Reserve approval of a new or revised capital plan, the bank is treated in the same manner as a significantly undercapitalized bank.

ISSUANCE OF PCA DIRECTIVES

The Federal Reserve must provide a state member bank, or company controlling a state member bank (company), a written notice of proposed action under section 38 (referred to as a directive), unless the circumstances of a particular case indicate that immediate action is necessary to serve the purpose of PCA. These directives are issued for reasons such as reclassifying a bank and implementing discretionary provisions, the latter of which includes the dismissal of directors or senior executive officers.

A notice of intent to issue a directive should include—

- a statement of the bank's capital measures and levels.
- a description of the restrictions, prohibitions, or affirmative actions that the Federal Reserve proposes to impose or require.
- the proposed date when such restrictions or prohibitions would be effective or the proposed date for completion of such affirmative actions.
- the date by which the bank or company subject to the directive may file with the Federal Reserve a written response to the notice.

When a directive becomes effective at a future date, the Federal Reserve must provide the bank or company an opportunity to appeal the directive before taking final action. This requires the bank to submit information relevant to the decision within the time period set by the Federal Reserve, which must be at least 14 calendar days from the date of the notice, unless the Federal Reserve determines that a shorter period is appropriate in light of the financial condition of the bank or other relevant circumstances. In either case, a decision must be rendered within 60 calendar days of the receipt of the appeal.

In the case of a directive that is immediately effective upon notification of the bank, the Federal Reserve's rules provide an opportunity for the bank or company to seek an expedited modification or rescission of the directive. A bank or company that appeals a directive effective immediately is required to file a written appeal within 14 days of receiving the notice, and the Federal Reserve must rule on the appeal within 60 days of receiving it. During the period that the appeal is under review the directive remains in effect, unless the effectiveness of the directive is delayed by the Federal Reserve.

Part of the appeal process includes the bank's right to an informal hearing. This hearing is conducted by a representative selected by the Federal Reserve and permits oral testimony or witnesses. This request for a hearing should accompany the bank's response to notification of a PCA directive, and the Federal Reserve must generally issue an order for the hearing to commence no later than 30 days after receipt of the bank's request. The presiding officer at the hearing must make a recommendation to the Federal Reserve regarding the bank's appeal within 20 calendar days of the closing of the record of the hearing proceeding. The Federal Reserve must then issue a decision within 60 calendar days of the date of the closing of the hearing record. Any bank that has been reclassified or subjected to a PCA directive may, upon a change in circumstances, request in writing that the Federal Reserve reconsider the terms of the directive, and may propose that the directive be modified, rescinded, or removed. The directives issued will remain in place while the request is pending unless otherwise ordered by the Federal Reserve.

Dismissal of Directors or Senior Executive Officers

The Federal Reserve's rules establish a special procedure permitting an opportunity for senior executive officers and directors dismissed from a state member bank as a result of a PCA directive to petition for reinstatement. A director or senior executive officer who is required to be dismissed in compliance with a Federal Reserve directive may have the dismissal reviewed by filing, within 10 days, a petition for reinstatement with the Federal Reserve. The petitioner will also be given the opportunity to submit written materials in support of the petition and to appear at an informal hearing before representatives of the Federal Reserve. The date for the hearing and for the ultimate decision follows the same timeframe as that indicated for the appeals process in the preceding paragraph.

Enforcement of Directives

PCA directives may be enforced in the federal courts, and may cause any bank, company, or bank-affiliated party that violates the directive to be subject to civil money penalties. The failure of a bank to implement a capital restoration plan, or the failure of a company having control of a state member bank to fulfill a guarantee that the company has given in connection with a capital plan accepted by the Federal Reserve, could subject the bank or company or any of their bank-affiliated parties to a civil money penalty assessment.

TABLE—SUMMARY OF SPECIFICATIONS OF CAPITAL CATEGORIES FOR PROMPT CORRECTIVE ACTION

Capital category	*Total risk-based ratio*	*Tier 1 risk-based ratio*	*Leverage ratio*	*Additional criteria*
Well capitalized	10% or above; plus	6% or above; plus	5% or above; plus	is not subject to a capital directive to meet a specific level for any capital measure
Adequately capitalized	8% or above; plus	4% or above; plus	4% or above;[1] plus	does not meet the definition of well capitalized
Under-capitalized	under 8%; or	under 4%; or	under 4%[2]	
Significantly under-capitalized	under 6%; or	under 3%; or	under 3%	
Critically under-capitalized	not applicable	not applicable	not applicable	can only be assigned to this category if the ratio of tangible equity to total assets is equal to or less than 2%[3]

1. Three percent or above for banks rated composite 1 in their most recent report of examination and that are not experiencing or anticipating significant growth.

2. Under 3 percent for banks rated composite 1 in their most recent report of examination and that are not experiencing or anticipating significant growth.

3. Tangible equity is defined as core capital elements plus cumulative perpetual preferred stock, net of all intangible assets except those amounts of purchased mortgage-servicing rights allowable into tier 1 capital.

Prompt Corrective Action
Examination Objectives
Effective date November 1994

1. To determine if prompt-corrective-action (PCA) provisions are necessary.
2. To determine if the policies, practices, and procedures are in place to ensure compliance with PCA mandatory and discretionary provisions.
3. To ensure that undercapitalized, significantly undercapitalized, and critically undercapitalized banks have effective capital restoration plans that comply with PCA.

INTRODUCTION

The Board has a longstanding policy on real estate appraisals that emphasizes the importance of sound appraisal policies and procedures in a bank's real estate lending activity. In December 1987 the Board and the other banking regulatory agencies jointly adopted guidelines for real estate appraisal policies and review procedures. With the passage of title XI of the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989, the Board as well as the other federal financial institutions regulatory agencies adopted in August 1990 regulations regarding the performance and utilization of appraisals by federally regulated financial institutions. In September 1992 the Board issued revised guidelines for real estate appraisal and evaluation programs, which were later amended on June 7, 1994.

The intent of title XI and the Board's regulation is to protect federal financial and public policy interests in real estate–related financial transactions requiring the services of an appraiser. Title XI also requires that real estate appraisals be in writing and be performed in accordance with uniform standards and by individuals with demonstrated competency whose professional conduct is subject to effective supervision. In this regard, title XI permitted each state to establish a program for certifying and licensing real estate appraisers who are qualified to perform appraisals in connection with federally related transactions. Additionally, title XI designated the Appraisal Foundation, a nonprofit appraisal industry group, as the authority for establishing qualifications criteria for appraiser certification and standards for the performance of an appraisal. However, title XI left to the states the authority to establish qualification standards for licensing. Title XI established the Appraisal Subcommittee of the Federal Financial Institutions Examination Council (FFIEC) to monitor the requirements established to meet the intent of title XI.

Effective Date

The Board's appraisal regulation (Regulation H, 12 CFR 208)[1] requires that appraisals performed in connection with federally related transactions after the effective date of August 9, 1990, comply with the regulation. Appraisals for real estate–related financial transactions entered into before this date do not have to comply with the regulation. However, the bank would have had to adhere to the Board's supervisory guidelines, issued in 1987, for such real estate appraisals, as well as to safe and sound banking practices. Transactions are deemed to have been entered into and a loan is deemed to have been originated if there was a binding commitment to perform before the effective date.

The requirement to use a state-certified or -licensed appraiser had a separate effective date of January 1, 1992, but was extended by the FDIC Improvement Act of 1991 to no later than December 31, 1992. Consequently, states had the flexibility to adopt an earlier implementation date regarding state requirements that an appraiser be certified or licensed to perform an appraisal within their state. Financial institutions doing business in a state that had an earlier effective date for mandatory use of a certified or licensed appraiser than the federally mandated effective date would have had to abide by the state law.

BANK APPRAISAL AND EVALUATION POLICY

An institution's board of directors is responsible for adopting policies and procedures that establish effective real estate appraisal and evaluation programs. Analyzing real estate collateral at a loan's inception and over its life requires a sufficient understanding of appraisals and evaluations to fully assess credit risk. While the appraisal plays an important role in the loan approval process, the bank should not unduly rely on the collateral value in lieu of an adequate assessment of the borrower's repayment ability. However, when a credit becomes troubled, the primary source of repayment often shifts from the borrower's capacity to repay to the value of the collateral. For these reasons, it is important that banks have sound appraisal policies and procedures.

1. The standards applicable to appraisals are set forth in subpart G of the Board's Regulation Y, 12 CFR 225.

Appraisal and Evaluation Program

An institution's appraisal and evaluation program should be tailored to the institution's size, location, and the nature of its real estate market and attendant real estate–related activity. The program should establish prudent standards and procedures that ensure written appraisals or evaluations are obtained and analyzed for real estate–related financial transactions before the bank makes its final credit decision.

The bank's appraisal and evaluation program should also establish the manner in which the institution selects, evaluates, and monitors individuals who perform real estate appraisals or evaluations. The key elements of the institution's program should ensure that individuals are fairly considered for the assignment, possess the requisite expertise to satisfactorily complete the assignment, hold the proper state certification or license if applicable, and are capable of rendering a high-quality written appraisal or evaluation.

Compliance Procedures

To ensure the bank is complying with the regulation and supervisory guidelines, the bank should have established regulatory compliance procedures for all appraisals and evaluations. The compliance review may be part of a loan officer's overall credit analysis and may take the form of a narrative or a checklist. The individual who prepared the appraisal or evaluation should take corrective action for noted deficiencies. Unreliable appraisals or evaluations should be replaced before the final credit decision.

Additionally, a bank should have comprehensive analytical procedures that focus on certain types of loans, such as large-dollar credits, loans secured by complex or specialized properties, nonresidential construction loans, or out-of-area real estate. These comprehensive analytical procedures should be designed to verify the appropriateness of the methods and approaches used and to assess the reasonableness of the analysis, opinions, and conclusions. The bank should maintain formal documentation or evidence of the review. An individual performing the review, either an employee of the bank or an outside consultant, should have real estate–related training or experience and be independent of the transaction. The individual may not change the appraisal's or evaluation's estimate of value as a result of the review unless that person is appropriately licensed or certified and performs the review in accordance with the review procedures contained in the Uniform Standards of Professional Appraisal Practice (USPAP) Standard 3.

FEDERALLY RELATED FINANCIAL TRANSACTIONS

A federally related transaction is defined in title XI as a real estate–related financial transaction that a federal financial institutions regulatory agency engages in, contracts for, or regulates and that requires the services of an appraiser. Title XI further defines a real estate–related financial transaction as any transaction involving the sale, lease, purchase, investment in, or exchange of real property, including interests in property, or the financing thereof; the refinancing of real property or interests in real property; or the use of real property or interests in property as security for a loan or investment, including mortgage-backed securities.

The Board recognizes that not all real estate–related financial transactions require the services of an appraiser. In this regard, the Board has determined that certain categories of real estate–related financial transactions do not require the services of a certified or licensed appraiser and as such are not considered federally related transactions. However, for certain transactions that do not require a certified or licensed appraisal, an evaluation of the underlying collateral is required under the Board's supervisory guidelines.

Transaction Value

The transaction value is defined as the amount of the loan or extension of credit under consideration. For a pool of loans or a mortgage-backed security, the transaction value is the amount of each individual loan. In determining transaction value, the senior and junior debt are considered separate transactions under the appraisal rule. However, a series of related transactions will be considered as one transaction if it appears that an institution is attempting to avoid the appraisal requirement by structuring the transactions below the appraisal threshold.

Transactions Not Requiring the Services of a Licensed or Certified Appraiser

An appraisal performed by a state-certified or -licensed appraiser is required for all real estate–related financial transactions except those in which—

- the transaction value is $250,000 or less;
- a lien on real estate has been taken as collateral in an abundance of caution;
- the transaction is not secured by real estate;
- a lien on real estate has been taken for purposes other than the real estate's value;
- the transaction is a business loan that has a transaction value of $1 million or less and is not dependent on the sale of, or rental income derived from, real estate as the primary source of repayment;
- a lease of real estate is entered into, unless the lease is the economic equivalent of a purchase or sale of the leased real estate;
- the transaction involves an existing extension of credit at the lending institution, provided that there has been no obvious and material change in market conditions or physical aspects of the property that threatens the adequacy of the institution's real estate collateral protection after the transaction, even with the advancement of new monies, or there is no advancement of new monies, other than funds necessary to cover reasonable closing costs;
- the transaction involves the purchase, sale, investment in, exchange of, or extension of credit secured by a loan or interest in a loan, pooled loans, or interests in real property, including mortgage-backed securities, and each loan or interest in a loan, pooled loan, or real property interest met the Board's regulatory requirements for appraisals at the time of origination;
- the transaction is wholly or partially insured or guaranteed by a U.S. government agency or U.S. government–sponsored agency;
- the transaction either qualifies for sale to a U.S. government agency or U.S. government–sponsored agency, or involves a residential real estate transaction in which the appraisal conforms to the Federal National Mortgage Association or Federal Home Loan Mortgage Corporation appraisal standards applicable to that category of real estate;
- the regulated institution is acting in a fiduciary capacity and is not required to obtain an appraisal under other law; or
- the Board determines that the services of an appraiser are not necessary to protect federal financial and public policy interests in real estate–related financial transactions or to protect the safety and soundness of the institution.

For transactions that do not require title XI appraisals because they are below the appraisal threshold or because they qualify for the $1 million or less business-loan exemption or the existing extension-of-credit exemption, the Board still requires an appropriate evaluation of the real property collateral that is consistent with safe and sound banking practices.

The Board reserves the right to require a bank to obtain an appraisal on an exempt transaction whenever it is necessary to address safety-and-soundness concerns. Whether a bank will be required to obtain an appraisal for a particular transaction or an entire group of credits will depend on the condition of the bank. For example, if a bank is in troubled condition that is attributable to underwriting problems in its real estate loan portfolio, the Board may require the bank to obtain an appraisal for all *new* transactions below the threshold. However, regardless of a bank's condition, an examiner may require a bank to obtain an appraisal for a particular real estate–related transaction to address safety-and-soundness concerns.

Obtaining an Appraisal

The bank or its agent is responsible for engaging the appraiser and obtaining the appraisal in sufficient time to be analyzed before the bank arrives at its final credit or other decision. A bank may not accept an appraisal prepared for a potential borrower as the appraisal for a federally related transaction. However, a bank may use an appraisal prepared by an appraiser engaged directly by another regulated or nonregulated financial services institution as long as the bank has established procedures for reviewing appraisals, the review indicates that the appraisal meets the regulation, and the review is documented in writing.

For a multiphased development or construction loan, the appraisal of an earlier phase cannot be used for a new phase due to the change in risk to the bank. However, if the original appraisal was prepared for all phases of the project, the bank may use the project appraisal if the appraisal's value for the new phase is still valid at the time the bank extends the additional credit.

APPRAISAL REQUIREMENTS

The objective of an appraisal is to communicate the appraiser's reasoning and conclusions in a logical manner so that the reader is led to the appraiser's estimation of market value. The contents of appraisals should conform to the standards of the Board's appraisal regulation and the Uniform Standards of Professional Appraisal Practice (USPAP), promulgated by the Appraisal Standards Board of the Appraisal Foundation. The actual form, length, and content of appraisal reports may vary, depending on the type of property being appraised and the nature of the assignment. Standard forms completed in compliance with the rule and USPAP are also acceptable.

Appraisal Standards

Title XI prescribes the minimum standard for appraisals performed in connection with federally related transactions as those standards set forth in USPAP as well as any other appropriate standards that the Board deems necessary. At a minimum, the Board's appraisal regulation requires that an appraisal—

- conform to generally accepted appraisal standards as evidenced by USPAP, unless principles of safe and sound banking require compliance with stricter standards;
- be written and contain sufficient information and analysis to support the bank's decision to engage in the transaction;
- analyze and report appropriate deductions and discounts for proposed construction or renovation, partially leased buildings, nonmarket lease terms, and tract developments with unsold units;
- be based upon the definition of market value as set forth in the regulation; and
- be performed by state-licensed or -certified appraisers in accordance with the requirements in the regulation.

The Board's appraisal regulation also permits banks to use appraisals prepared in accordance with the USPAP Departure Provision. The Departure Provision permits limited exceptions to ''specific guidelines'' in USPAP. Appraisers preparing appraisals using the Departure Provision still must comply with all ''binding requirements'' of USPAP and must be sure that the resulting appraisal will not be misleading.

Appraisal Assignment

A bank may engage an appraiser to perform either a complete or a limited appraisal, referred to as an appraisal assignment. In a complete appraisal assignment, an appraiser must meet all USPAP standards and guidelines in estimating market value. In a limited appraisal assignment, the appraiser elects to depart from certain specific guidelines by invoking the Departure Provision. Before beginning the appraisal, the appraiser must obtain the bank's concurrence that the use of the Departure Provision is appropriate for the transaction. The appraiser must ensure that the resulting appraisal report will not mislead the bank or other intended users of the appraisal report. The bank should realize that, as the degree of departure increases, the corresponding level of reliability of the limited appraisal decreases, resulting in a higher level of risk.

Appraisal Reports

The appraisal report usually includes a disclosure of sales history and an opinion as to the highest value and best use of the property. After preparing a report, appraisers must certify that—

- statements of fact are true and correct;
- limiting conditions have been disclosed;
- they have no interest (present or future) in the transaction or property;
- compensation is not contingent on rendering a specified value;
- they have complied with USPAP;
- an inspection of the property was or was not performed; and
- assistance was or was not received in the preparation of the appraisal.

There are three different report formats that can be used for both the complete and the limited appraisal assignment: a self-contained report, a summary report, and a restricted report. Since USPAP requires all appraisal reports to encompass all aspects of the assignment, differences among these reports relate to the degree of detail presented. The self-contained appraisal report provides the most detail; the summary appraisal report condenses the information; and the restricted appraisal report contains a minimal presentation of information with the supporting details maintained in the appraiser's work files.

The restricted report is not appropriate for a significant number of federally related transactions because the minimal amount of information limits the usefulness of the document for underwriting, compliance, and other decision-making purposes. However, it might be appropriate to use this type of appraisal report when providing ongoing collateral monitoring of a bank's real estate transactions and under other circumstances when a bank's program requires an evaluation.

Appraisal Content

The appraisal must reflect a market value of the real estate. The regulation defines market value as the most probable price that a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller each acting prudently and knowledgeably, and assuming the price is not affected by undue stimulus.

Implicit in this definition is the consummation of a sale as of a specified date and the passing of title from the seller to the buyer under conditions whereby—

- buyer and seller are typically motivated;
- both parties are well informed or well advised, and acting in what they consider their own best interests;
- a reasonable time is allowed for exposure in the open market;
- payment is made in terms of cash in U.S. dollars or in terms of financial arrangements comparable thereto; and
- the price represents the normal consideration for the property sold unaffected by special or creative financing or sales concessions granted by anyone associated with the sale.

To properly underwrite a construction loan, a bank may need to know a prospective value of a property in addition to the market value as of the date of the appraisal. A prospective value is based upon events yet to occur, such as completion of construction or renovation, reaching stabilized occupancy, or some other event yet to be determined. Thus, more than one value may be reported in an appraisal as long as all values are clearly described and reflect the projected dates when future events could occur.

APPRAISAL VALUATION APPROACHES

The appraiser typically utilizes three market-value approaches to analyze the value of property:

- cost approach
- market data or direct comparable sales approach
- capitalization of income approach

All three approaches have particular merits depending upon the type of real estate being appraised. For single-family residential property, the cost and comparable sales approaches are most frequently used since the common use of the property is the personal residence of the owner. However, if a single-family residential property is intended to be used as a rental property, the appraiser would have to consider the income approach as well. For special-use commercial properties, the appraiser may have difficulty obtaining sales data on comparable properties and may have to base the value estimate on the cost and capitalization of income approaches.

If an approach is not used in the appraisal, the appraiser should disclose the reason the approach was not used and whether this affects the value estimate.

Cost Approach

In the cost approach to value estimation, the appraiser obtains a preliminary indication of value by adding the estimated depreciated reproduction cost of the improvements to the estimated land value. This approach is based on the assumption that the reproduction cost is the upper limit of value and that a newly constructed building would have functional and mechanical advantages over an existing building. The appraiser would evaluate any functional depreciation (disadvantages or deficiencies) of the existing building in relation to a new structure.

The cost approach consists of four basic steps: (1) estimate the value of the land as though vacant, (2) estimate the current cost of reproducing the existing improvements, (3) estimate depreciation and deduct from the reproduction cost estimate, and (4) add the estimate of land value and the depreciated reproduction cost of improvements to determine the value estimate.

Market Data or Direct Comparable Sales Approach

The essence of the market data or direct comparable sales approach is to determine the price at which similar properties have recently sold on the local market. Through an appropriate adjustment for differences in the subject property and the selected comparable properties, the appraiser estimates the market value of the subject property based on the sales price of the comparable properties. The process used in determining the degree of comparability of two or more properties involves judgment about their similarity with respect to age, location, condition, construction, layout, and equipment. The sales price or list price of those properties deemed most comparable tend to set the range for the value of the subject property.

Capitalization of Income Approach

The income approach estimates the project's expected income over time converted to an estimate of its present value. The income approach is typically used to determine the market value of income-producing properties such as office buildings, apartment complexes, hotels, and shopping centers. In the income approach, the appraiser can use several different capitalization or discounted cash-flow techniques to arrive at a market value. These techniques include the band-of-investments method, mortgage-equity method, annuity method, and land-residual technique. Which technique is used depends on whether there is project financing, whether there are long-term leases with fixed-level payments, and whether the value is being rendered for a component of the project such as land or buildings.

The accuracy of the income-approach method depends on the appraiser's skill in estimating the anticipated future net income of the property and in selecting the appropriate capitalization rate and discounted cash-flow. The following data are assembled and analyzed to determine potential net income and value:

- Rent schedules and the percentage of occupancy for the subject property and for comparable properties for the current year and several preceding years. This provides gross rental data and shows the trend of rentals and occupancy, which are then analyzed by the appraiser to estimate the gross income the property should produce.
- Expense data such as taxes, insurance, and operating costs being paid from revenues derived from the subject property and by comparable properties. Historical trends in these expense items are also determined.
- A timeframe for achieving stabilized, or normal, occupancy and rent levels (also referred to as a holding period).

Basically, the income approach converts all expected future net operating income into present-value terms. When market conditions are stable and no unusual patterns of future rents and occupancy rates are expected, the direct capitalization method is used to value income properties. This method calculates the value of a property by dividing an estimate of its stabilized annual income by a factor called a cap rate. Stabilized income is generally defined as the yearly net operating income produced by the property at normal occupancy and rental rates; it may be adjusted upward or downward from today's actual market conditions. The cap rate—usually defined for each property type in a market area—is viewed by some analysts as the required rate of return stated as a percent of current income.

The use of this technique assumes that the use of either the stabilized income or the cap rate accurately captures all relevant characteristics of the property relating to its risk and income potential. If the same risk factors, required rate of return, financing arrangements, and income projections are used, explicit discounting and direct capitalization should yield the same results.

For special-use properties, new projects, or troubled properties, the discounted cash flow (net present value) method is the more typical approach to analyzing a property's value. In this method, a timeframe for achieving a stabilized, or normal, occupancy and rent level is projected. Each year's net operating income during that period is discounted to arrive at the present value of expected future cash flows. The property's anticipated sales value at the end of the period until stabilization (its terminal or reversion value) is then estimated. The reversion value represents the capitalization of all future income streams of the property after the projected occupancy level is achieved. The terminal or reversion value is then discounted to its present value and added to the discounted income stream to arrive at the total present market value of the property.

Most importantly, the analysis should be based on the ability of the project to generate income over time based upon reasonable and supportable assumptions. Additionally, the discount rate should reflect reasonable expectations about the rate of return that investors require under normal, orderly, and sustainable market conditions. For further discussion, see the manual section on Real Estate Loans.

Value Correlation

The three value estimates—cost, market, and income—must be evaluated by the appraiser and correlated into a final value estimate based on the appraiser's judgment. Correlation does not imply averaging the value estimates obtained by using the three different approaches. Where these value estimates are relatively close together, correlating them and setting the final market value estimate presents no special problem. It is in situations where widely divergent values are obtained by using the three appraisal approaches that the examiner must exercise judgment in analyzing the results and determining the estimate of market value.

Other Definitions of Value

While the Board's appraisal regulation requires that the appraisal contain the market value of the real estate collateral, there are other definitions of value that are encountered in appraising and evaluating real estate transactions. These include the following.

Fair Value. This is an accounting term that is generally defined as the amount in cash or cash-equivalent value of other consideration that a real estate parcel would yield in a current sale between a willing buyer and a willing seller (the selling price), that is, other than in a forced or liquidation sale.[2] According to accounting literature, fair value is generally used in valuing assets in nonmonetary transactions, troubled debt restructuring, quasi-reorganizations, and business combinations accounted for by the purchase method. An accountant generally defines fair value as market value; however, depending on the circumstances, these values may not be the same for a particular property.

Investment Value. This is based on the data and assumptions that meet the criteria and objectives of a particular investor for a specific property or project. The investor's criteria and objectives are often substantially different from participants' criteria and objectives in a broader market. Thus, investment value can be significantly higher than market value in certain circumstances and should not be used in credit analysis decisions.

Liquidation Value. This assumes that there is little or no current demand for the property but the property needs to be disposed of quickly, resulting in the owner sacrificing potential property appreciation for an immediate sale.

Going-Concern Value. This is based on the value of a business entity rather than the value of just the real estate. The valuation is based on the existing operations of the business that has a proven operating record, with the assumption that the business will continue to operate.

Assessed Value. This represents the value on which a taxing authority bases its assessment. The assessed value and market value may differ considerably due to tax assessment laws, timing of reassessments, and tax exemptions allowed on properties or portions of a property.

2. FASB Statement of Standards No. 67, "Accounting for Costs and Initial Rental Operations of Real Estate Projects," appendix A.

Net Realizable Value (NRV). This is recognized under generally accepted accounting principles as "the estimated selling price in the ordinary course of business less estimated costs of completion (to the stage of completion assumed in determining the selling price), holding, and disposal."[3] The NRV is generally used to evaluate the carrying amount of assets being held for disposition and properties representing collateral. While the market value or future selling price are generally used as the basis for the NRV calculation, the NRV also reflects the current owner's costs to complete the project and to hold and dispose of the property. For this reason, the NRV will generally be less than the market value.

EVALUATION REQUIREMENTS

The Board's appraisal regulation allows banks to use evaluations for real estate–related financial transactions that do not require title XI appraisals for certain exempt transactions. Exempt transactions include—

- transactions below the $250,000 threshold,
- transactions qualifying for the exemption for the business loans of $1 million or less where income from real estate is not the primary source of repayment, and
- subsequent transactions resulting from an existing extension of credit (for example, renewals and refinancings).

An evaluation should provide a general estimate of the value of the real estate and need not meet the detailed requirements of a title XI appraisal.[4] An evaluation must provide appropriate information to enable the bank to make a prudent decision regarding the transaction. Moreover, a bank is not precluded from obtaining an appraisal that conforms to the regulation for any exempt transaction.

At a minimum, an evaluation should—

- describe the real estate collateral, including its condition and current use,
- describe the source(s) of information used in the analysis,
- describe the analysis and supporting information, and
- provide an estimate of the real estate's market value, with any limiting conditions.

Form and Content of Evaluations

Since a bank must tailor evaluations to provide appropriate information for different types of transactions, the content and form of evaluations will vary for different transactions. The documentation for evaluations should fully support the estimate of value and include sufficient information to understand the analysis and assumptions. There is no requirement that the evaluation be based on a particular form or valuation approach, but the analysis should be applicable to the type of property and fully explain the value rendered.

Prudent practices require that as the bank's exposure in a real estate–related financial transaction increases, a more detailed evaluation should be performed. An evaluation for a transaction that needs a more detailed analysis should fully describe the property and discuss its use, especially for nonresidential property.

An evaluation for a transaction that requires a less-detailed analysis may be based upon information such as comparable property sales information from sales data services (for example, the multiple listing service) or current tax-assessed value in appropriate situations.[5] An evaluation may also be based on the bank's own real estate loan portfolio experience and value estimates prepared for recent loans on comparable properties where appraisals meeting the requirements of the regulation were obtained. Regardless of the method, the bank must document its analysis and findings in the loan file.

An evaluation must be in writing, signed, dated, and include the preparer's name and address. The evaluation should include a presentation of the calculations, supporting assumptions for the estimate of value, and, if utilized, a discussion of comparable property sales.

3. FASB Statement of Standards No. 67, "Accounting for Costs and Initial Rental Operations of Real Estate Projects," appendix A.

4. An appraisal means the kind of specialized opinion as to the value of real estate, containing certain formal elements recognized by appraisal industry practices and standards.

5. Because assessed values for tax purposes may be a specified fraction of market value as determined by the tax assessor, tax-assessed values should be adjusted to a market-value equivalent. In cases where the assessed value does not have a reliable correlation to current value, the use of assessed value would be inappropriate as the basis for an evaluation.

USEFUL LIFE OF APPRAISALS OR EVALUATIONS

Since a bank may wish to use an existing appraisal or evaluation for a subsequent loan or investment, the bank's appraisal and evaluation program should include criteria to determine the validity of an existing appraisal or evaluation. When deciding if an appraisal or evaluation may be used for a subsequent transaction, a bank should determine if there has been any material change to the underlying assumptions that would affect the original estimate of value.

The useful life of an appraisal or evaluation will vary depending upon the circumstances affecting the property and the marketplace. Examples of factors that could cause material changes to reported values include the passage of time; the volatility of the local market; the availability of financing; the inventory of competing properties; new improvements to, or lack of maintenance of, the subject or competing, surrounding properties; change in zoning; or environmental contamination.

The bank should document its information sources and analyses used to determine if an existing appraisal or evaluation remains valid and if the bank will be using the appraisal or evaluation in a subsequent transaction.

REAPPRAISALS OR REEVALUATIONS

Real estate formerly pledged as collateral to secure an extension of credit that has been acquired by a bank through foreclosure proceedings, or that has been deeded to the bank in lieu of foreclosure proceedings, qualifies for the appraisal exemption for existing extensions of credit. In these circumstances, although a bank is *not* required to obtain an appraisal, it is required to obtain an evaluation, generally before entering into the transaction. In the interest of protecting the value of its collateral, however, a bank may initiate foreclosure action and obtain the evaluation in a reasonable period of time after taking title to the property.

The bank should develop criteria for obtaining reappraisals or reevaluations as part of a program of prudent portfolio review and monitoring techniques—even when additional financing is not being contemplated. Examples of such types of situations include large credit exposures and out-of-area loans.

The decision to reappraise or reevaluate the real estate collateral for a subsequent transaction should be guided by the appraisal exemption for renewals, refinancings, and other subsequent transactions. Loan workouts, debt restructurings, loan assumptions, and similar transactions involving the addition or substitution of borrowers may qualify for the exemption for renewals, refinancings, and other subsequent transactions. Use of this exemption depends upon the condition and quality of the loan, the soundness of the underlying collateral, and the validity of the existing appraisal or evaluation.

A bank may renew or refinance a loan based on a valid appraisal or evaluation if the planned future use of the property is consistent with the use identified in the appraisal or evaluation. However, if the property has reportedly appreciated because of a planned change in use, such as rezoning, an appraisal would be required for a federally related transaction unless another exemption applied, such as the amount financed is below the appraisal threshold.

While the Board's appraisal regulation generally allows appropriate evaluations of real estate collateral in lieu of an appraisal for loan renewals and refinancings, in certain situations an appraisal is required. If new funds are advanced over reasonable closing costs, a bank would be expected to obtain a new appraisal for the renewal of an existing transaction when there is a material change in market conditions that threatens the bank's real estate collateral protection.

For loan workouts involving the modification of the terms and conditions of an existing extension of credit, including the acceptance of new or additional real estate collateral, that facilitates the orderly collection of the credit or reduces the bank's risk of loss, a reappraisal or reevaluation may be prudent, even if it is obtained after the modification occurs. In a troubled-loan situation, a reappraisal would not be required when a bank advances funds to protect its interest in a property, such as to repair damaged property, because these funds should be used to restore the damaged property to its original condition.

QUALIFICATIONS CRITERIA FOR APPRAISERS AND INDIVIDUALS PERFORMING EVALUATIONS

The accuracy of an appraisal or evaluation depends on the competence and integrity of the individual performing the appraisal or evaluation, as well as the individual's expertise at developing and interpreting pertinent data for the subject property. The individual should have adequate training, experience, and knowledge of the local real estate market to make sound judgments about the value of a particular property. The level of training, experience, and knowledge should be commensurate with the type and complexity of the property to be valued. Additionally, the individual should be independent of the credit decision, have no interest in the property being valued, and have no affiliations or associations with the potential borrower. Absent absolute lines of independence, a bank must be able to demonstrate that it has prudent safeguards in place to isolate its collateral-evaluation process from influence or interference from the loan-production process.

Appraiser Qualifications

Under title XI of FIRREA, two classifications of appraisers were identified to be used in federally related transactions: state-certified appraiser and state-licensed appraiser. For a certified appraiser, title XI contemplated that the states would adopt similar standards for certification based on the qualification criteria of the Appraiser Qualifications Board of the Appraisal Foundation. These standards set forth minimum educational, testing, experience, and continuing education requirements. For a licensed appraiser, the states have some latitude in establishing qualification standards provided that the criteria are adequate to protect federal financial and public policy interest.

The Appraisal Subcommittee of the FFIEC is responsible for monitoring the states for compliance with title XI. The Board also has the authority to impose additional certification and licensing requirements to those standards adopted by a given state.

Selection of an Appraiser

An independent appraisal is one in which the appraiser is not participating in the administration of the credit or in the approval of the transaction and has no interest, financial or otherwise, in the property. In certain instances involving small banks, officers and directors who perform appraisals must take appropriate steps to ensure independence from the transaction under consideration.

In selecting an appraiser for an appraisal assignment, a bank is expected to consider whether the individual holds the proper state certification or license and has the appropriate experience and educational background to complete the assignment. Financial institutions may not exclude a qualified appraiser from consideration for an appraisal assignment solely because the appraiser lacks membership in a particular appraisal organization or does not hold a particular designation from an appraisal association, organization, or society.

In that regard, banks are expected to treat all appraisers fairly and equitably in determining whether the institution will use the services of a particular appraiser. Generally, banks have established procedures for selecting appraisers and maintaining an approved appraiser list. The practice of preapproving appraisers for ongoing appraisal work and maintaining an approved appraiser list is acceptable so long as all appraisers are required to follow the same approval process. However, a bank that requires appraisers who are not members of a particular appraisal organization to formally apply, pay an application fee, and submit samples of previous appraisal reports for review—but does not have identical requirements for appraisers who are members of certain appraisal organizations—would be viewed as having a discriminatory selection process.

Appraisals Performed by Certified or Licensed Appraisers

A bank is required to use a certified appraiser for—

- all federally related transactions over $1 million,
- nonresidential federally related transactions more than $250,000, and
- complex residential federally related transactions more than $250,000.[6]

6. Complex one- to four-family residential property appraisal means one in which the property to be appraised, the form of ownership, or market conditions are atypical.

A bank may use either a state-certified or a state-licensed appraiser for—

- noncomplex residential federally related transactions that are under $1 million.

Other Appraiser Designations

Some states have adopted other appraiser designations that may cause confusion about whether a particular appraiser holds the appropriate designation for a given appraisal assignment. Additionally, some states use designations such as "certified residential" appraiser and "certified general" appraiser, which leads to further confusion. Other states have no specified license designation, but use the term "certified residential," based on the standards for licensing. For this reason, the bank needs to understand the qualifications criteria set forth by the state appraiser regulatory body and whether these standards are the equivalent to the federal designations as accepted by the Appraisal Subcommittee.

Currently, the Appraisal Subcommittee has recognized four state appraiser designations: certified general, certified residential, licensed, and transitional licensed. For the certified residential appraiser, the minimum qualification standards are those established by the Appraiser Qualifications Board for "certified residential real estate appraiser." Under the Board's regulation, a certified residential appraiser would be permitted to appraise real estate in connection with a federally related transaction designated for a "certified" appraiser so long as the individual is competent for the particular appraisal assignment.

The Appraisal Subcommittee and the Board have also expressed their willingness to recognize a transitional license, which would allow a state to issue a license to an appraiser provided that the individual has passed an examination and has satisfied either the education or experience requirement. A transitional-licensed appraiser is permitted to appraise real estate collateral in connection with a federally related transaction as if licensed. The transitional-licensed appraiser is expected to complete the missing education or experience requirement within a set timeframe or the license expires. The recognition of a transitional license was believed to be necessary to ease the initial problems and inefficiencies resulting from the establishment of a new regulatory program. The Appraisal Subcommittee has advised the states that the use of the transitional license should be phased out over time once the appraiser regulatory program is fully established. As a result, the use of transitional license and the applicable timeframe will vary from state to state.

Qualifications of Individuals Who May Perform Evaluations

Evaluations may be performed by a competent person who has experience in real estate–related activities, which includes but is not limited to appraisals, real estate lending experience, real estate consulting, and real estate sales. A bank may also augment in-house expertise by hiring an outside consultant familiar with a certain market or a particular type of real estate. The bank's evaluation procedures should have established standards for selecting qualified individuals to perform evaluations and confirming their qualifications and independence to perform an evaluation for a particular transaction. An individual performing an evaluation need not be licensed or certified. However, if a bank desires, it may use state-licensed or -certified appraisers to prepare evaluations.

SUPERVISORY POLICY

A bank's appraisal and evaluation policies and procedures are reviewed as part of the examination of an institution's overall real estate–related activities. This includes a review of the procedures for selecting an individual for a particular appraisal or evaluation assignment and confirming that the individual is qualified, independent, and, if applicable, licensed/certified to undertake the assignment. If an institution maintains a list of qualified real estate appraisers acceptable for the bank's use, the examiner should ascertain whether the board of directors or senior management has reviewed and approved the list.

If a bank is in troubled condition that is attributable to underwriting problems in its real estate loan portfolio, the Board may require the bank to obtain appraisals for all *new* real estate–

related financial transactions below the threshold that are not subject to another exemption. The Reserve Bank will determine if a particular bank will have to obtain appraisals below the threshold.

When analyzing individual credits, examiners look at appraisals or evaluations to determine if the methods, assumptions, findings, and conclusions are reasonable and in compliance with the Board's rule, policies, and supervisory guidelines. Examiners should not challenge the underlying assumptions, including discount rates and capitalization rates used in appraisals, that differ only in a limited way from norms that would generally be associated with the property under review. Additionally, an examiner is not bound to accept the results of the appraisal or evaluation, regardless of whether a new appraisal or evaluation was requested during the examination. If an examiner concludes that an appraisal or evaluation is deficient for any reason, that fact will be taken into account in reaching a judgment on the quality of the credit.

When the examiner can establish that the underlying facts or assumptions are inappropriate and can support alternative assumptions, the examiner may adjust the estimated value of the property for credit-analysis purposes. It is important to emphasize that an examiner's overall analysis and classification of a credit may be based upon other credit or underwriting standards, even if the loan is secured by real property whose value is supported by an appraisal or evaluation. (Further discussion on the examiner's assessment of value for loan classification is in the manual sections 2060 and 2090, ''Classification of Credits'' and ''Real Estate Loans.'')

Significant failures to meet standards and procedures as outlined above will be criticized and corrective action will be required. Furthermore, inadequate appraisal and evaluation procedures may be considered an unsafe and unsound banking practice if the failure to accurately reflect the value of assets on a timely basis misrepresents the bank's financial condition. In this situation, formal corrective measures will be pursued as appropriate.

The appraisal regulation and guidelines require that banks use the services of qualified, independent certified or licensed appraisers to perform appraisals. Furthermore, a bank that knowingly uses the services of an individual to perform an appraisal in connection with a federally related transaction who is not properly certified or licensed is in violation of section 1120(a)(1) of title XI of FIRREA. Any action of a state-certified or -licensed appraiser that is contrary to the purpose of title XI should be reported by the examiner to the Federal Reserve Bank for referral to the appropriate state appraiser regulatory agency for investigation.

Real Estate Appraisals and Evaluations
Examination Objectives
Effective date November 1995

Section 4140.2

1. To determine whether policies, practices, procedures and internal controls regarding real estate appraisals and evaluations for real estate–related financial transactions are adequate.
2. To determine whether bank officers and employees are operating in conformance with the board of director's appraisal policies.
3. To determine that appraisals performed in connection with federally related transactions comply with the minimum standards of the Board's regulation and the Uniform Standards of Professional Appraisal Practice.
4. To determine that appraisers used in connection with federally related transactions are certified or licensed as appropriate.
5. To determine that appraisers are competent to render appraisals in federally related transactions, and are independent of the specific transaction, or other lending, investment, or collection functions as appropriate.
6. To initiate corrective action when policies, practices, procedures or internal controls are deficient, or when violations of laws or regulations or noncompliance with provisions of supervisory guidelines have been noted.

1. Based upon the evaluation of internal controls and the work performed by internal/external auditors, determine the scope of the examination.
2. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examination procedures. Also, obtain a listing of any deficiencies noted in the latest review performed by internal/external auditors and determine if appropriate corrections have been made.
   a. Provide copies of the bank's appraisal and evaluation policies and procedures to examiners assigned to functional areas where real estate–related transactions may require the services of an appraiser or evaluator.
   b. When individual real estate–related transactions such as loan or OREO transactions are examined, appraisals and evaluations should be reviewed for compliance with the Board's appraisal regulation, the interagency appraisal guidelines, and the bank's appraisal and evaluation programs.
   c. When real estate–related transactions are examined on a portfolio basis, the appraisal and evaluation processes for the specific activity should be examined. Examiners should determine whether these processes ensure that appraisals and evaluations comply with the Board's appraisal regulation, the interagency appraisal guidelines, and the bank's appraisal and evaluation programs.
3. Regarding appraisal and evaluation programs:
   a. Has the board of directors adopted policies and procedures that establish appraisal and evaluation programs?
   b. Do these programs include appraisal and evaluation critique procedures?
   c. Do the appraisal and evaluation programs establish the manner in which the institution selects, evaluates, and monitors individuals who perform or critique real estate appraisals or evaluations?
   d. Does the appraisal program ensure that appraisals conform to the Board's appraisal regulation?
   e. Does the evaluation program ensure that evaluations conform to the Board's guidance on evaluations?
   f. Do these programs reflect appropriately the bank's size, location, and the nature and complexity of the bank's real estate–related activities?
   g. Do these policies and procedures require that appraisals and evaluations be written?
   h. Does the board or senior management review annually its appraisal and evaluation related policies and procedures, and record such review in its minutes?
4. Evaluate the bank with respect to:
   a. The adequacy of written appraisal and evaluation programs.
   b. The manner in which bank officers are operating in conformance with established policy.
   c. Internal control deficiencies or exceptions.
   d. The integrity of the appraisal and evaluation process, including appraisal and evaluation compliance procedures.
   e. The integrity of individual appraisals and evaluations regarding the adequacy, reasonableness, and appropriateness of the methods, assumptions, and techniques used, and their compliance with the Board's appraisal regulation and interagency real estate appraisal and evaluation guidelines.
   f. The eligibility of the bank to assign a 50 percent risk weight to certain one- to four-family residential mortgage loans for risk-based capital purposes. See the section on Assessment of Capital Adequacy.
   g. Recommended corrective action when policies, practices, or procedures are deficient.
   h. The degree of violations, if any, of the Board's appraisal regulation, and extent of noncompliance with the interagency appraisal guidelines, if noted.
   i. Other matters of significance:
      - misrepresentation of data such as the omission of information on favorable financing, seller concessions, sales history, feasibility, zoning, easements, or deed restrictions.
      - inadequate techniques of analysis, i.e., failure to use cost, comparable sales, or income approach in the appraisal when

the approach is appropriate for the type of property.
- use of dissimilar comparables in the comparable sales approach to valuation, e.g., age, size, quality or location of comparable is significantly different from subject property making reconciliation of value difficult.
- underestimation of factors such as construction cost, construction period, lease-up period, and rent concessions.
- use of best case assumptions for the income approach to valuation without performing a sensitivity analysis on the factors which would identify the lender's downside risk.
- overly optimistic assumptions such as a high absorption rate in an overbuilt market.
- demographic factors such as existing housing inventory, projected completions, and expected market share are not reconciled to the value rendered, but are only discussed as background information.

5. Report any instances of questionable conduct by appraisers along with supporting documentation to the Reserve Bank for possible referral to the appropriate state appraisal authorities.
6. Update workpapers with any information that will facilitate future examinations.

Review the bank's internal controls, policies, practices and procedures for real estate appraisals and evaluations. The bank's system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used and other pertinent information. Items marked with an asterisk require substantiation by observation or testing.

POLICIES

1. Has the board of directors, consistent with its duties and responsibilities, adopted written appraisal and evaluation policies that define:
   a. Bank management's responsibility for selecting, evaluating and monitoring the individual who is performing the appraisal or evaluation?
   b. Basis for selecting staff appraisers and engaging fee appraisers for a particular appraisal assignment, ensuring that the individual is independent of the transaction, possesses the requisite expertise, and holds the proper state certification or license if applicable?
   c. Procedures for when to obtain appraisals and evaluations?
   d. Procedures for when to obtain a reappraisal or reevaluation, including frequency and scope?
   e. Appraisal and evaluation compliance procedures to determine that appraisals and evaluations comply with the Board's regulations, policies, and guidelines?
   f. Appraisal and evaluation review procedures to ensure that the bank's appraisals and evaluations are consistent with the standards of Uniform Standards of Professional Appraisal Practice (USPAP) and the Board's regulation and guidelines?
2. Does the board of directors on an annual basis review its appraisal, evaluation, and review policies and procedures to ensure that the appraisal and evaluation policies and procedures meet the needs of the bank's real estate lending activity?

APPRAISALS

*3. Are appraisals in writing, dated and signed?

*4. Does the appraisal meet the minimum standards of the Board's regulation and the Uniform Standards of Professional Appraisal Practice, including:
   a. Purpose?
   b. Market value?
   c. Effective date?
   d. Marketing period?
   e. Sales history of subject property?
   f. Reflect the valuation using the cost, income, and comparable sales approaches?
   g. Evaluate and correlate the three approaches into a final value estimate based on the appraiser's judgment?
   h. Explain why an approach is inappropriate and not used in the appraisal?
   i. Fully support the assumptions and the value rendered through adequate documentation?

*5. Are appraisals received prior to the bank making its final credit or other credit decision (e.g., is the date the loan committee approved the credit later than the date of the appraisal)?

*6. If the bank is depending upon an appraisal obtained for another federally regulated financial institution as support for its transaction, does the bank have appraisal review procedures to ensure that the appraisal meets the standards of the appraisal regulation? These types of transactions would include loan participations and mortgage-backed securities.

*7. If an appraisal for one transaction is used for a subsequent transaction, does the bank sufficiently document its determination that the appraisal is still valid?

APPRAISERS

8. Are appraisers fairly considered for assignments regardless of their membership or lack of membership in a particular appraisal organization?
9. Do appraisers have requisite knowledge

and experience to complete the appraisal prior to taking the assignment?

10. Do appraisers that discover deficiencies in their expertise prior to taking the assignment, or while performing the appraisal:
    a. Disclose their lack of knowledge and/or experience to the client prior to accepting the assignment, or at the point that the deficiencies became readily apparent?
    b. Describe in the appraisal their lack of knowledge and/or experience and the steps taken to competently complete the assignment?
11. Are appraisers independent of the transaction?
    a. Are staff appraisers independent of the lending, investment, and collection functions, and not involved, except as an appraiser, in the federally related transaction, and have no direct or indirect interest, financial or otherwise, in the property?
    b. Are fee appraisers engaged directly by the bank or its agent, and have no direct or indirect interest, financial or otherwise, in the property or transaction?
12. If staff appraisers are used, does the bank periodically have test appraisals made by independent appraisers to check the bank's knowledge of trends, values, and markets?
13. If fee appraisers are used by the bank, does the bank investigate their qualifications and reputations?
14. Is the status of an appraiser's state certification or license verified with the state appraiser regulatory authority to ensure that the appraiser is in good standing?
15. Are fee appraisers paid the same fee whether or not the loan is granted?
16. If the transaction is outside the local geographic market of the bank, does the bank engage an appraiser with knowledge of the market where the real estate collateral is located?

EVALUATIONS

17. Are individuals performing evaluations independent of the transaction?

*18. Are evaluations required to be in writing, dated, and signed?

*19. Does the bank require sufficient information and documentation to support the estimate of value and the evaluator's analysis?

*20. If an evaluation obtained for one transaction is used for a subsequent transaction, does the bank sufficiently document its determination that the evaluation is still valid?

*21. Are evaluations received prior to the bank entering into a binding commitment?

*22. If the bank is depending upon an evaluation obtained for another federally regulated financial institution as support for its transaction, does the bank have evaluation review procedures to ensure that the evaluation meets the Board's regulation and guidance?

EVALUATORS

23. Are individuals who perform evaluations competent to complete the assignment?
24. Are evaluations prepared by individuals who are independent of the transaction?

REAPPRAISALS AND REEVALUATIONS

25. Does the bank follow a formal reappraisal and reevaluation program?
26. Does the bank sufficiently document and follow its criteria for obtaining reappraisals or reevaluations?

The Federal Reserve System relies on the timely and accurate filing of regulatory reports by domestic and foreign financial institutions. Data collected from regulatory reports facilitate early identification of problems that can threaten the safety and soundness of reporting institutions; ensure timely implementation of the prompt-corrective-action provisions required by law; and serve other legitimate supervisory purposes. Certain regulatory report information is used for public disclosure so investors, depositors, and creditors can better assess the financial condition of the reporting banks. Information that comes primarily from the Consolidated Reports of Condition and Income (call reports) is used to prepare the Uniform Bank Performance Report (UBPR), which employs ratio analyses to detect unusual or significant changes in a bank's financial condition as of the reporting dates. The UBPR also is used to detect changing patterns of behavior in the entire banking system; consequently, any inaccurate data in the regulatory reports may result in ratios that conceal deteriorating trends in the bank or the industry.

The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) and the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) amended various banking statutes to enhance the Federal Reserve's authority to assess civil money penalties against state member banks, bank holding companies, and foreign institutions that file "late," "false," or "misleading" regulatory reports. The civil money penalties also can be assessed against individuals who cause or participate in such filings.

The Federal Reserve has identified a late regulatory report as an official copy of a report that is not received by the Reserve Bank or its designated electronic collection agent in a timely manner. The filing of an institution's completed original report is timely in the following cases:

- The report is received by the end of the reporting day on the submission deadline.
- The report is mailed first-class and postmarked no later than the third calendar day preceding the submission deadline, regardless of when the report is received by the Federal Reserve District. In the absence of a postmark, an institution may be called on to provide proof of timely mailing if the report has been received after the submission deadline.
- The completed original report is put into an overnight-delivery system on the day before the submission deadline. An institution may be called on to provide proof of timely delivery to this system if the report has been received after the submission deadline.
- For electronic filers, the report is received by the Reserve Bank by the end of the reporting day on the submission deadline, or, for call reports, the report is received by the electronic collection agent by the submission deadline.

The filing of a false report generally involves the submission of mathematically incorrect data, such as addition errors or transpositions, or the submission of a regulatory report without appropriate schedules. Conversely, the filing of a misleading report involves some degree of negligent behavior on the part of the filer that results in the submission of inaccurate information to the Federal Reserve.

The Federal Reserve System has a Regulatory Reports Monitoring Program (the program) to identify those banking institutions it supervises—including state member banks, bank holding companies, Edge Act and agreement corporations, and the branches and agencies of foreign banks—that file late and false reports. Each Reserve Bank identifies and maintains records of late and false reporters; however, Reserve Banks are no longer required to submit monthly exception reports to the Board.

Generally, all regulatory reports of financial condition and income that domestic and foreign banking organizations are required by statute and regulation to file with the Federal Reserve are subject to the program. However, reports filed in connection with supervisory actions and applications for mergers and acquisitions, as well as Federal Reserve monetary aggregate reports, are not subject to the program.

To promote consistent treatment under the program, the Reserve Banks may not grant grace periods or extensions of the submission dates of regulatory reports of more than five calendar days without first consulting the Board. No extensions of due dates greater than five calendar days will be allowed, unless there are exigent circumstances. In addition, the program requires Board staff responsible for enforcement actions to consult with Reserve Bank staff to ensure that chronic late and false reporters are subject to appropriate follow-up supervisory actions.

The program is not designed to automatically assess civil money penalties or initiate any other type of enforcement action against banking institutions that the Federal Reserve supervises. However, Reserve Banks should continue to determine, on a case-by-case basis, when a banking institution has become a chronic late or false reporter and what supervisory action it will recommend against such a reporter.

REVIEW AND REFILING OF REGULATORY REPORTS

Review of regulatory reports involves determining whether the management of the member bank has submitted all required reports to the Federal Reserve in a timely and accurate manner. The examiner assigned to a specific area of examination is responsible for reviewing the reports relating to that area and for verifying that they are accurate and meet statutory and regulatory requirements. If the examiner finds a material difference in the reports, management should be instructed to refile corrected copies, if appropriate.

Examiners should discuss on the ''Examination Conclusions and Comments'' and ''Matters Requiring Board Attention'' pages of the examination report material errors or the filing of chronically late reports. They also should discuss with Reserve Bank staff any regulatory report filing that is considered misleading; such a report could lead to the issuance of criminal referrals against the involved individuals. In addition, management should be reminded that civil money penalties or other enforcement proceedings could occur as a result of chronically late or false regulatory report filing.

Banks should maintain effective manual or automated internal systems and procedures to ensure that reporting meets the appropriate regulatory requirements. They should develop clear, concise, and orderly workpapers to support the compilation of data. Preparation of proper workpapers provides not only a logical tie between report data and the bank's financial records but also facilitates accurate reporting and verification. Ideally, as part of an effective internal-control program, bank management should implement a procedure to verify the compilation of the data. At a minimum, an independent person or department should verify the data that have been compiled for inclusion in the report.

A bank's internal-control and audit programs for regulatory reports should be sufficient to ensure that all required reports are submitted on time and are accurate. The specific internal controls a bank employs to meet those objectives depend largely on the volume of reports, the scope of a bank's operations, and the complexity of its accounting system.

COMMONLY REQUIRED REGULATORY REPORTS

This section describes the regulatory reports most commonly required either to be submitted by the member bank to the Federal Reserve Bank or the Board, or to be maintained by the member bank for review during an examination.

Consolidated Reports of Condition and Income

Under 12 USC 324 and the Board's Regulation H, all state member banks are required to file Consolidated Reports of Condition and Income (call reports) as of the last day of each calendar quarter. The specific reporting requirements, including the form to be used (for example, FFIEC 031 or FFIEC 041), depend on the asset size of the bank and whether it has a foreign office. Details of the appropriate reporting guidelines, along with the specific report form to be filed, are found in the instructions for preparation of Reports of Condition and Income.

The bank should submit completed call reports to the appropriate supervisory agencies no more than 30 calendar days after the report date. Any bank with more than one foreign office, other than a shell branch or international banking facility, may request from its supervisory agency a 15-day extension of the submission deadline. State member banks are no longer required to publish their Reports of Condition, according to section 308 of the Riegle Community Development and Regulatory Improvement Act of 1994.

However, a state member bank may still be required to publish its Report of Condition under state law. There are no federal publication requirements for state member or nonmember banks' Reports of Income.

The Report of Condition provides consolidated, detailed financial information on assets, liabilities, capital, and off-balance-sheet activity, which permits a uniform analysis and comparison of the reporting bank's data to that of other insured banks. The report also aggregates certain figures on loans to executive officers, directors, principal shareholders, and their related interests. The Report of Income provides information such as consolidated earnings, changes in capital accounts and the allowance for loan and lease losses, and charge-offs and recoveries.

The examiner should carefully review both reports to ensure that all pertinent data have been reported and are properly categorized in accordance with the instruction manual. To understand a particular bank's call report, the examiner must understand the bank's accounting methods as well as the information located in, and the relationships between, the bank's general books and subsidiary ledgers. This understanding can be obtained only by a careful review of the workpapers used in the preparation of these reports and their supplementary schedules.

Reports of Indebtedness to Correspondent Banks

Section 215.22 of the Board's Regulation O requires principal shareholders and executive officers of member banks and such persons' ''related interests'' to make a written report to the board of directors of their bank if they have outstanding an extension of credit from a correspondent bank of their own bank during the preceding year. This report should be made by January 31.

A correspondent bank is defined as a bank that maintains one or more correspondent accounts for a member bank during the calendar year and, when aggregated, these accounts exceed certain amounts specified in the regulation. Form FFIEC 004, or a substitute acceptable to the bank, is to be used for reporting these transactions. These reports will facilitate the review of insider transactions by examiners, directors, senior management, auditors, and attorneys.

REPORTS REQUIRED BY THE MONETARY CONTROL ACT OF 1980

The Federal Reserve has established a basic deposits-reporting framework for administering Regulation D, Reserve Requirements of Depository Institutions, and for constructing, analyzing, and controlling the monetary and reserves aggregates. The framework consists of four reporting categories, which are defined by two measures:

- the reserve-requirement ''exemption amount,'' which is the amount of total reservable liabilities at each depository institution that is subject to a 0 percent reserve requirement
- two separate ''deposit cutoffs'' applicable to nonexempt and exempt institutions, respectively

Both measures are indexed annually; see Regulation D for the appropriate exemption and cutoff amounts.

The exemption amount and the deposit cutoff for any one calendar year are used by the Federal Reserve to determine deposit-reporting panels for September of that year to September of the following year. (Annual panel determinations are discussed in the subsection below.) All deposit reports are mandatory.

Reporting Categories

In general, the larger the institution, the more detailed or frequent its reporting requirements, subject to exceptions discussed later in this section. The first two reporting categories require detailed reporting and apply to nonexempt institutions, that is, those institutions whose total reservable liabilities are greater than the reserve-requirement exemption amount. The last two categories are characterized as ''reduced reporting'' and apply to exempt institutions, or those institutions whose total reservable liabilities are less than or equal to the exemption amount and, therefore, are fully exempt from reserve requirements. The filing-requirement frequency of the four reporting categories is as follows:

- Nonexempt institutions with total deposits greater than or equal to the deposit cutoff for nonexempt institutions file the FR 2900 (Report of Transaction Accounts, Other Deposits and Vault Cash) weekly. The report covers a seven-day reporting period beginning on Tuesday and ending on the following Monday.
- Nonexempt institutions with total deposits less than the deposit cutoff for nonexempt institutions file the FR 2900 quarterly, in March, June, September, and December. Each quarterly report covers a seven-day reporting period starting on the third Tuesday of the given month and ending the following Monday. *All nonexempt institutions with foreign branches or that obtain funds from foreign sources file the FR 2950 or FR 2951 (Report of Certain Eurocurrency Transactions) with the same frequency as the FR 2900, which is based on their deposit cutoff.*
- Exempt institutions with total reservable liabilities less than or equal to the exemption amount *and* with total deposits greater than or equal to the exemption amount file the two-item FR 2910a (Annual Report of Total Deposits and Total Reservable Liabilities). This report is filed as of the Monday that follows the third Tuesday in June (which corresponds to the last day of the June reporting week for the quarterly FR 2900 report).
- Exempt institutions with total deposits less than the exemption amount are generally not required to submit any deposits report as long as their total deposits, or estimates thereof, can be derived by the Federal Reserve from other existing sources of data, such as call reports.

There are exceptions to the above categories: Edge Act and agreement corporations and U.S. branches and agencies of foreign banks, regardless of the level of deposits or reservable liabilities they have, must file the FR 2900 or FR 2951 (Eurocurrency report) weekly.

Allocation Report

Regulation D allows only a single exemption and a single low reserve tranche for all combined offices of the same parent depository institution. For the calculation of required reserves, any FR 2900 respondent, whether weekly or quarterly, that files separate reports for individual offices (or groups of offices) also is required to file at least annually a report that allocates the exemption and the low reserve tranche among those offices (FR 2930 or FR 2930a). (Currently, only about 200 institutions file the allocation report, mostly Edge and agreement corporations, U.S. branches and agencies of foreign banks, and a handful of savings and loan institutions.)

Annual Panel Determinations

Each year the Federal Reserve reviews the institutions in the four reporting categories, and reassignments of institutions (“panel shifts”), as necessary, occur each September. The panel shifts reflect movements in each individual depository institution’s total deposits or total reservable liabilities across the prevailing boundaries (the exemption amount and the deposit cutoff) that separate the reporting categories. Documentation is available on the Federal Reserve’s procedures (including the reports, data items, and reporting periods) for measuring an institution’s total reservable liabilities and total deposits against the prevailing cutoffs for the annual panel determinations. Two special types of panel shifts are described below.

- *Voluntary shifts.* By late summer, the Federal Reserve informs each institution of its particular reporting requirement for September of that year to September of the following year. Any depository institution assigned to one particular category may elect instead to report deposits (and, if appropriate, to maintain reserves) in accordance with a higher-level category. (For example, an institution assigned to the FR 2900 quarterly reporting category may elect instead to report the FR 2900 weekly.) However, any such voluntary shifts may take place only once a year during the normal September panel shifts. Voluntary shifts to a lower-level category are not permitted.

- *Fast-growing institutions.* The Federal Reserve may require a depository institution that is experiencing above-normal growth to report on a more detailed or frequent basis before the September panel shifts.

REPORTS REQUIRED UNDER REGULATION H AND THE SECURITIES EXCHANGE ACT OF 1934

Section 12(i) of the Securities Exchange Act of 1934 (the 1934 act), as amended by the Sarbanes-Oxley Act of 2002, vests the Board with the authority to administer and enforce certain provisions of the 1934 act and the Sarbanes-Oxley Act with respect to state member banks that have a class of securities registered under section 12(b) or 12(g) of the 1934 act (registered state member banks). In particular, the Board is charged with enforcing sections 12, 13, 14(a), 14(c), 14(d), 14(f), and 16 of the 1934 act and sections 301, 302, 303, 304, 306(a), 401(b), 404, 406, and 407 of the Sarbanes-Oxley Act[1] with respect to registered state member banks. Section 208.36(a) of Regulation H, which implements these provisions, generally requires registered state member banks to comply with any rules, regulations, and forms adopted by the Securities and Exchange Commission (SEC) under the above-listed sections of the 1934 act and the Sarbanes-Oxley Act. (See 12 CFR 208.36(a), as amended by 68 *Fed. Reg.* 4092 (January 28, 2003).) Registered state member banks, however, generally must file any forms or reports required by these rules with the Board, rather than the SEC.

If a state member bank has a class of securities registered under section 12 of the 1934 act and, thus, is a registered state member bank, the examiner should consult with the bank's management to ensure that the reports required by Regulation H are properly filed with the Board. Listed below are some of the most common forms and reports that must be filed with the Board by a registered state member bank pursuant to Regulation H. This list, however, is not exclusive and examiners should consult Board staff or Regulation H, the 1934 act, the Sarbanes-Oxley Act, and the SEC's implementing rules if questions arise concerning the filing of reports by a registered state member bank.

Section 12 of the 1934 Act

Form 8-A is for the registration of certain classes of securities pursuant to sections 12(b) or 12(g) of the 1934 act for, among other things, listing on national securities exchanges. Form 8-B is for the registration of securities of certain successor issuers pursuant to sections 12(b) or 12(g) of the 1934 act. Form 10 is the general form for registration of securities pursuant to sections 12(b) or 12(g) of the 1934 act for classes of securities of issuers for which no other form is prescribed.

Section 13 of the 1934 Act

Form 8-K must be filed within 15 days after the occurrence of the earliest of one or more specified events that are required to be reported and that affect the bank or its operations, such as changes in control of registrant or an acquisition or disposition of significant assets. Form 10-Q is for quarterly and transition reports and must be filed within 45 days after the end of each of the first three fiscal quarters. Form 10-K is for annual and transition reports that must be filed within 90 calendar days after the end of the registrant's fiscal year. Accelerated 10-K and 10-Q report filing deadlines apply to certain public companies that have a public float of at least $75 million. The SEC has adopted rules accelerating the time frames and has expanded the triggers for the filing of Form 8-K. (See Exchange Act Release No. 34-46464 (April 30, 2003).)

Section 16 of the 1934 Act

Section 16 requires the directors, officers, and principal shareholders of public companies to file reports concerning the purchase and sale of the company's equity securities. Form 3 reports the insider's initial beneficial ownership of registered companies, including banks. Form 4 is filed to report changes in the insider's beneficial ownership. Form 5 is an annual statement of the insider's beneficial ownership.

Sarbanes-Oxley Act

The Sarbanes-Oxley Act[2] (the act) and the SEC's implementing rules require the principal executive officer and principal financial officer

1. See 15 USC 78j-1, 78*l*–78n, 78p, 7241–7244(a), 7261(b), 7262, 7264, and 7265.

2. See 15 USC 7241 (section 302 of the act).

of public companies to file certain certifications with the company's annual 10-K report and quarterly 10-Q reports. The certifications must, among other things, state that the officer has reviewed the report, indicate that the report (to the officer's knowledge) does not contain any material misstatements or omissions, and contain certain representations concerning the company's internal controls.

The act requires the annual 10-K report of public companies to include a statement of management's responsibility for maintaining adequate internal-control structures and procedures for financial reporting and to contain an assessment of the effectiveness of these controls and procedures.[3] The company's external auditor must attest to, and report on, management's assessment. These reports and attestations are similar to the internal-control reports and attestations required by section 36 of the Federal Deposit Insurance Act (12 USC 1831m) for insured depository institutions with total assets of $500 million or more. The SEC published proposed rules to implement section 404 in October 2002. (See 67 *Fed. Reg.* 66207 (October 30, 2002).)

The act[4] and the SEC's implementing rules also require public companies to disclose in their periodic reports whether the company has adopted a code of ethics for its senior financial officers and whether the company's audit committee includes a "financial expert." If the company has not adopted a code of ethics or does not have a financial expert on its audit committee, the company must explain the reasons why not.

REPORTING AND INQUIRY REQUIREMENTS FOR LOST AND STOLEN SECURITIES

Every national securities exchange member, registered securities association member, broker, dealer, municipal securities dealer, government securities broker or dealer, registered transfer agent, and registered clearing agency and its participants, as well as every member bank of the Federal Reserve System and every bank whose deposits are insured by the Federal Deposit Insurance Corporation (reporting institutions), must register with the SEC's designee, the Securities Information Center, Inc. (SIC). All lost, missing, stolen, or counterfeit securities must be reported to the SIC. Except in certain limited circumstances, each insured bank is responsible for contacting the SIC to determine if the securities coming into its possession, whether by pledge, transfer, or some other manner, have been previously reported as missing, lost, stolen, or counterfeit.

All functions within a bank that handle or process securities are subject to the *reporting* requirements. Only the transfer-agent function is exempt from the *inquiry* requirements. Accordingly, all bank departments likely to be affected, including the trust, investment, transfer-agent, custody, or dealer departments, and the lending operations as relating to collateral loans, should be familiar with the requirements set out in 17 CFR 240.17f-1. Securities exempt from the reporting requirements are—

- registered securities of the U.S. government and federal agencies thereof,
- securities that have not been assigned CUSIP numbers, and
- bond coupons.

Securities exempt from the inquiry requirements are—

- securities received directly from the issuer or its agent at issuance,
- securities received from another reporting institution or from a Federal Reserve Bank or Branch,
- securities received from a customer of the reporting institution in the name of the customer or nominee, and
- securities that are a part of a transaction of $10,000 or less (aggregate face value for bonds or market value for stocks).

Lost, Missing, Stolen, or Counterfeit Securities

Form X-17F-1A must be filed with the SIC within one business day after the discovery of—

- a theft or loss of any security when there is a substantial indication of criminal activity,
- a security that has been lost or missing for two business days, and

3. See 15 USC 7262 (section 404 of the act).
4. See 15 USC 7264–7265 (sections 406 and 407 of the act).

- a security that is counterfeit.

The form must be filed within two business days of notification of nonreceipt when delivery of securities sent by the bank—

- is made by mail or draft and payment is not received within 10 business days, and confirmation of nondelivery has been made by the receiving institution; and

- is in person and no receipt is maintained by the bank.

If securities sent by the bank, either in person or through a clearing agency, are lost in transit and the certificate numbers of the securities can be determined, the bank must supply the receiving institution with the certificate numbers of the securities within two business days from the date of the request from the receiving institution. The delivery of lost or missing securities to the bank must be reported within one business day after discovery and notification of certificate numbers. Securities that are considered lost or missing as a result of counts or verifications must be reported no later than 10 business days after discovery or as soon as certificate numbers can be ascertained.

Copies of all reports required to be filed under 17 CFR 240.17f-1 must also be submitted to the registered transfer agent for the issue being reported and, if criminal activities are suspected, to the Federal Bureau of Investigation. Copies of filed or received Forms X-17F-1A must be maintained in an easily accessible place for three years.

TRANSFER-AGENT ACTIVITIES

If a bank acts as a transfer agent for its own stock, the stock of its holding company, or any other equity security, it may have to register with the Board as a transfer agent pursuant to the requirements of Regulation H (section 208.31) by filing uniform interagency Form TA-1. State member bank transfer agents must comply with the SEC's rules prescribing operational and reporting requirements, which the SEC adopted pursuant to section 17A of the 1934 act (for example, 17 CFR 240.17Ac2-2 and 240.17Ad-1–240.17Ad-16). (See section 208.31(b) of Regulation H).

MUNICIPAL SECURITIES DEALER ACTIVITIES

A state member bank, subsidiary, department, or division thereof that is a municipal securities dealer must register with both the SEC and the Board as a municipal securities dealer by filing Form MSD, pursuant to SEC Rule 15Ba2-1. A discussion of the bank's responsibilities as a municipal securities dealer, filing requirements, and other information, including examination procedures, are discussed in the Board's *Municipal Securities Dealer Examination Manual*. The Board has also developed a separate Report of Examination of Municipal Securities Dealer Activities.

GOVERNMENT SECURITIES BROKER AND DEALER ACTIVITIES

If a state member bank, a foreign bank, a state branch or an agency of a foreign bank, or a commercial lending company owned or controlled by a foreign bank acts as a government securities broker or dealer, it may have to file notice with the Board as a government securities broker or dealer by filing Form FR G-FIN, pursuant to section 15C(a)(1)(B) of the 1934 act. A discussion of the bank's responsibilities as a government securities broker or dealer, filing requirements, and other information, including examination procedures, are discussed in the Board's supervisory letter SR-87-37. The Board has also developed a separate Summary Report of Examination of Government Securities Broker/Dealer or Custodial Activities.

INTERNATIONAL ACTIVITIES

A bank must file certain reports if it is conducting or intends to conduct international activities through either foreign branches or Edge Act or agreement corporations. Listed below is a brief description of each of these reports.

FFIEC 009—Country Exposure Report

FFIEC 009 is filed quarterly by all U.S. banks and bank holding companies that meet certain ownership criteria and that, on a fully consolidated basis, have total outstanding claims on foreign residents in excess of U.S.$30 million (or equivalent). Information is collected on the distribution by country of these foreign claims held by U.S. banking organizations.

FFIEC 009a—Country Exposure Information Report

FFIEC 009a is a quarterly supplement to the Country Exposure Report (FFIEC 009) that provides public disclosure of significant country exposures of U.S. banking institutions. Part A must be filed when exposure to a single country exceeds 1 percent of the banking institution's total assets or 20 percent of that institution's capital, whichever is less. Part B provides a list of countries where exposure exceeds between 0.75 percent and 1 percent of the respondent's assets or between 15 percent and 20 percent of capital.

FFIEC 030—Foreign Branch Report of Condition

Every insured commercial bank with one or more branch offices in a foreign country is required to file the FFIEC 030 as of December 31 of each year. Significant branches, with either total assets of at least $2 billion or commitments to purchase foreign currencies and U.S. dollar exchange of at least $5 billion as of the end of a quarter, are required to file the report quarterly.

FR 2058—Notification of Foreign Branch Status

FR 2058 should be filed by any member bank, bank holding company, or Edge Act or agreement corporation within 30 days of the opening, closing, or relocation of a foreign branch of that U.S. organization or of its foreign subsidiary (or subsidiaries).

FR 2064 Recordkeeping Requirements

Internationally active U.S. banking organizations are still expected to maintain adequate internal records to allow examiners to review compliance with the investment provisions of Regulation K, under the recordkeeping requirements of FR 2064 (no form is associated with this recordkeeping requirement). For each investment made under subpart A of Regulation K, records should be maintained on the type of investment (for example, equity (voting shares, nonvoting shares, partnerships, interests conferring ownership rights, participating loans), binding commitments, capital contributions, and subordinated debt), the amount of the investment, the percentage ownership, activities conducted by the company and the legal authority for such activities, and whether the investment was made under general-consent, prior-notice, or specific-consent authority. For those investments made under general-consent authority, information also must be maintained that demonstrates compliance with the various limits set out in section 211.9 of Regulation K.

Information maintained by the banking organization should be made available to examination staff during the course of on-site examinations and pursuant to other supervisory requests. The recordkeeping must be adequate to permit examiners to determine compliance. Examiners are expected to review a sample of these investments to determine the accuracy of the organization's records and to determine compliance with the regulation. (See SR-02-2.)

FR 2314—Annual Report of Condition for Foreign Subsidiaries of U.S. Banking Organizations

- FR 2314a—This report should be filed as of December 31 of each year by foreign companies with total assets exceeding U.S.$250 million.
- FR 2314b—This report should be filed as of December 31 of each year by foreign companies with total assets greater than or equal to $50 million and less than or equal to $250 million.
- FR 2314c—This report should be filed as of December 31 of each year by foreign companies with total assets less than $50 million.

FR 2502q—Quarterly Report of Assets and Liabilities of Large Foreign Offices of U.S. Branches

FR 2502q is collected from large foreign branches of U.S. banking institutions, Edge Act and agreement corporations, and large foreign bank subsidiaries. It provides a geographic breakdown of each office's assets and liabilities. Branches of a U.S. bank with $500 million or more in total assets and foreign banking subsidiaries with $2 billion or more in total assets, or $10 million in deposit liabilities, are required to file this report.

FR 2886b—Consolidated Report of Condition and Income for Edge Act and Agreement Corporations

FR 2886b covers the operations of the reporting corporation, including any international banking facilities of the reporter. Corporations engaged in banking must submit this report at least quarterly.

FR 2915—Report of Foreign Currency Deposits

FR 2915 collects seven-day averages of the amounts outstanding of foreign currency–denominated deposits held at U.S. offices of the depository institution, converted to U.S. dollars and included in the Report of Transaction Accounts, Other Deposits and Vault Cash (FR 2900). The report is collected with the reporting week that begins the third Tuesday of March, June, September, and December.

FR Y-10—Report of Changes in Organizational Structure

The FR Y-10 is used to report, among other things, information on investments of bank holding companies, U.S. banks, and Edge and agreement corporations in any equity, including a foreign bank, held under subpart A of Regulation K, and in any export trading company held under subpart C of Regulation K. The form includes detailed information on the structure of top-tier bank holding companies; state member banks that are not controlled by a BHC; Edge and agreement corporations that are not controlled by a member bank, a domestic BHC, or a foreign banking organization (FBO); nationally chartered banks that are not controlled by a BHC, with regard to their foreign investments only; and FBOs that are BHCs and nonqualifying FBOs. Within 30 calendar days of the occurrence of a reportable transaction or event, banking organizations are required to report changes in investments (both foreign and domestic) on the FR Y-10 report. The form includes the structure information on foreign investments (those reported previously on FR 2064). The FR Y-10 also collects information on the commencement of new foreign activities.

The Board has placed greater importance on monitoring the level of international investments to ensure compliance with relevant banking laws and regulations, and to ensure that banking organizations do not expose themselves to undue risk. Examiners and other Federal Reserve System staff have a continuing need to monitor compliance with the Federal Reserve Act and sections 211.8–211.10 of the revised Regulation K.

Investments of less than 25 percent of the voting shares of a foreign nonbanking company are reported on the FR Y-10 report.[5] However, using the FR Y-6 report, banking organizations are required to report annually all investments, including those between 5 percent and 25 percent of voting shares.[6] The FR Y-6 and the FR Y-10 collect information on structure and geographical information relating to foreign investments for ongoing monitoring.

Examiners are expected to review investment amounts and activities during the examination process. The portion of an examination dealing with Regulation K compliance should focus on confirming investments made pursuant to the general-consent provisions to meet the restrictions on investment amount and activities in sections 211.8–211.10 of Regulation K. Investments made under the general-consent provisions of Regulation K can be sizeable, and thus can pose significant risk to the banking organization. Examiners should keep in mind that the Board has the authority to rescind an organization's general-consent investment privileges for various reasons, including safety-and-soundness concerns and noncompliance with the existing requirements of Regulation K. (See SR-02-2.)

5. Regulation K authorizes portfolio investments in less than 20 percent of the shares of a foreign company regardless of the activities engaged in by that company. Portfolio investments within the general-consent limits are required to be reported annually on the FR Y-6 report.

6. Investments representing less than 5 percent ownership are not required to be reported.

Treasury International Capital Forms

The following reports are collected to gather information on international capital movements by U.S. banks and their Edge Act and agreement corporations, other depository institutions, international banking facilities, and bank holding companies. A $25 or $50 million (or equivalent) threshold applies to reporting institutions, as applicable.

- BL-1 Liabilities to Foreigners, Payable in Dollars
- BL-2 Custody Liabilities to Foreigners
- BC Claims on Foreigners, Payable in Dollars
- BQ-1 Part 1. Claims on Foreigners
  Part 2. Domestic Customers' Claims on Foreigners Held by Reporter
- BQ-2 Part 1. Liabilities to and Claims on Foreigners Payable in Foreign Currencies
  Part 2. Domestic Customers' Claims on Foreigners (in Foreign Currencies)
- S Purchase & Sales of Long-Term Securities by Foreigners

Treasury Foreign-Currency Report

Weekly reports are required of U.S. banking organizations (Form FC-1) or their majority-owned foreign subsidiaries (Form FC-2) with net foreign-currency positions of U.S.$100 million (or equivalent) or more for specified currencies.

1. To determine that required reports are being filed on time.
2. To determine that the contents of reports are accurate.
3. To effect corrective action when official reporting, practices, policies, or procedures are deficient.

1. Complete or update the Internal Control Questionnaire, if selected for implementation.
2. Determine the bank's historical record of submitting timely and accurate reports by reviewing workpapers and the Regulatory Reports Monitoring Program.
3. Instruct those examiners assigned specific departments that generate regulatory reports to:
   a. Determine from department records what regulatory reports should have been filed because of the passage of time or the occurrence of an event.
   b. Obtain copies of all regulatory reports filed by the department since the previous examination.
   c. Check the reports obtained in the preceding step and the date of filing against statutory and regulatory requirements.
   d. Instruct the bank to prepare and submit any delinquent reports.
   e. For the most recent filing of those reports submitted on a periodic basis and all other reports submitted since the last examination, perform the following:
      - Reconcile the line items shown on the reports to the bank's general ledger, subsidiary ledgers, or daily statements.
      - Obtain the bank's workpapers applicable to each line item and reconcile individual items to the reports.
      - Determine whether other examining personnel uncovered any misstatement of assets, liabilities, income, or expense during their examination of the various departments.
      - Determine that the reports are prepared in accordance with Federal Reserve and/or other applicable instructions.
   f. On the basis of the work performed in the preceding step, perform either of the following, as appropriate:
      - If the reports are found to be substantially correct, limit the review of the remaining periodic reports filed since the last examination to the reconciliation of financial statement account categories to general ledger control accounts.
      - If the reports are found to be substantially incorrect, extend the procedures outlined in step 3.e to the remaining periodic reports filed since the last examination for those areas where items were found to be substantially incorrect.
   g. Scan all periodic reports for unusual fluctuations. Investigate fluctuations, if any.
4. Review compliance with the missing, lost, counterfeit, or stolen securities requirements of 17 CFR 240.17f-1 by:
   a. Discussing with appropriate officers and personnel the procedures in effect regarding the filing of Form X-17F-1A (Missing, Lost, Stolen, or Counterfeit Securities Report).
   b. Discussing with the appropriate persons the procedures in effect regarding compliance with the inquiry requirements.
   c. Substantiating Internal Control questions 6 through 15, as appropriate.
5. Prepare comments in appropriate report form and discuss with management:
   a. Violations of law or regulations.
   b. Inaccurate reports, and, if applicable, the need for amended reports. If amended reports are considered appropriate, consult with Reserve Bank supervisory personnel before requesting the bank to refile the report(s).
   c. Material differences in the annual report of the state member bank whose securities are subject to registration pursuant to the Securities Exchange Act of 1934. (State law governs the furnishing of annual reports to stockholders for banks with less than 500 shareholders.)
   d. Recommended corrective action when policies, practices, or procedures are deficient or when reports have been filed incorrectly, late, or not at all.

   The comments must include, if applicable, the name(s) and the "as of" date(s) of amended report(s); and the date of filing, amount of, and explanation of any material difference existing in either the numerical items or narrative statements in the annual report.
6. Update the workpapers with any information that will facilitate future examinations.

Review the bank's internal controls, policies, practices, and procedures for regulatory reports. The bank's system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used, and other pertinent information.

1. Do requests for all regulatory reports come to one individual or department?
2. Does that individual or department have the authority to request that required information be prepared by the applicable banking department?
3. To ensure that all regulatory reports are submitted on a timely basis and are accurate, determine the following:
   a. If completion of the report requires information from several departments:
      - Is a written memorandum sent to the various departments requesting the information?
      - Is the memorandum addressed to a department head?
      - Does the memorandum have a due date?
      - Are procedures in effect to send second requests if the memorandum is not returned by its original due date?
      - Does completion of the memorandum require two signatures, that of the person gathering the information and that of the person's superior who is held responsible for its accuracy?

   b. If completion of the report requires information from one department, is there separation of duties to ensure that the raw data to complete the report is compiled by one person and verified by another person, prior to submission?
4. After the report is prepared, but prior to its submission, is it checked by:
   a. The supervisor of the department preparing the report, who takes personal responsibility for its accuracy and submission on a timely basis?
   b. Bank personnel who have no part in the report's preparation?
5. Do report workpapers leave a clear audit trail from the raw data to the finished report and are they readily available for inspection?

   Review the bank's system for compliance with the reporting and inquiry requirements of the lost and stolen securities provisions of 17 CFR 240.17f-1.

6. Has the bank registered as a direct or indirect inquirer with the Securities Information Center, Inc.?
7. Are reports submitted within one business day of discovery when:
   a. Theft or loss of a security is believed to have occurred through criminal activity?
   b. A security has been missing or lost for two business days, except in certain cases?
   c. A security is counterfeit?
8. Are reports submitted by the bank, as a delivering institution, within two business days of notification of nonreceipt when:
   a. Delivery is in person and no receipt is maintained by the bank?
   b. Delivery of securities is made by mail or via draft, and payment is not received within 10 business days and confirmation of nondelivery has been made by the receiving institution?
   c. Securities are lost in transit and the certificate number(s) can be determined?
9. Are reports submitted by the bank, as a receiving institution, within one business day of discovery and notification of the certificate number(s) when:
   a. Securities are delivered through a clearing agency and the delivering institution has supplied the certificate numbers within the required two business days after request?
   b. Securities are delivered over the window and the delivering institution has a receipt and supplies the certificate number(s) within the required two business days after request?
10. Are securities that are considered to be lost or missing as a result of counts or verifications reported no later than ten business days after discovery or as soon after as the certificate number(s) can be ascertained?
11. Are copies of those reports submitted to the registered transfer agent for the issue and, in

the case of suspected criminal activity, the Federal Bureau of Investigation?

12. Are all recoveries of securities reported within one business day of recovery or finding? (Note: Only the institution that initially reported the security as missing can make a recovery report.)
13. Are inquiries made when the bank takes in any security that is not:
    a. Received directly from the issuer or issuing agent at issuance?
    b. Received from another reporting institution or Federal Reserve bank in its capacity as fiscal agent?
    c. Received from a bank customer and is registered in the name of the customer or its nominee?
14. Are all reports made on Form X-17F-1A or facsimile?
15. Are copies of Form X-17F-1A and subsequent confirmations and other information received maintained for three years in an easily accessible location?

CONCLUSION

16. Does the foregoing information provide an adequate basis for evaluating internal controls in that deficiencies in areas not covered by this questionnaire do not significantly impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
17. Are internal controls adequate based on a composite evaluation, as evidenced by answers to the foregoing questions?

Sale of Uninsured Nondeposit Debt Obligations on Bank Premises

Effective date May 1996

Section 4160.1

INTRODUCTION

State member banks have, at times, engaged in issuing nondeposit debt securities on their own behalf or assisted in the sale of these instruments (for example, commercial paper or other short-term or long-term debt securities, such as thrift notes and subordinated debentures) on behalf of their parent bank holding companies or other affiliates. It is important to ensure that these securities are not issued, marketed, or sold in a manner that could give the purchaser the impression that the obligations are federally insured deposits. Consequently, state member banks and their subsidiaries that have issued or plan to issue nondeposit debt securities should not market or sell these instruments in any public area of the bank where retail deposits are accepted, including any lobby area of the bank.

PROCEDURES

This policy is not intended to prevent banks from selling their uninsured debt instruments in a manner that is consistent with sound and prudent banking practices. These instruments generally may be sold to investors in various ways away from the retail deposit-taking and general lobby areas of the bank. In this regard, personnel not regularly involved in deposit-taking activities or in opening new deposit accounts may make prospective investors in the community aware of uninsured debt obligations outside of the retail deposit-taking and general lobby areas. Also, these instruments may generally be sold by an employee or officer segregated from the retail deposit-taking and general lobby areas of the bank, even if the employee or officer occasionally accepts deposits or opens an account (but not as a part of his or her regular duties), so long as the arrangement is not structured in a way that misleads the purchaser or is otherwise contrary to supervisory guidelines.

Further, state member banks involved in this activity should establish procedures to ensure that potential purchasers understand that the debt security is not federally insured or guaranteed. Specifically, the debt security should boldly state on its face that it is not insured by the Federal Deposit Insurance Corporation. In addition, this information should be verbally stated to the purchaser, and, in cases where purchasers do not take physical possession of the obligation, the purchaser should be provided with printed advice that conveys this information.

SUPERVISORY GUIDANCE

As noted, a state member bank may also become involved in the sale of uninsured debt obligations of its parent bank holding company or a nonbank affiliate. It is a longstanding policy of the Federal Reserve that debt obligations of a bank holding company or a nonbank affiliate not be issued, marketed, or sold in a way that conveys the misimpression or misunderstanding that these instruments are either (1) federally insured deposits or (2) obligations of or guaranteed by the subsidiary bank. The purchase of these holding company obligations by retail depositors of the subsidiary bank can, in the event of default, result in losses to individuals who believed that they had acquired federally insured or guaranteed instruments. In addition to the problems created for these individuals, this situation could impair public confidence in the bank and lead to unexpected withdrawals or liquidity pressures.

If a state member bank intends to market or sell or to allow its parent holding company or a nonbank affiliate to market or sell uninsured nondeposit debt obligations on bank premises, the bank should establish internal controls to ensure that the promotion, sale, and subsequent customer relationship resulting from the sale of these debt obligations is separated from the retail deposit-taking functions of the bank. For further information on commercial paper, see section 2030, ‘‘Bank Dealer Activities.’’

Sale of Uninsured Nondeposit Debt Obligations on Bank Premises

Examination Objectives

Effective date May 1996

Section 4160.2

1. To determine if uninsured nondeposit debt obligations of the state member bank or an affiliate are sold on bank premises.
2. To determine if the policies, practices, procedures, and internal controls for the sale of uninsured nondeposit debt instruments are adequate.
3. To ensure that the marketing and sale of uninsured nondeposit debt instruments are not conducted in a manner that conveys the impression or suggestion that they are federally insured deposits. Additionally, holding company or affiliate instruments should not convey the impression or suggestion that they are obligations of or guaranteed by the state member bank.
4. To ensure that the marketing and sale of uninsured nondeposit debt obligations are sufficiently separated and distinguished from retail banking operations, particularly the deposit-taking function.
5. To initiate corrective action if policies, practices, or procedures related to the sale of uninsured nondeposit debt instruments are deficient.

Sale of Uninsured Nondeposit Debt Obligations on Bank Premises
Examination Procedures
Effective date September 1992

Section 4160.3

1. Verify that the bank does not sell uninsured nondeposit debt instruments at teller windows or other areas where retail deposits are routinely accepted, including general lobby areas surrounding teller windows and personal banking desks.
2. Assess the adequacy of disclosures and the separation of the marketing and sale of uninsured nondeposit debt obligations from the retail deposit-taking function by assuring that:
   a. the debt instrument, advertising, and all related documents disclose prominently in bold print that the debt instrument is not insured by the Federal Deposit Insurance Corporation (bank holding company debt instruments should also state that the instrument is not an obligation of, or guaranteed by, the bank);
   b. advertisements that promote uninsured debt obligations of the bank (or an affiliate) do not also promote insured deposits of the bank in a way that could lead to confusion;
   c. the obligor of the uninsured debt instrument is prominently disclosed and names or logos of the bank are not used on holding company or nonbank affiliate instruments in a way that might suggest the insured bank is the obligor;
   d. adequate verbal disclosures are made during telemarketing contacts and at the time of sale (a review of employee instructions or a telemarketing script, or appropriate questions directed to an employee handling this function, could assist an examiner in assessing the adequacy of verbal disclosure);
   e. retail deposit-taking employees of the insured depository institution are not engaged in the promotion or sale of uninsured nondeposit debt instruments;
   f. information on uninsured nondeposit debt instruments is not contained in the retail deposit statements of customers or in the immediate retail deposit-taking area; and
   g. account information on holdings of uninsured nondeposit debt instruments is not included on insured deposit statements.
3. Encourage the bank to obtain a signed statement from the customer indicating that the customer understands that the uninsured debt instrument is not a deposit and is not FDIC insured.

INTRODUCTION

Depository institutions have become increasingly involved in selling uninsured nondeposit investment products, such as mutual funds or annuities, on their premises to retail customers. In response to this development, an interagency statement on retail sales of nondeposit investment products (interagency statement) was issued on February 15, 1994, to enhance customer protection and lessen possible customer confusion that these products are insured deposits.[1] The interagency statement applies to all insured banks and thrifts, including state member banks and the U.S. branches and agencies of foreign banks.

The guidelines contained in the interagency statement apply to retail recommendations or sales of nondeposit investment products made by—

- employees of a depository institution,
- employees of an affiliated or unaffiliated third party occurring on the premises of the banking organization (including telephone sales, investment recommendations by employees, and sales or recommendations initiated by mail from its premises), and
- sales resulting from a referral of retail customers by the institution to a third party when the depository institution receives a benefit for the referral.

Retail sales include (but are not limited to) sales to individuals by depository-institution personnel or third-party personnel conducted in or adjacent to a depository institution's lobby area. The sales of government and municipal securities made in a depository institution's dealer department located away from the lobby area are not subject to the interagency statement. In addition, the interagency statement generally does not apply to fiduciary accounts administered by a depository institution. However, for fiduciary accounts where the customer directs investments, such as self-directed individual retirement accounts, the disclosures prescribed by the interagency statement (see the ''Disclosures and Advertising'' subsection below) should be provided. Furthermore, the interagency statement applies to affiliated broker-dealers when the sales occur on the premises of the depository institution. The interagency statement also applies to sales activities of an affiliated broker-dealer resulting from a referral of retail customers by the depository institution.

The Rules of Fair Practice of the National Association of Securities Dealers (NASD) govern sales of securities by its member broker-dealers. In addition, the federal securities laws prohibit materially misleading or inaccurate representations in connection with the offer or sale of securities and require that sales of registered securities be accompanied by a prospectus that complies with SEC disclosure requirements.

Examiners should determine whether the institution has adequate policies and procedures to govern the conduct of the sales activities on bank premises and, in particular, whether sales of nondeposit investment products are distinguished from the deposit-taking activities of the bank through disclosure and physical means that are designed to prevent customer confusion.

Although the interagency statement does not apply to sales of nondeposit investment products to nonretail customers, such as fiduciary customers, examiners should also apply the examination procedures prescribed in SR-94-34 (''Examination Procedures for Retail Sales of Nondeposit Investment Products,'' May 26, 1994) when retail customers are directed to the institution's trust department, where they may purchase nondeposit investment products by simply completing a customer agreement.

For additional information on the subject of retail sales of nondeposit investment products, examiners and other interested parties may find it helpful to refer to ''Retail Investment Sales—Guidelines for Banks,'' (industry guidelines) February 1994, published collectively by six bank trade associations and available from the American Bankers Association.

1. The interagency statement was issued to Federal Reserve Banks under cover of a supervisory letter, SR-94-11 (''Interagency Statement on Retail Sales of Nondeposit Investment Products,'' February 17, 1994). This SR-letter superseded SR-93-35 dated June 17, 1993, which addressed the retail sale of mutual funds on state member bank premises. Additional guidance regarding the interagency statement was provided in SR-95-46 (''Interpretation of Interagency Statement on Retail Sales of Nondeposit Investment Products,'' September 14, 1995).

PROGRAM MANAGEMENT

Banks must adopt policies and procedures governing nondeposit investment product retail sales programs. These policies and procedures should be in place before the commencement of the retail sale of nondeposit investment products on bank premises.

The bank's board of directors is responsible for ensuring that retail sales of nondeposit investment products comply with the interagency statement and with all applicable state and federal laws and regulations. Therefore, the board, or a designated committee of the board, should adopt written policies that address the risks and management of these sales programs. Policies and procedures should reflect the size, complexity, and volume of the institution's activities or, when applicable, the institution's arrangements with any third parties selling these products on bank premises. The bank's policies and procedures should be reviewed periodically by the board of directors, or its designated committee, to ensure that they are consistent with the institution's current practices, applicable laws, regulations, and guidelines.

As discussed in more detail below, a bank's policies and procedures for nondeposit investment products should, at a minimum, address disclosure and advertising, the physical separation of investment sales from deposit-taking activities, compliance and audit requirements, suitability concerns, and other sales practices and related risks. In addition, policies and procedures should address the following areas.

Types of Products Sold

When evaluating nondeposit investment products, management should consider what products best meet the needs of the bank's customers. Policies should outline the criteria and procedures that will be used to select and periodically review nondeposit investment products that are recommended or sold on the bank's premises. Institutions should periodically review the products offered to ensure they meet their customers' needs.

Use of Identical or Similar Names

Because of the possibility of customer confusion, a nondeposit investment product must not have a name that is identical to the name of the bank or its affiliates. However, a bank may sell a nondeposit investment product with a similar name as long as the sales program addresses the even greater risk that customers may regard the product as an insured deposit or other obligation of the bank. Moreover, the bank should review the issuer's disclosure documents for compliance with SEC requirements, which call for a thorough explanation of the relationship between the bank and the mutual fund.

The Federal Reserve applies a stricter rule under Regulation Y (12 CFR 225.125) when a bank holding company (as opposed to a bank) or nonbank subsidiary acts as an investment advisor to a mutual fund. In this case, the fund may not have a name that is identical to, similar to, or a variation of the name of the bank holding company.

Permissible Use of Customer Information

Banks should adopt policies and procedures on the use of confidential customer information for any purpose in connection with the sale of nondeposit investment products. The industry guidelines permit institutions to share with third parties only limited customer information, such as the name, address, telephone number, and types of products owned. The guidelines do not permit the sharing of more confidential information, such as specific or aggregate dollar amounts of investments or net worth, without the customer's prior acknowledgment and written consent.

Arrangements with Third Parties

A majority of all nondeposit investment products sold on bank premises are sold by representatives of third parties. Under these arrangements, the third party has access to the institution's customers, and the bank is able to make nondeposit investment products available to interested customers without having to commit the resources and personnel necessary to sell the products directly. Third parties include wholly owned subsidiaries of a bank, bank-affiliated broker-dealers (section 20 companies[2] or discount brokerage firms), unaffiliated broker-dealers, insurance companies, or other companies in the business of distributing nondeposit investment products on a retail basis.

Bank management should conduct a comprehensive review of an unaffiliated third party before entering into any arrangement. The review should include an assessment of the third party's financial status, management experience, reputation, and ability to fulfill its contractual obligations to the bank, including its compliance with the interagency statement.

Banks should enter into written agreements with any affiliated and unaffiliated third parties that sell nondeposit investment products on bank premises. These agreements should be approved by the bank's board of directors or its designated committee. Agreements should outline the duties and responsibilities of each party; describe third-party activities permitted on the institution's premises; address the sharing or use of confidential customer information for investment sales activities; and define the terms for use of the bank's office space, equipment, and personnel. If an arrangement includes dual employees (bank employees also utilized by a third party), the agreement must provide for written employment contracts that specify the duties of these employees and their compensation arrangements.

In addition, a third-party agreement should specify that the third party will comply with all applicable laws and regulations and will conduct its activities in a manner consistent with the interagency statement. The agreement should authorize the institution to monitor the third party's compliance with its agreement, as well as authorize the bank and Federal Reserve examination staff to have access to third-party records considered necessary to evaluate this compliance. These records should include examination results, sales practice reviews, and related correspondence provided to the third party by securities regulatory authorities. Finally, the agreement should provide for indemnification of the institution by an unaffiliated third party for the conduct of its employees in connection with its sales activities. Notwithstanding the provisions of a third-party agreement, bank management should monitor the conduct of nondeposit investment product sales programs to ensure that sales of the products are distinct from other bank activities and are not conducted in a manner that could confuse customers about the lack of insurance coverage for these investments.

2. A nonbank subsidiary of a bank holding company that has been authorized to underwrite and deal in certain debt and equity securities that cannot be underwritten or dealt in by member banks directly.

Contingency Planning

Nondeposit investment products are subject to price fluctuations caused by changes in interest rates and stock market valuations. In the event of a sudden, sharp drop in the market value of nondeposit investment products, institutions may experience a heavy volume of customer inquiries, complaints, and redemptions. Therefore, management should develop contingency plans to address these situations. A major element of any contingency plan should be to provide customers with access to information about their investments. Other factors to consider in contingency planning include public relations and the ability of operations staff to handle increased volumes of transactions.

DISCLOSURES AND ADVERTISING

Content, Form, and Timing of Disclosures

Nondeposit investment product sales programs should ensure that customers are clearly and fully informed of the nature and risks associated with these products. In addition, nondeposit investment products must be clearly differentiated from insured deposits. The interagency statement identifies the following minimum disclosures that must be made to customers when providing investment advice, making investment recommendations, or effecting nondeposit investment product transactions:

- They are not insured by the FDIC.
- They are not deposits or other obligations of the institution and are not guaranteed by the institution.
- They are subject to investment risks, including the possible loss of the principal invested.

There are limited situations in which the disclosure guidelines need not apply or where a shorter logo format may be used in lieu of the longer written disclosures.

The interagency statement disclosures do not need to be provided in the following situations:

- radio broadcasts of 30 seconds or less;
- electronic signs,[3] and
- signs, such as banners and posters, when they are used only as location indicators.

Additionally, third-party vendors not affiliated with the depository institution need not make the interagency statement disclosures on nondeposit investment product confirmations and in account statements that may incidentally, with a valid business purpose, contain the name of the depository institution.

Shorter, logo-format disclosures may be used in visual media, such as television broadcasts, ATM screens, billboards, signs, posters, and written advertisements and promotional materials, such as brochures. The text of an acceptable logo-format disclosure would include the following statements:

- Not FDIC-Insured.
- No Bank Guarantee.
- May Lose Value.

Disclosure is the most important way of ensuring that the differences between nondeposit investment products and insured deposits are understood by retail customers. Accordingly, it is critical that the minimum disclosures be presented clearly and concisely in both oral and written communications. In this regard, the minimum disclosures should be provided—

- orally during any sales presentations (including telemarketing contacts) or when investment advice is given,
- orally and in writing before or at the time an investment account to purchase these products is opened, and
- in all advertisements and other promotional materials (discussed further below).

3. ''Electronic signs'' may include billboard-type signs that are electronic, time-and-temperature signs, and ticker-tape signs. Electronic signs would not include such media as television, on-line services, or ATMs.

The minimum disclosures may be made on a customer account agreement or on a separate disclosure form. The disclosures must be conspicuous (highlighted through bolding, boxes, and/or a larger typeface). Disclosures contained directly on a customer account agreement should be located on the front of the agreement or adjacent to the customer signature block.

Banks are to obtain a written acknowledgment—on the customer account agreement or on a separate form—from a customer confirming that he or she has received and understands the minimum disclosures. For nondeposit investment product accounts established before the issuance of the interagency statement, banks should obtain a disclosure acknowledgment from the customer at the time of the customer's next purchase transaction. If an institution solicits customers by telephone or mail, it should ensure that the customers receive the written disclosures and an acknowledgment to be signed and returned to the institution.

Customer account statements, including combined statements for linked accounts and trade confirmations that are provided by the bank or an affiliate, should contain the minimum disclosures if they display the name or logo of the bank or its affiliate. Statements that provide account information about insured deposits and nondeposit investment products should clearly segregate the information about nondeposit investment products from the information about deposits to avoid customer confusion.

Advertising

The interagency statement provides that advertisements in all media forms that identify specific investment products must conspicuously include the minimum disclosures and must not suggest or convey any inaccurate or misleading impressions about the nature of a nondeposit investment product. Promotional material that contains information about both FDIC-insured products and nondeposit investment products should clearly segregate the information about the two product types. When promotional sales materials related to nondeposit investment products are displayed in the bank's retail areas, they should be grouped separately from material related to insured bank products.

Telemarketing scripts should be reviewed to determine whether bank personnel are inquiring about customer investment objectives, offering investment advice, or identifying particular investment products or types of products. In these cases, the scripts must contain the minimum disclosures, and bank personnel relying on the scripts must be formally authorized to sell nondeposit investment products by their employers. Further, these personnel must have training that is the substantive equivalent of that required for personnel qualified to sell securities as registered representatives (see the ''Training'' subsection below).

Additional Disclosures

A bank should apprise customers of certain material relationships. For example, a customer should be informed by sales personnel orally and in writing before the sale about any advisory relationship existing between the bank (or an affiliate) and a mutual fund whose shares are being sold by the institution. Similarly, fees, penalties, or surrender charges associated with a nondeposit investment product should be disclosed by sales personnel orally and in writing before or at the time the customer purchases the product. The SEC requires written disclosure of this information in the investment product's prospectus.

If sales activities include any written or oral representations concerning insurance coverage by any entity other than the FDIC (for example, SIPC insurance of broker-dealer accounts, a state insurance fund, or a private insurance company), then clear and accurate explanations of the coverage must also be provided to customers at that time to minimize possible confusion with FDIC insurance. These disclosures should not suggest that other forms of insurance are the substantive equivalent to FDIC deposit insurance.

SETTING AND CIRCUMSTANCES

Physical Separation from Deposit Activities

Selling or recommending nondeposit investment products on bank premises may give the impression that the products are FDIC-insured or are obligations of the bank. To minimize customer confusion with deposit products, nondeposit investment product sales activities should be conducted in a location that is physically distinct from the areas where retail deposits are taken. Bank employees located at teller windows may not provide investment advice, recommend investment products, or accept orders (even unsolicited orders) for nondeposit investment products.

To decide whether nondeposit investment product sales activities are sufficiently separate from deposit activities, the particular circumstances of each bank need to be evaluated. FDIC insurance signs and insured deposit-related promotional material should be removed from the investment product sales area and replaced with appropriate signs indicating that the area is used for the sale of investment products. Signs referring to specific investments should prominently contain the minimum disclosures. In the limited situation where physical constraints prevent nondeposit investment product sales activities from being conducted in a distinct and separate area, the institution has a heightened responsibility to ensure that appropriate measures are taken to minimize customer confusion.

In the case of banks that are affiliated with section 20 companies that sell retail investment products directly to bank customers, the requirement for separation of deposit-taking facilities from the securities operations of the section 20 company is absolute under the relevant firewall conditions imposed on these companies by the Board. Accordingly, retail sales activities conducted by a section 20 company must be in a separate office which, at a minimum, is set off from deposit-taking activities by partitions and identified by signs with the name of the section 20 company. Further, section 20 company employees may not be dual employees of the bank. Business cards for designated sales personnel should clearly indicate that they sell nondeposit investment products or, if applicable, are employed by a broker-dealer.

The interagency statement was intended generally to cover sales made to retail customers in the bank lobby. However, some institutions may have an arrangement whereby retail customers purchase nondeposit investment products at a location of the institution that is generally confined to institutional services (for example, corporate money desk). In these cases, the bank should still ensure that retail customers receive the minimum disclosures to minimize any possible customer confusion with nondeposit investment products and insured deposits.

Hybrid Instruments and Accounts

When an institution offers accounts that link traditional bank deposits with nondeposit investment products, such as a cash-management account,[4] the accounts should be opened in the investment sales area by trained personnel. In light of the hybrid characteristics of these products, the opportunity for customer confusion is amplified, and the institution should take special care during the account-opening process to ensure that a customer is accurately informed that

- funds deposited into a sweep account will only be FDIC-insured until they are swept into a nondeposit investment product account and
- customer account statements may disclose balances for both insured and nondeposit product accounts.

DESIGNATION, TRAINING, AND SUPERVISION OF PERSONNEL

Hiring and Training of Sales Personnel

Banks hiring sales personnel for nondeposit investment product programs should investigate the backgrounds of prospective employees. When a candidate for employment has previous investment industry experience, the bank should check whether the individual has been the subject of any disciplinary actions by securities, state, or other regulators.

Unregistered bank sales personnel should receive training that is the substantive equivalent of that provided to personnel qualified to sell securities as registered representatives. Training should cover the areas of product knowledge, trading practices, regulatory requirements and restrictions, and customer-protection issues. In addition, training programs should cover the bank's policies and procedures for sales of nondeposit investment products and should be conducted continually to ensure that staff are familiar with new products and compliance issues.

For those bank employees whose sales activities are limited to mutual funds or variable annuities, the equivalent training is that ordinarily needed to pass NASD's series 6 limited representative examination, which typically involves approximately 30 to 60 hours of preparation, including about 20 hours of classroom training. Bank employees who are authorized to sell additional investment products and securities should receive training that is appropriate to pass the NYSE's series 7 general securities representative examination, which typically involves 160 to 250 hours of study, including at least 40 hours of classroom training.

The training of third-party or dual employees is the responsibility of the third party. When entering into an agreement with a third party, bank management should be satisfied that the third party is able to train third-party and dual employees with respect to compliance with the minimum disclosures and other requirements of the interagency statement. Copies of third-party training and compliance materials should be obtained and reviewed by the bank to monitor the third party's performance regarding its training obligations.

Training of Bank Personnel Who Make Referrals

Bank employees, such as tellers and platform personnel, who are not authorized to provide investment advice, make investment recommendations, or sell nondeposit investment products, but who may refer customers to authorized nondeposit investment products sales personnel, should receive training about the strict limitations on their activities. In general, bank personnel who are not authorized to sell nondeposit investment products are not permitted to discuss general or specific investment products, prequalify prospective customers as to financial status and investment history and objectives, open new accounts, or take orders on a solicited or unsolicited basis. These personnel may contact customers for the purposes of—

- determining whether the customer wishes to receive investment information
- inquiring whether the customer wishes to discuss investments with an authorized sales representative, and
- arranging appointments to meet with authorized bank sales personnel or third-party broker-dealer registered sales personnel.

4. A hybrid account may incorporate deposit and brokerage services, credit/debit card features, and automated sweep arrangements.

The minimum disclosure guidelines do not apply to referrals made by personnel not authorized to sell nondeposit investment products if the referral does not provide investment advice, identify specific investment products, or make investment recommendations.

Supervision of Personnel

Bank policies and procedures should designate, by title or name, the individuals responsible for supervising nondeposit investment product sales activities, as well as the referral activities of bank employees not authorized to sell these products. Personnel responsible for managing the sales programs for these products should have supervisory experience and training equivalent to that required of a general securities principal, as required by the NASD for broker-dealers. Supervisory personnel should be responsible for the bank's compliance with policies and procedures on nondeposit investment products, applicable laws and regulations, and the interagency statement. When sales of these products are conducted by a third party, supervisory personnel should be responsible for monitoring compliance with the agreement between the bank and the third party, as well as compliance with the interagency statement, particularly the guideline calling for nondeposit investment product sales to be separate and distinct from the deposit activities of the bank.

SUITABILITY AND SALES PRACTICES

Suitability of Recommendations

Suitability refers to the matching of customer financial means and investment objectives with a suitable product. If customers are placed into unsuitable investments, the resulting loss of consumer confidence could have detrimental effects on the bank's reputation. Many first-time investors may not fully understand the risks associated with nondeposit investment products and may assume that the bank is responsible for the preservation of the principal of their investment.

Banks that sell nondeposit investment products directly to customers should develop detailed policies and procedures addressing the suitability of investment recommendations and related recordkeeping requirements. Sales personnel that recommend nondeposit investment products to customers should have reasonable grounds for believing that the recommended products are suitable for the particular customer on the basis of information he or she has provided. A reasonable effort must be made to obtain, record, and update information concerning the customer's financial profile (for example, tax status, other investments, income), investment objectives, and other information necessary to make recommendations.

In determining whether sales personnel are meeting their suitability responsibilities, examiners should review the practices for conformance with the bank's policies and procedures. The examiner's review should include a sample of customer files to determine the extent of customer information collected, recorded, and updated (for subsequent purchases) and should determine whether investment recommendations appear unsuitable in light of this information.

Nondeposit investment product sales programs conducted by third-party broker-dealers are subject to the NASD's suitability and other sales practice rules. To avoid duplicating NASD examination efforts, examiners should rely on the NASD's most recent sales practice review of the third party, when available. If an NASD review has not been completed within the last two years, Reserve Banks should consult with Board staff to determine an appropriate examination scope for suitability compliance before proceeding further.

Sales Practices and Customer Complaints

Banks should have policies and procedures that address undesirable practices by sales personnel, such as practices to generate additional commission income for the employee by churning or switching accounts from one product to another. Banks should have policies and procedures for handling customer complaints related to nondeposit investment products. The process should provide for the recording and tracking of all complaints and require periodic reviews of complaints by compliance personnel. The merits and circumstances of each complaint (including all documentation relating to the transaction) should be considered when determining the proper form of resolution. Reasonable time-frames should be established for addressing complaints.

COMPENSATION

Incentive compensation programs specifically related to the sale of nondeposit investment products may include sales commissions, limited fees for referring prospective customers to an authorized sales representative, and nonmonetary compensation (prizes, awards, and gifts). Compensation that is paid by unaffiliated third parties (for example, mutual fund distributors) to bank staff must be approved in writing by bank management, be consistent with the bank's written internal code of conduct for the acceptance of remuneration from third parties, and be consistent with the proscriptions of the Bank Bribery Act (18 USC 215) and the banking agencies' implementing guidelines to that act. (See SR-87-36, "Bank Bribery Act Guidelines," October 30, 1987.) Compensation policies should establish appropriate limits on the extent of compensation that may be paid to banking organization staff by unaffiliated third parties.

Incentive compensation programs must not be structured in such a way that they result in unsuitable investment recommendations or sales to customers. In addition, if sales personnel sell both deposit and nondeposit products, similar financial incentives should be in place for sales of both types of products. A compensation program that offers significantly higher remuneration for selling a specific product (such as a proprietary mutual fund) may be inappropriate if it results in unsuitable recommendations to customers. A compensation program that is intended to provide remuneration for a group of bank employees (such as a branch or department) is permissible as long as the program is based on the group's overall performance in meeting bank objectives for a broad variety of bank services and products and not on the volume of sales of nondeposit investment products.

Individual bank employees, such as tellers, may receive a one-time nominal fee of a fixed-dollar amount for referring customers to authorized sales personnel to discuss nondeposit investment products. However, the payment of the fee should not depend on whether the referral results in a transaction. Nonmonetary compensation to bank employees for referrals should be similarly structured. Auditors and compliance personnel should not participate in incentive compensation programs that are directly related to the results of nondeposit investment product sales programs.

COMPLIANCE

Banks must develop and maintain written policies and procedures that effectively monitor and assess compliance with the interagency statement and other applicable laws and regulations and that ensure appropriate follow-up to correct identified deficiencies. Compliance programs should be independent of sales activities with respect to scheduling, compensation, and performance evaluations. Compliance findings should periodically be reported to the bank's board of directors or a designated committee of the board as part of the institution's ongoing oversight of nondeposit investment product activities. Compliance personnel should have appropriate training and experience with nondeposit investment product sales programs, applicable laws and regulations, and the interagency statement.

Banks should institute compliance programs for nondeposit investment products that are similar to those of securities broker-dealers. This includes a review of new accounts and a periodic review of transactions in existing accounts to identify any potentially abusive practices, such as unsuitable recommendations, churning, or switching. Compliance personnel should also oversee the prompt resolution of customer complaints and review complaint logs for questionable sales practices. Management-information-system reports on early redemptions and sales patterns for specific sales representatives and products should also be used by compliance personnel to identify any potentially abusive practices. In addition, the referral activities of bank personnel should be reviewed to ensure that they conform to the guidelines in the interagency statement.

When nondeposit investment products are sold by third parties on bank premises, the bank's compliance program should provide for oversight of the third party's compliance with its agreement with the bank, including its conformance to the disclosure and separate-facilities guidelines of the interagency statement. The results of this oversight should be reported to the board of directors or a designated committee of the board. Management should obtain the third party's commitment to promptly correct identified problems. Proper follow-up by the bank's compliance personnel should verify the third party's corrective actions.

AUDITS

Audit personnel should be responsible for assessing the effectiveness of the institution's compliance function and overall management of the nondeposit investment product sales program. The scope and frequency of audit reviews of nondeposit investment product activities will depend on the complexity and sales volume of a sales program and on whether there are any indications of potential or actual problems. Audits should cover all of the issues discussed in the interagency statement. Internal audit staff should be familiar with nondeposit investment products and receive ongoing training. Findings should be reported to the board of directors or to a designated committee of the board, and proper follow-up should be performed. Audit activities with respect to third parties should include a review of their compliance function and the effectiveness of the bank's oversight of the third party's activities.

1. To determine that the banking organization has taken appropriate measures to ensure that retail customers clearly understand the differences between insured deposits and nondeposit investment products and that they receive the minimum disclosures both orally during sales presentations (including telemarketing) and in writing.
2. To assess the adequacy of the institution's policies and procedures, sales practices, and oversight by management and the board of directors to ensure an operating environment that fosters customer protection in all facets of the sales program.
3. To ensure that the sales program is conducted in a safe and sound manner that is in compliance with the interagency statement, Federal Reserve guidelines, regulations, and applicable laws.
4. To assess the effectiveness of the institution's compliance and audit programs for nondeposit investment product operations.
5. To obtain commitments for corrective action when policies, procedures, practices, or management oversight is deficient or when the institution has failed to comply with the interagency statement or applicable laws and regulations.

1. Verify through the minutes of the board of directors that the directors have approved the sale of uninsured annuities, reviewed, and approved the choice of an underwriter in the past year.
2. Determine if the bank adequately evaluates the underwriter's financial condition at least annually and regularly reviews the credit ratings assigned to the underwriter by at least two independent agencies evaluating annuity underwriters. (Banks engaged in the sale of annuities are expected to sell only products of financially secure underwriters and to make current ratings of the underwriter available to an investor when purchasing an uninsured annuity.)
3. Verify that the bank does not sell uninsured annuities at teller windows or other areas where retail deposits are routinely accepted.
4. Assess the adequacy of disclosures and the separation of the marketing and sale of uninsured annuities from the retail deposit-taking function by ensuring that—
   a. the contract, advertising, and all related documents disclose prominently in bold print that the annuities are not deposits or obligations of an insured depository institution and are not insured by the Federal Deposit Insurance Corporation;
   b. advertisements do not contain words, such as "deposit," "CD," etc., that could lead an investor to believe an annuity is an insured deposit instrument;
   c. the obligor of the annuity contract is prominently disclosed and names or logos of the insured bank are not used in a way that might suggest the insured bank is the obligor;
   d. adequate verbal disclosures are made during telemarketing contacts and at the time of sale;
   e. retail deposit-taking employees of the insured depository institution are not engaged in the promotion or sale of uninsured annuities;
   f. information on uninsured annuities is not contained in retail deposit statements of customers (either as advertising on deposit statements or as "junk mail" stuffers included with deposit statements) or in the immediate retail deposit-taking area;
   g. account information on annuities owned by customers is not included on insured deposit statements; and
   h. officer or employee remuneration associated with selling annuities is limited to reasonable levels in relation to the individual's salary. (As a guideline in reviewing remuneration, see the Board's policy statement on disposition of credit life insurance, as discussed in the Consumer Credit, Examination Procedures, section of this manual.)
5. If the bank allows a third-party entity to market annuities on depository-institution premises, assess the adequacy of disclosures and the separation of the marketing and sale of uninsured annuities from the retail deposit-taking function by determining that—
   a. the bank has ensured that the third-party company is properly registered or licensed to conduct this activity,
   b. bank personnel are not involved in sales activities conducted by the third party,
   c. desks or offices used to market or sell annuities are separate and distinctly identified as being used by an outside party, and
   d. bank personnel do not normally use desks or offices used by a third party for annuities sales.
6. Encourage the bank to obtain a signed statement from the customer indicating that the customer understands that the annuity is not a deposit or any other obligation of the bank, that the bank is only acting as an agent for the insurance company (underwriter), and that the annuity is not FDIC-insured.

Fiduciary activities and other related services generally include traditional trust services, such as personal trust, corporate trust, and transfer-agent services and employee benefit account products and services, as well as custody and securities-lending services, clearing and settlement, private banking, asset management, and investment advisory activities. (See SR-01-5.)

Pursuant to 12 USC 24 (seventh), 92a, and 93a, the Office of the Comptroller of the Currency (OCC) has established standards (the OCC rules for fiduciary activities of national banks). These rules are typically considered the industry standard for fiduciary activities of all financial institutions operating in the United States. (See 12 CFR 9.) When considering whether a state member bank has adhered to industry standards for fiduciary activities, Federal Reserve System (FRS) examiners can refer to the guidance set forth in the OCC rules and FRS and OCC examination manuals, as well as the examination materials issued by other U.S. financial institution regulatory agencies. With respect to a state member bank subsidiary, the appropriate bank, thrift, or functional regulator has the primary supervisory responsibility for evaluating risks, hedging, and risk management at the legal-entity level for the entity that the regulator supervises. (See SR-00-13.) Examiners should seek to use the examination findings of the functional regulator.

A risk-focused fiduciary examination concentrates on understanding and evaluating risk and assessing the internal controls the state member bank has employed to manage risk. The program encompasses continuous monitoring; targeted reviews of fiduciary activities; preparation of supervisory risk profiles and assessments; and the development of supervisory plans, which are integrated into the preplanning of an examination. Conclusions are used to develop an overall safety-and-soundness evaluation of the state member bank's fiduciary activities. (See SR-96-10.)

The Federal Reserve System's fiduciary-examination program reviews and assesses the risk-management practices and related aspects of a state member bank's fiduciary activities. This approach results in (1) the use of a more diversified examiner population, including those with capital-markets, information systems, and safety-and-soundness experience; (2) an emphasis on assessing the individual organization's unique risk profile; and (3) reviews of risk identification, measurement, monitoring, and control. Examiners should use the state member bank's control disciplines (internal audit, risk management, and compliance program) whenever possible.

Examiners have access to a broad variety of FRS supervisory information and analytical support tools to evaluate the fiduciary activities of financial institutions. The Uniform Bank Performance Report (UBPR) can assist examiners in evaluating a state member bank's fiduciary business lines or activities relative to its peers. (See the UBPR, pages Trust 1 and Trust 1A.) Beginning with the December 2002 release, "Section II: Technical Information" of the *UBPR User's Guide* (available online at www.ffiec.gov/ubprguide.htm) discusses the availability of the Total Fiduciary Assets within a fiduciary group number (peer group). (See page II-3.) "Total Fiduciary Assets" are the totals of managed and nonmanaged fiduciary assets for FDIC-insured commercial and savings banks, as reported on Schedule RC-T of the call report.

COMPLEX FIDUCIARY ORGANIZATIONS

SR-01-5 explains that complex fiduciary organizations are those banking organizations that conduct significant or complex fiduciary activities. This includes large complex banking organizations (LCBOs), other large or regional institutions for which fiduciary activities represent a significant portion of their business, and clearing agencies registered with the Securities and Exchange Commission (SEC) for which the Federal Reserve is the primary supervisor. The fiduciary-examination frequency should be determined on the basis of the impact that fiduciary activities have on the organization's risk profile. At a minimum, all material fiduciary business lines should be subject to examination over a two-year period or examination cycle as part of the continuous supervision process, with higher-risk areas generally reviewed annually.

Composite Uniform Interagency Trust Rating System (UITRS) ratings and transfer-agent ratings reflecting the overall condition of the fiduciary function at each institution, and any component ratings considered relevant, should be assigned or updated in a timely manner on the basis of the results of examinations, targeted reviews, or other assessments of fiduciary activities. UITRS ratings do not need to be assigned for each targeted business-line review. However, at a minimum, composite UITRS and transfer-agent ratings should be updated annually, and any material findings related to these areas should be included in the annual summary supervisory report. Any significant concerns should be reflected in the safety-and-soundness examination ratings. Fiduciary risks and fiduciary-risk management assessments should also be reflected in the relevant risk-assessment and risk-management ratings for the banking organization, as necessary.

OTHER INSTITUTIONS OFFERING FIDUCIARY AND TRANSFER-AGENT SERVICES

The frequency of fiduciary and transfer-agent examinations for other institutions, generally smaller state-chartered Federal Reserve member banks and trust companies with noncomplex operations, should be determined on the basis of the significance of their fiduciary and transfer-agent activities and an assessment of the level of risk the activities present to the institution. This scheduling guidance also applies to initial examinations of new institutions and to those institutions subject to Federal Reserve supervision as a result of a charter conversion.

At a minimum, fiduciary activities should be reviewed no less frequently than during every other routine safety-and-soundness examination. Examinations governed by alternating examination programs with state banking authorities may continue to be performed in accordance with those arrangements or as necessary to incorporate the provisions of SR-01-5. Examinations of fiduciary activities at noncomplex limited-purpose trust companies and other fiduciary institutions subject to supervision by the Federal Reserve that do not receive routine safety-and-soundness examinations should be conducted no less frequently than every two years.

Composite UITRS and transfer-agent examination ratings reflecting the overall condition of the function, and any component ratings considered relevant, should be assigned or updated at the completion of the examination or assessment. Material examination findings should be integrated into the overall examination report for the institution, which should clearly indicate the significance of any findings to the safety and soundness of the institution and the impact of the findings on any relevant risk assessments and risk-management ratings.

ORGANIZATIONS WITH SUPERVISORY CONCERNS

Organizations whose fiduciary activities have raised supervisory concerns should be subject to an additional level of supervisory attention on the basis of the severity of those supervisory concerns. Generally, this would include those organizations with a composite UITRS rating of 3, 4, or 5; a transfer-agent rating of B or C; or significant deficiencies in one or more component-rating categories. In the case of an institution assigned a UITRS rating of 4 or 5 or a transfer-agent rating of C, supervisory action should be initiated promptly and continued until the problems or deficiencies have been appropriately addressed.

Under the Securities and Exchange Act of 1934, the Federal Reserve continues to be responsible for examining transfer agents and clearing agencies for which it is the primary supervisor, including reviewing compliance with SEC rules. Any material violations of transfer-agent or clearing-agency rules must be reported promptly to Board staff to facilitate coordination with the SEC.

RISK PROFILE OF FIDUCIARY ACTIVITIES

Regular supervisory assessments of the risk of fiduciary activities, as outlined in SR-01-5, support the supervisory process. Risk profiles for LCBOs are updated quarterly in accordance with the provisions of SR-99-15. These risk profiles should include explicit consideration of the risks of fiduciary activities. For other complex fiduciary organizations, risk profiles reflecting fiduciary activities should be prepared and updated as needed, but no less frequently than annually. For these organizations, supervisory plans should detail the fiduciary specialist's recommended examination coverage of fiduciary activities. For banking organizations supervised by the Federal Reserve that have smaller, noncomplex fiduciary operations, formal risk profiles may not be necessary. However, fiduciary-risk information should normally be updated at each examination or inspection and incorporated into supervisory plans.

Risk profiles should include an assessment of the inherent risk in the organization's fiduciary activities, as well as a consideration of the effectiveness of its risk management. Risk assessments would normally include the following factors:

- the size and number of fiduciary accounts and assets administered
- the nature and complexity of fiduciary products and services offered
- significant changes to management or staffing for fiduciary services
- significant changes to data processing systems supporting fiduciary services
- new affiliations, partnerships, or outsourcing arrangements
- changes in strategic direction affecting fiduciary services or exposure to emerging risks
- significant litigation, settlements, or charge-offs
- the length of time since the last on-site examination in which fiduciary activities were reviewed, and the scope of that examination
- the significance of prior examination findings
- the effectiveness of the organization's control environment, including its audit function, and the adequacy of its risk-management practices relative to the nature and scope of its business

RISK FOCUS

As explained in SR-96-10, for a complex institution, fiduciary examiners will direct their attention to assessing the organization's functions and its ability to identify, measure, monitor, and control fiduciary, market, credit, and operational risks. Examiners should assess risks that result from the fiduciary's investment-management, investment advisory, mutual funds, global custody, and securities-lending and processing activities. Any other activities that are subject to adverse movements in market rates or prices, or to operating problems associated with processing a large volume of securities, should also be assessed. These fiduciary activities could result in material losses to trust customers and, in turn, expose the institution to financial losses and litigation if not conducted in a manner consistent with the fiduciary's duty of loyalty and the investor's stated objectives.

A review of internal controls and policies and procedures is an integral part of the examination program. Facets of a fiduciary examination include management competence and accountability, management's review of risks associated with the introduction of new products and services, and management's overall risk awareness.

The emphasis on risk assessment and control parallels the guidelines and procedures pertaining to state member bank examinations and bank holding company inspections, as described in SR-95-51, and recognizes the efforts of many progressive institutions in establishing fiduciary-risk assessment and control initiatives of their own. When rating the quality of risk management of fiduciary activities, examiners should place primary consideration on findings relating to the following elements of a sound risk-management system: (1) active board and senior management oversight; (2) adequate policies, procedures, and limits; (3) adequate risk-measurement, -monitoring, and management information systems; and (4) comprehensive internal controls. Each of these elements is described further below, along with a list of considerations relevant to assessing the adequacy of each element.

Active Board and Management Oversight

Given that a board of directors has ultimate responsibility for all of the activities of its institution, the board should approve overall fiduciary business strategies and policies, including those related to identifying, measuring, monitoring, and controlling fiduciary risks. A board of directors must understand the nature of the risks that are significant to the organization, and it should ensure that management is taking the steps necessary to manage these risks.

Senior management has the responsibility for implementing approved strategies in a way that will limit fiduciary risks and ensure compliance with laws and regulations. Senior management should, therefore, be fully involved in the fiduciary activities of their institution and have sufficient knowledge of all fiduciary business lines to ensure that necessary policies, controls, and risk-monitoring systems are in place and that accountability and lines of authority are clearly defined. In assessing the quality of fiduciary oversight by boards of directors and senior management, examiners should consider whether these conditions exist:

- The board and senior management have a clear understanding and working knowledge of the types of fiduciary activities the institution performs and of the risks inherent in them. They have approved appropriate policies, procedures, recordkeeping systems, and reporting systems to support the fiduciary activities and to help measure and monitor risks. They have established procedures to stay informed about changes in fiduciary activities and the associated risks.
- Management at all levels adequately supervises the daily activities of officers and employees to ensure that the lines of fiduciary business are managed and staffed by persons whose knowledge, experience, and expertise are consistent with the nature and scope of the organization's fiduciary activities.
- Before offering new services or introducing new products, management identifies the fiduciary risks associated with them and ensures that internal controls are in place to manage the service or product and its accompanying risk.

Adequate Policies, Procedures, and Limits

An institution's directors and senior management should establish fiduciary and fiduciary-risk management policies and procedures commensurate with the types of activities the institution conducts. The policies and procedures should provide enough detailed guidance to ensure that all material areas of fiduciary activity and risk are addressed. They should also be modified when necessary to respond to changes in the organization's activities. A smaller, less complex institution that has effective management and that is heavily involved in daily operations generally would be expected to have more basic policies addressing the significant areas of its activities and setting forth a limited but appropriate set of requirements and procedures. In a larger institution, where senior management must rely on a widely dispersed staff to implement strategies in a wide range of complex situations, far more detailed policies and related procedures would be expected. In assessing the adequacy of an institution's fiduciary and fiduciary-risk management policies and procedures, examiners should consider whether these conditions exist:

- The institution's policies and procedures adequately address the fiduciary activities performed and are consistent with management's experience level and with the institution's stated goals and objectives.
- The institution's policies and procedures provide for adequate identification, measurement, monitoring, and control of the risks posed by its fiduciary activities.
- Policies clearly establish accountability and set forth lines of authority.
- Policies provide for review of new fiduciary services and activities to ensure that they are suitable and consistent with fiduciary-customer objectives, and to ensure that the systems necessary to identify, measure, monitor, and control risks associated with new services and activities are in place before the activity is initiated.

Adequate Risk-Monitoring and Management Information Systems

Risk monitoring requires institutions to identify and measure all areas of material fiduciary risk continuously. Risk-monitoring activities must be supported by management information systems that provide senior management with timely reports on financial condition, operating performance, marketing efforts, new products and services, pending or threatened litigation, and risk exposure arising from fiduciary activities. The information system also must provide regular and more detailed reports for managers engaged in the daily management of the institution's activities.

The sophistication of risk-monitoring and control information systems should be commensurate with the complexity of the institution's fiduciary operations. Less complex institutions may require only a limited number of management reports to support risk-monitoring activities. Larger, more complex institutions, however, would be expected to have much more comprehensive reporting and monitoring systems. These systems would allow for more frequent reporting and closer monitoring of complex activities. In assessing the adequacy of an institution's measurement and monitoring of fiduciary risk, examiners should consider whether these conditions exist:

- The institution's fiduciary-risk monitoring practices and reports encompass all of its business lines and activities, and they are structured to monitor exposures consistent with established goals, limits, and objectives.
- Key assumptions, data sources, and procedures used in identifying, measuring, and monitoring fiduciary risk are appropriate for the activities the institution performs and are adequately documented and continuously tested for reliability.
- Reports to management are accurate and timely and contain sufficient information for policy and decision makers to identify any adverse trends and any potential or real problems. The reports must be adequate for management to evaluate the level of fiduciary risk faced by the institution.

Adequate Internal Controls

A comprehensive internal-control structure is critical to the safe and sound functioning of an institution and its fiduciary-risk management system. Establishing and maintaining a system of internal controls that sets forth official lines of authority and an appropriate segregation of duties is one of management's most important responsibilities.

A well-structured system of internal controls promotes effective fiduciary operations and reliable reporting; safeguards assets; and helps to ensure compliance with laws, regulations, and institutional policies. Controls should be periodically tested by an independent party (preferably the auditor or at least an individual not involved in the process being reviewed) who reports directly to either the institution's board of directors or one of its designated committees. Given the importance of appropriate internal controls to organizations of all sizes and risk profiles, the results of these reviews should be adequately documented, as should management's responses to them. In evaluating the adequacy of an institution's internal controls as they relate to fiduciary activities, examiners should consider whether these conditions exist:

- The system of internal controls is appropriate to the type and level of fiduciary activities.
- The institution's organizational structure establishes clear lines of authority and responsibility.
- Reporting lines are sufficiently independent of the control areas and from the business lines, and there is adequate separation of duties throughout the institution.
- Financial, operational, and regulatory reports are reliable, accurate, and timely.
- Adequate procedures exist for ensuring compliance with laws and regulations.
- Internal-audit or other control-review practices provide for independence and objectivity.
- Internal controls and information systems are adequately tested and reviewed, with findings documented and weaknesses given appropriate and timely attention.
- The board of directors or the audit committee reviews the effectiveness of internal audits and other control-review activities regularly.

The fiduciary-risk assessment and control categories and tools listed above are not all-inclusive. They are guidelines for the fiduciary examiner and fiduciary-activities management to use in their risk-assessment and -control efforts. The examination of fiduciary activities may require some modification, depending on how the activities are organized and the complexity of the products and services offered.

INVESTMENT OF FIDUCIARY ASSETS IN MUTUAL FUNDS AND POTENTIAL CONFLICTS OF INTEREST

Banks and trust institutions encounter various direct or indirect financial incentives to place trust assets with particular mutual funds. These incentives include fees for using nonaffiliated fund families as well as incentives for using an institution's proprietary mutual funds. The primary supervisory concern is that an institution may fail to act in the best interest of its beneficiaries if it stands to benefit independently from a particular investment. As a result, an institution may be exposed to an increased risk of legal action by account beneficiaries, and it could potentially violate laws or regulations. The Federal Reserve Board issued SR-99-7 to help institutions minimize these risks and ensure that their activities meet fiduciary standards.

Institutions should ensure that they perform and document an appropriate level of due diligence before entering into any compensation arrangements with mutual fund providers or before placing fiduciary assets in their own proprietary mutual funds. SR-99-7 discusses the type of measures that should be included in this process, including a reasoned legal opinion addressing the activity, appropriate policies and procedures, and documented analysis and ongoing review of investment decisions. For issues pertaining to retail sales of nondeposit investment products and matters relating to compensation, see section 4170.1.

Types of Financial Incentives

Financial incentives for placing trust assets with particular mutual funds range from payments structured as reimbursements for services or for transferring business to an unaffiliated fund family, to financial benefits that arise from using mutual funds that are managed by the institution or an affiliate. In some cases, such as service fees for administrative and recordkeeping functions performed by the trust institution, the permissibility of such payments may be specifically addressed under state law. However, guidance under applicable law may be less clear for other financial incentives. In all cases, decisions to place fiduciary assets in particular investments must be consistent with the underlying trust documents and must be undertaken in the best interest of the trust beneficiary.

Certain mutual fund providers offer compensation in the form of "service" fees to institutions that invest fiduciary assets in particular mutual funds. These fees, referred to variously as shareholder, subaccounting, or administrative-service fees, are structured as payments to reimburse the institution for performing standard recordkeeping and accounting functions for the institution's fiduciary accounts, such as maintaining shareholder subaccounts and records, transmitting mutual fund communications as necessary, and arranging mutual fund transactions. These fees are typically based on a percentage or basis-point amount of the dollar value of assets invested or on transaction volume.

Nearly every state legislature modified its laws in the 1990s to allow explicitly the acceptance of such service fees by fiduciaries under certain conditions. These conditions often include compliance with standards of prudence, quality, and appropriateness for the account, and a determination of the ''reasonableness'' of the fees received by the institution. The Office of the Comptroller of the Currency (OCC) also adopted these general standards for national banks.[1] However, the Employee Retirement Income Security Act of 1974 (ERISA) generally prohibits fee arrangements between fiduciaries and third parties, such as mutual fund providers, with limited exceptions.[2] ERISA requirements supersede state laws and guidelines put forth by the bank regulatory agencies.

Although there has been no comprehensive review of the extent to which mutual fund providers are offering the types of incentive payments cited above, the practice is not uncommon. In addition to these service fees, another form of compensation reportedly offered by some mutual fund providers is a lump-sum payment based on assets transferred into a mutual fund.

Similar conflict-of-interest concerns are raised by the investment of fiduciary-account assets in mutual funds for which the institution or an affiliate acts as investment adviser (referred to as ''proprietary'' funds). In this case, the institution receives a financial benefit from management fees generated by the mutual fund investments.[3]

Due-Diligence Measures

Although many state laws explicitly authorize certain fee arrangements in conjunction with the investment of trust assets in mutual funds, institutions nonetheless face heightened legal and compliance risks from activities in which a conflict of interest exists, particularly if proper fiduciary standards are not observed and documented. Section 23B of the Federal Reserve Act (FRA) requires, before a member bank purchases shares issued by an affiliate, including investment-fund shares, that the board of directors approve the purchase based on a determination that the purchase is a sound investment for the bank, irrespective that an affiliate is the principal underwriter.[4] Even for investments in which the institution does not exercise investment discretion, disclosure or other requirements may apply. Therefore, institutions should ensure that they perform and document an appropriate level of due diligence before entering into any fee arrangements similar to those described above or before placing fiduciary assets in proprietary mutual funds. According to SR-99-7, the following measures should be included in this process:

- *A reasoned legal opinion.* The institution should obtain a reasoned opinion of counsel that addresses the conflict of interest inherent in the receipt of fees or other forms of compensation from mutual fund providers in connection with the investment of fiduciary assets. The opinion should address the permissibility of the investment and compensation under applicable state or federal laws, the trust instrument, or court order, as well as any applicable disclosure requirements or ''reasonableness'' standard for fees set forth in the law.
- *Establishment of policies and procedures.* The institution should establish written policies and procedures governing the acceptance of fees or other compensation from mutual fund providers, as well as the use of proprietary mutual funds. The policies must be reviewed and approved by the institution's board of directors or its designated committee. Policies

1. In general, national banks may make these investments and receive such fees if the practice is authorized by applicable law and if the investment is prudent and appropriate for fiduciary accounts and consistent with fiduciary requirements established by state law. These requirements include a ''reasonableness'' test for any fees received by the institution. (OCC Interpretive Letter No. 704, February 1996.)

2. ERISA section 406(b)(3), Department of Labor, Pension Welfare and Benefits Administration Advisory Opinion 97-15A and Advisory Opinion 97-16A.

3. A Board interpretation of Federal Reserve Regulation Y addresses the investment of fiduciary-account assets in mutual funds for which the trustee bank's holding company acts as investment adviser. In general, such investments are prohibited unless specifically authorized by the trust instrument, court order, or state law. See *Federal Reserve Regulatory Service* 4–177.

4. 12 USC 371c-1(b)(2).

and procedures should, at a minimum, address the following issues: (1) designation of decision-making authority; (2) analysis and documentation of investment decisions; (3) compliance with applicable laws, regulations, and sound fiduciary principles, including any disclosure requirements or reasonableness standards for fees; and (4) staff training and methods for monitoring compliance with policies and procedures by internal or external audit staff.

- *Analysis and documentation of investment decisions.* Where an institution receives fees or other compensation in connection with fiduciary-account investments over which it has investment discretion or where such investments are made in the institution's proprietary mutual funds, the institution should fully document its analysis supporting the investment decision. This analysis should be performed on a regular, ongoing basis and would typically include factors such as historical performance comparisons to similar mutual funds, management fees and expense ratios, and ratings by recognized mutual-fund rating services. The institution should also document its assessment that the investment is, and continues to be, appropriate for the individual account, in the best interest of account beneficiaries, and in compliance with section 23B of the FRA and with provisions of the "prudent-investor" or "prudent-man rules," as appropriate.

UNIFORM INTERAGENCY TRUST RATING SYSTEM

In December 1998, the Federal Reserve Board issued implementing guidelines for the Uniform Interagency Trust Rating System (UITRS).[5] The revised UITRS was made effective for examinations commencing on or after January 1, 1999.[6] Federal Reserve examiners should assign UITRS ratings in conformance with the definitions adopted by the Federal Financial Institutions Examination Council (FFIEC), as augmented by the guidance below.

A full composite UITRS rating is *required* to be assigned as a result of all trust examinations, except for targeted examinations, where component ratings need only be assigned for those areas included within the examination's scope. In those cases, component ratings should be assigned as the targeted examinations are completed. When an institution's trust activities are examined as a series of limited reviews over a period of time, the full UITRS rating should be assigned when the examination is considered complete, or at least as often as required under SR-01-05.

Additional Considerations for Specific UITRS Components

Management

The revised UITRS puts greater emphasis on assessing the quality of an institution's risk management, consistent with guidance previously provided to Federal Reserve examiners in SR-96-10. Examiners should continue to include in risk profiles and risk-management assessments the key risks outlined in SR-95-51, including reputation risk, operational risk, legal risk, credit risk, market risk, and liquidity risk. Whether all of these risks or a subset of them is relevant to the assessment of risk management, and thus to the management rating, depends on the scope of the particular institution's fiduciary activities. The other four UITRS rating components may also include consideration of the institution's ability to manage some or all of these risks.

Earnings

Examiners must *evaluate* earnings for all institutions that exercise fiduciary powers. In addition, an earnings *rating* must be assigned for institutions that, at the time of the examination, have total fiduciary assets of more than $100 million and for all nondeposit trust companies. For all other institutions, examiners are not required to assign a rating and should only do so in cases where fiduciary activities are significant and the earnings rating would be meaningful to the overall rating. In these cases, examiners should use the standard earnings-rating definition, rather than the alternate-rating definitions provided in the UITRS. For examinations where no earnings

5. The UITRS was developed by the Federal Financial Institutions Examination Council. SR-98-37 mandated the use of UITRS for Federal Reserve examinations of fiduciary activities.

6. See 63 *Fed. Reg.* 54704 (October 13, 1998).

rating is assigned, a rating of 0 should be given for the earnings component, and this component should be excluded from consideration in the composite rating.

Earnings ratings of 3 or worse should be reserved for institutions whose earnings performance indicates a supervisory problem requiring corrective action, which, if left unaddressed, may pose a risk to the institution. Federal Reserve examiners may, therefore, assign an earnings rating of 2 for an institution that has experienced losses in its fiduciary activities, provided that (1) management has determined that there are benefits to the overall institution or its community from offering fiduciary services, (2) losses from fiduciary activities are stable and consistent with management expectations, and (3) such losses do not have a significant adverse effect on the profitability of the institution as a whole.

Asset Management

As noted in the UITRS, the asset-management component may not be applicable for some institutions because their activities do not involve the management of discretionary assets. A rating for asset management may, therefore, be omitted for examinations of institutions whose operations are limited to activities such as directed-agency relationships, securities clearing, nonfiduciary custody relationships, or transfer-agent or registrar activities. However, this component rating should be assigned for an institution that provides investment advice, even though it does not have discretion over the account assets. Where an asset-management rating is not assigned for a particular examination, a rating of 0 should be given, and this component should be excluded from consideration in the composite rating.

Examination Reports

SR-96-26 requires that the UITRS rating be disclosed to the institution in the summary section of each examination report. In addition, the individual numerical component ratings, which should also be disclosed in the open section of the report, may be included in the summary section. If the component ratings are included in the summary section, the ratings should also be included in the open-section pages of the report in which trust findings are presented. If the Reserve Bank prefers not to disclose the examiner's evaluation of the component ratings to the institution, this information may be included in the confidential section of the report. Regardless of where in the report it appears, the evaluation must include sufficient detail to justify the rating assigned.

UITRS Description

Under the UITRS, the fiduciary activities of financial institutions are assigned a composite rating based on an evaluation and rating of five essential components of an institution's fiduciary activities. Composite and component ratings are assigned based on a 1-to-5 numerical scale. A 1 is the highest rating and indicates the strongest performance and risk-management practices and the least degree of supervisory concern. A 5 is the lowest rating and indicates the weakest performance and risk-management practices and, therefore, the highest degree of supervisory concern. The evaluation of the composite and components considers the size and sophistication, the nature and complexity, and the risk profile of the institution's fiduciary activities.

The composite rating generally bears a close relationship to the component ratings assigned. However, the composite rating is not derived by computing an arithmetic average of the component ratings. Each component rating is based on a qualitative analysis of the factors that make up a particular component and on its interrelationship with the other components. When assigning a composite rating, some components may be given more weight than others depending on the situation at the institution. In general, the assignment of a composite rating may incorporate any factor that bears significantly on the overall administration of the financial institution's fiduciary activities. Assigned composite and component ratings are disclosed to the institution's board of directors and senior management.

Management's ability to respond to changing circumstances and address the risks that may arise from changing business conditions, or from the initiation of new fiduciary activities or products, is an important factor in evaluating an institution's overall fiduciary-risk profile and the level of supervisory attention warranted. For this reason, the management component is given special consideration when assigning a composite rating.

The ability of management to identify, measure, monitor, and control the risks of its fiduciary operations is also taken into account when assigning each component rating. It is recognized, however, that appropriate management practices may vary considerably among financial institutions, depending on the size, complexity, and risk profiles of their fiduciary activities. For less complex institutions engaged solely in traditional fiduciary activities and whose directors and senior managers are actively involved in the oversight and management of day-to-day operations, relatively basic management systems and controls may be adequate. On the other hand, at more complex institutions, detailed and formal management systems and controls are needed to address a broader range of activities and to provide senior managers and directors with the information they need to supervise day-to-day activities.

All institutions are expected to properly manage their risks. For less complex institutions engaging in less risky activities, detailed or highly formalized management systems and controls are not required to receive strong or satisfactory component or composite ratings.

Composite Ratings

Composite ratings are based on a careful evaluation of how an institution conducts its fiduciary activities. The review encompasses the capability of management, the soundness of policies and practices, the quality of service rendered to the public, and the effect of fiduciary activities on the soundness of the institution. The composite ratings are defined as follows.

Composite 1

Administration of fiduciary activities is sound in every respect. Generally, all components are rated 1 or 2. Any weaknesses are minor and can be handled in a routine manner by management. The institution is in substantial compliance with fiduciary laws and regulations. Risk-management practices are strong relative to the size, complexity, and risk profile of the institution's fiduciary activities. Fiduciary activities are conducted in accordance with sound fiduciary principles and give no cause for supervisory concern.

Composite 2

Administration of fiduciary activities is fundamentally sound. Generally, no component rating should be more severe than 3. Only moderate weaknesses are present and are well within management's capabilities and willingness to correct. Fiduciary activities are conducted in substantial compliance with laws and regulations. Overall risk-management practices are satisfactory relative to the institution's size, complexity, and risk profile. There are no material supervisory concerns and, as a result, the supervisory response is informal and limited.

Composite 3

Administration of fiduciary activities exhibits some degree of supervisory concern in one or more of the component areas. A combination of weaknesses exists that may range from moderate to severe; however, the magnitude of the deficiencies generally does not cause a component to be rated more severely than 4. Management may lack the ability or willingness to effectively address weaknesses within appropriate time frames. Additionally, fiduciary activities may reveal some significant noncompliance with laws and regulations. Risk-management practices may be less than satisfactory relative to the institution's size, complexity, and risk profile. Although problems of relative significance may exist, they are not of such importance as to pose a threat to the trust beneficiaries generally or to the soundness of the institution. The institution's fiduciary activities require more-than-normal supervision and may include formal or informal enforcement actions.

Composite 4

Fiduciary activities generally exhibit unsafe and unsound practices or conditions, resulting in unsatisfactory performance. The problems range from severe to critically deficient and may be centered around inexperienced or inattentive management, weak or dangerous operating practices, or an accumulation of unsatisfactory features of lesser importance. The weaknesses and problems are not being satisfactorily addressed or resolved by the board of directors and management. There may be significant noncompliance with laws and regulations. Risk-management practices are generally unacceptable relative to the size, complexity, and risk profile of fiduciary activities. These problems pose a threat to the account beneficiaries generally and, if left unchecked, could evolve into conditions that could cause significant losses to the institution and ultimately undermine public confidence in the institution. Close supervisory attention is required, which means, in most cases, formal enforcement action is necessary to address the problems.

Composite 5

Fiduciary activities are conducted in an extremely unsafe and unsound manner. Administration of fiduciary activities is critically deficient in numerous major respects, with problems resulting from incompetent or neglectful administration, flagrant or repeated disregard for laws and regulations, or a willful departure from sound fiduciary principles and practices. The volume and severity of problems are beyond management's ability or willingness to control or correct. Such conditions evidence a flagrant disregard for the interests of the beneficiaries and may pose a serious threat to the soundness of the institution. Continuous close supervisory attention is warranted and may include termination of the institution's fiduciary activities.

Component Ratings

The five key components used to assess an institution's fiduciary activities are (1) the capability of management; (2) the adequacy of operations, controls, and audits; (3) the quality and level of earnings; (4) compliance with governing instruments, applicable law (including self-dealing and conflicts-of-interest laws and regulations), and sound fiduciary principles; and (5) the management of fiduciary assets. Each of the component-rating descriptions is divided into three sections: a narrative description of the component, a list of the principal factors used to evaluate that component, and a description of each numerical rating for that component. Some of the evaluation factors are repeated under one or more of the other components to reinforce the interrelationship among components.

Management

The management rating reflects the capability of the board of directors and management, in their respective roles, to identify, measure, monitor, and control the risks of an institution's fiduciary activities. The rating also reflects the ability of the board of directors and management to ensure that the institution's fiduciary activities are conducted in a safe and sound manner and in compliance with applicable laws and regulations. Directors should provide clear guidance regarding acceptable risk-exposure levels and ensure that appropriate policies, procedures, and practices are established and followed. Senior fiduciary management is responsible for developing and implementing policies, procedures, and practices that translate the board's objectives and risk limits into prudent operating standards.

Depending on the nature and scope of an institution's fiduciary activities, management practices may need to address some or all of the following risks: reputation, operating or transaction, strategic, compliance, legal, credit, market, liquidity, and other risks. Sound management practices are demonstrated by active oversight by the board of directors and management; competent personnel; adequate policies, processes, and controls that consider the size and complexity of the institution's fiduciary activities; and effective risk-monitoring and management information systems. This rating should reflect the board's and management's ability as it applies to all aspects of fiduciary activities in which the institution is involved.

The management rating is based on an assessment of the capability and performance of management and the board of directors, including, but not limited to, the following evaluation factors:

- the level and quality of oversight and support of fiduciary activities by the board of directors and management, including committee structure and adequate documentation of committee actions
- the ability of the board of directors and management, in their respective roles, to plan for and respond to risks that may arise from

changing business conditions or the introduction of new activities or products
- the adequacy of and conformance with appropriate internal policies, practices, and controls addressing the operations and risks of significant fiduciary activities
- the accuracy, timeliness, and effectiveness of management information and risk-monitoring systems appropriate for the institution's size, complexity, and fiduciary-risk profile
- the overall level of compliance with laws, regulations, and sound fiduciary principles
- responsiveness to recommendations from auditors and regulatory authorities
- strategic planning for fiduciary products and services
- the level of experience and competence of fiduciary management and staff, including issues relating to turnover and succession planning
- the adequacy of insurance coverage
- the availability of competent legal counsel
- the extent and nature of pending litigation associated with fiduciary activities, and its potential impact on earnings, capital, and the institution's reputation
- the process for identifying and responding to fiduciary-customer complaints.

Ratings of management. A rating of 1 indicates strong performance by management and the board of directors and strong risk-management practices relative to the size, complexity, and risk profile of the institution's fiduciary activities. All significant risks are consistently and effectively identified, measured, monitored, and controlled. Management and the board are proactive and have demonstrated the ability to promptly and successfully address existing and potential problems and risks.

A rating of 2 indicates satisfactory management and board performance and risk-management practices relative to the size, complexity, and risk profile of the institution's fiduciary activities. Moderate weaknesses may exist, but are not material to the sound administration of fiduciary activities and are being addressed. In general, significant risks and problems are effectively identified, measured, monitored, and controlled.

A rating of 3 indicates management and board performance that needs improvement or risk-management practices that are less than satisfactory given the nature of the institution's fiduciary activities. The capabilities of management or the board of directors may be insufficient for the size, complexity, and risk profile of the institution's fiduciary activities. Problems and significant risks may be inadequately identified, measured, monitored, or controlled.

A rating of 4 indicates deficient management and board performance or risk-management practices that are inadequate considering the size, complexity, and risk profile of the institution's fiduciary activities. The level of problems and risk exposure is excessive. Problems and significant risks are inadequately identified, measured, monitored, or controlled and require immediate action by the board and management to protect the assets of account beneficiaries and to prevent erosion of public confidence in the institution. Replacing or strengthening management or the board may be necessary.

A rating of 5 indicates critically deficient management and board performance or risk-management practices. Management and the board of directors have not demonstrated the ability to correct problems and implement appropriate risk-management practices. Problems and significant risks are inadequately identified, measured, monitored, or controlled and now threaten the continued viability of the institution or its administration of fiduciary activities, and they pose a threat to the safety of the assets of account beneficiaries. Replacing or strengthening management or the board of directors is necessary.

Operations, Internal Controls, and Auditing

The operations, internal controls, and auditing rating reflects the adequacy of the institution's fiduciary operating systems and internal controls in relation to the volume and character of business conducted. Audit coverage must ensure the integrity of the financial records, the sufficiency of internal controls, and the adequacy of the compliance process.

Fiduciary operating systems, internal controls, and the audit function subject an institution primarily to transaction and compliance risk. Other risks, including reputation, strategic, and financial risk, also may be present. The ability of management to identify, measure, monitor, and control these risks is reflected in this rating.

The operations, internal controls, and auditing rating is based on, but not limited to, an assessment of the following evaluation factors:

- operations and internal controls, including the adequacy of—
  - — staff, facilities, and operating systems;
  - — records, accounting, and data processing systems (including controls over systems access and such accounting procedures as aging, investigation, and disposition of items in suspense accounts);
  - — trading functions and securities-lending activities;
  - — vault controls and securities movement;
  - — segregation of duties;
  - — controls over disbursements (checks or electronic) and unissued securities;
  - — controls over income-processing activities; and
  - — reconciliation processes (depository, cash, vault, subcustodians, suspense accounts, etc.)
- disaster or business-recovery programs—
  - — hold-mail procedures and controls over returned mail, and
  - — investigation and proper escheatment of funds in dormant accounts
- auditing, including—
  - — the independence, frequency, quality, and scope of the internal and external fiduciary-audit function relative to the volume, character, and risk profile of the institution's fiduciary activities;
  - — the volume or severity of internal-control and audit exceptions and the extent to which these issues are tracked and resolved; and
  - — the experience and competence of the audit staff.

Ratings of operations, internal controls, and auditing. A rating of 1 indicates that operations, internal controls, and auditing are strong in relation to the volume and character of the institution's fiduciary activities. All significant risks are consistently and effectively identified, measured, monitored, and controlled.

A rating of 2 indicates that operations, internal controls, and auditing are satisfactory in relation to the volume and character of the institution's fiduciary activities. Moderate weaknesses may exist, but are not material. Significant risks, in general, are effectively identified, measured, monitored, and controlled.

A rating of 3 indicates that operations, internal controls, or auditing need improvement in relation to the volume and character of the institution's fiduciary activities. One or more of these areas are less than satisfactory. Problems and significant risks may be inadequately identified, measured, monitored, or controlled.

A rating of 4 indicates deficient operations, internal controls, or audits. One or more of these areas are inadequate or the level of problems and risk exposure is excessive in relation to the volume and character of the institution's fiduciary activities. Problems and significant risks are inadequately identified, measured, monitored, or controlled and require immediate action. Institutions with this level of deficiencies may make little provision for audits, or they may evidence weak or potentially dangerous operating practices in combination with infrequent or inadequate audits.

A rating of 5 indicates critically deficient operations, internal controls, or audits. Operating practices, with or without audits, pose a serious threat to the safety of assets of fiduciary accounts. Problems and significant risks are inadequately identified, measured, monitored, or controlled and now threaten the ability of the institution to continue engaging in fiduciary activities.

Earnings

The earnings rating reflects the profitability of an institution's fiduciary activities and their effect on the financial condition of the institution. The use and adequacy of budgets and earnings projections by functions, product lines, and clients are reviewed and evaluated. Risk exposure that may lead to negative earnings is also evaluated.

An evaluation of earnings is required for all institutions with fiduciary activities. An assignment of an earnings rating, however, is required only for institutions that, at the time of the examination, have total trust assets of more than $100 million or that are a nondeposit trust company.

The evaluation of earnings is based on, but not limited to, an assessment of the following factors:

- the profitability of fiduciary activities in relation to the size and scope of those activities and to the overall business of the institution
- the overall importance to the institution of offering fiduciary services to its customers and local community

- the effectiveness of the institution's procedures for monitoring fiduciary-activity income and expense relative to the size and scope of these activities and their relative importance to the institution, including the frequency and scope of profitability reviews and planning by the institution's board of directors or a committee thereof

For those institutions for which a rating of earnings is mandatory, additional factors should include the following:

- the level and consistency of profitability, or the lack thereof, generated by the institution's fiduciary activities in relation to the volume and character of the institution's business
- dependence on nonrecurring fees and commissions, such as fees for court accounts
- the effects of charge-offs or compromise actions
- unusual features regarding the composition of business and fee schedules
- accounting practices that contain practices such as (1) unusual methods of allocating direct and indirect expenses and overhead, or (2) unusual methods of allocating fiduciary income and expense where two or more fiduciary institutions within the same holding company family share fiduciary services or processing functions
- the extent of management's use of budgets, projections, and other cost-analysis procedures
- methods used for directors' approval of financial budgets or projections
- management's attitude toward growth and new-business development
- new-business development efforts, including types of business solicited, market potential, advertising, competition, relationships with local organizations, and an evaluation by management of the risk potential inherent in new business areas

Ratings of earnings. A rating of 1 indicates strong earnings. The institution consistently earns a rate of return on its fiduciary activities that is commensurate with the risk of those activities. This rating would normally be supported by a history of consistent profitability over time and a judgment that future earnings prospects are favorable. In addition, management techniques for evaluating and monitoring earnings performance are fully adequate, and there is appropriate oversight by the institution's board of directors or a committee thereof. Management makes effective use of budgets and cost-analysis procedures. Methods used for reporting earnings information to the board of directors, or a committee thereof, are comprehensive.

A rating of 2 indicates satisfactory earnings. Although the earnings record may exhibit some weaknesses, earnings performance does not pose a risk to the overall institution nor to its ability to meet its fiduciary obligations. Generally, fiduciary earnings meet management targets and appear to be at least sustainable. Management processes for evaluating and monitoring earnings are generally sufficient in relationship to the size and risk of fiduciary activities that exist, and any deficiencies can be addressed in the normal course of business. A rating of 2 may also be assigned to institutions with a history of profitable operations if there are indications that management is engaging in activities with which it is not familiar or where there may be inordinately high levels of risk present that have not been adequately evaluated. Alternatively, an institution with otherwise strong earnings performance may also be assigned a 2 rating if there are significant deficiencies in its methods used to monitor and evaluate earnings.

A rating of 3 indicates less-than-satisfactory earnings. Earnings are not commensurate with the risk associated with the fiduciary activities undertaken. Earnings may be erratic or exhibit downward trends, and future prospects are unfavorable. This rating may also be assigned if management processes for evaluating and monitoring earnings exhibit serious deficiencies, provided the deficiencies identified do not pose an immediate danger to either the overall financial condition of the institution or its ability to meet its fiduciary obligations.

A rating of 4 indicates earnings that are seriously deficient. Fiduciary activities have a significant adverse effect on the overall income of the institution and its ability to generate adequate capital to support the continued operation of its fiduciary activities. The institution is characterized by fiduciary earnings performance that is poor historically or that faces the prospect of significant losses in the future. Management processes for monitoring and evaluating earnings may be poor. The board of directors has not adopted appropriate measures to address significant deficiencies.

A rating of 5 indicates critically deficient earnings. In general, an institution with this rating is experiencing losses from fiduciary activities that have a significant negative impact on the overall institution, representing a distinct threat to its viability through the erosion of its capital. The board of directors has not implemented effective actions to address the situation.

Alternate rating of earnings. The UITRS alternate rating of earnings is *not* for use by Federal Reserve System examiners, per the December 1998 Federal Reserve UITRS implementing guidelines. For institutions where the assignment of an earnings rating is not required by the UITRS, an FFIEC federal supervisory agency has the option to assign an earnings rating using an alternate set of ratings. The alternate ratings are provided here so examiners will be able to interpret earnings ratings assigned by other banking supervisors that have adopted the alternate-rating system for earnings. Under the alternate-ratings scheme, alternate ratings are assigned based on the level of implementation of four minimum standards by the board of directors and management:

- *Standard No. 1.* The institution has reasonable methods for measuring income and expense commensurate with the volume and nature of the fiduciary services offered.
- *Standard No. 2.* The level of profitability is reported to the board of directors, or a committee thereof, at least annually.
- *Standard No. 3.* The board of directors periodically determines that the continued offering of fiduciary services provides an essential service to the institution's customers or to the local community.
- *Standard No. 4.* The board of directors, or a committee thereof, reviews the justification for the institution to continue to offer fiduciary services, even if the institution does not earn sufficient income to cover the expenses of providing those services.

Ratings to be applied for the alternate rating of earnings. A rating of 1 may be assigned where an institution has implemented all four minimum standards. If fiduciary earnings are lacking, management views this as a cost of doing business as a full-service institution and believes that the negative effects of not offering fiduciary services are more significant than the expense of administrating those services.

A rating of 2 may be assigned where an institution has implemented, at a minimum, three of the four standards. This rating may be assigned if the institution is not generating positive earnings or where formal earnings information may not be available.

A rating of 3 may be assigned if the institution has implemented at least two of the four standards. Although management may have attempted to identify and quantify other revenue to be earned by offering fiduciary services, it has decided that these services should be offered as a service to customers, even if they cannot be operated profitably.

A rating of 4 may be assigned if the institution has implemented only one of the four standards. Management has undertaken little or no effort to identify or quantify the collateral advantages, if any, to the institution from offering fiduciary services.

A rating of 5 may be assigned if the institution has implemented none of the standards.

Compliance

The compliance rating reflects an institution's overall compliance with applicable laws, regulations, accepted standards of fiduciary conduct, governing account instruments, duties associated with account administration, and internally established policies and procedures. This component specifically incorporates an assessment of a fiduciary's duty of undivided loyalty and compliance with applicable laws, regulations, and accepted standards of fiduciary conduct related to self-dealing and other conflicts of interest.

The compliance component includes reviewing and evaluating the adequacy and soundness of adopted policies, procedures, and practices generally and as they relate to specific transactions and accounts. It also includes reviewing policies, procedures, and practices to evaluate the sensitivity of management and the board of directors to refrain from self-dealing, minimize potential conflicts of interest, and resolve actual conflict situations in favor of the fiduciary-account beneficiaries.

Risks associated with account administration are potentially unlimited because each account is a separate contractual relationship that contains specific obligations. Risks associated with account administration include failure to comply with applicable laws, regulations, or terms of the governing instrument; inadequate account-administration practices; and inexperienced management or inadequately trained staff. Risks associated with a fiduciary's duty of undivided loyalty generally stem from engaging in self-dealing or other conflict-of-interest transactions. An institution may be exposed to compliance, strategic, financial, and reputation risk related to account-administration and conflicts-of-interest activities. The ability of management to identify, measure, monitor, and control these risks is reflected in this rating. Policies, procedures, and practices pertaining to account administration and conflicts of interest are evaluated in light of the size and character of an institution's fiduciary business.

The compliance rating is based on, but not limited to, an assessment of the following evaluation factors:

- compliance with applicable federal and state statutes and regulations, including, but not limited to, federal and state fiduciary laws, the Employee Retirement Income Security Act of 1974, federal and state securities laws, state investment standards, state principal and income acts, and state probate codes
- compliance with the terms of governing instruments
- the adequacy of overall policies, practices, and procedures governing compliance, considering the size, complexity, and risk profile of the institution's fiduciary activities
- the adequacy of policies and procedures addressing account administration
- the adequacy of policies and procedures addressing conflicts of interest, including those designed to prevent the improper use of ''material inside information''
- the effectiveness of systems and controls in place to identify actual and potential conflicts of interest
- the adequacy of securities-trading policies and practices relating to the allocation of brokerage business; the payment of services with ''soft dollars''; and the combining, crossing, and timing of trades
- the extent and permissibility of transactions with related parties, including, but not limited to, the volume of related commercial and fiduciary relationships and holdings of corporations in which directors, officers, or employees of the institution may be interested
- the decision-making process used to accept, review, and terminate accounts
- the decision-making process related to account-administration duties, including cash balances, overdrafts, and discretionary distributions

Ratings of compliance. A rating of 1 indicates strong compliance policies, procedures, and practices. Policies and procedures covering conflicts of interest and account administration are appropriate in relation to the size and complexity of the institution's fiduciary activities. Accounts are administered in accordance with governing instruments, applicable laws and regulations, sound fiduciary principles, and internal policies and procedures. Any violations are isolated, technical in nature, and easily correctable. All significant risks are consistently and effectively identified, measured, monitored, and controlled.

A rating of 2 indicates fundamentally sound compliance policies, procedures, and practices in relation to the size and complexity of the institution's fiduciary activities. Account administration may be flawed by moderate weaknesses in policies, procedures or practices. Management's practices indicate a determination to minimize the instances of conflicts of interest. Fiduciary activities are conducted in substantial compliance with laws and regulations, and any violations are generally technical in nature. Management corrects violations in a timely manner and without loss to fiduciary accounts. Significant risks are effectively identified, measured, monitored, and controlled.

A rating of 3 indicates compliance practices that are less than satisfactory in relation to the size and complexity of the institution's fiduciary activities. Policies, procedures, and controls have not proven effective and require strengthening. Fiduciary activities may be in substantial non-compliance with laws, regulations, or governing instruments, but losses are no worse than minimal. Although management may have the ability to achieve compliance, the number of violations that exist, or the failure to correct prior violations, is an indication that management has not devoted sufficient time and attention to its compliance responsibilities. Risk-management practices generally need improvement.

A rating of 4 indicates an institution with deficient compliance practices in relation to the size and complexity of its fiduciary activities. Account administration is notably deficient. The institution makes little or no effort to minimize potential conflicts or refrain from self-dealing, and it is confronted with a considerable number of potential or actual conflicts. Numerous substantive and technical violations of laws and regulations exist, and many may remain uncorrected from previous examinations. Management has not exerted sufficient effort to effect compliance and may lack the ability to effectively administer fiduciary activities. The level of compliance problems is significant and, if left unchecked, may subject the institution to monetary losses or reputation risk. Risks are inadequately identified, measured, monitored, and controlled.

A rating of 5 indicates critically deficient compliance practices. Account administration is critically deficient or incompetent, and there is a flagrant disregard for the terms of the governing instruments and interests of account beneficiaries. The institution frequently engages in transactions that compromise its fundamental duty of undivided loyalty to account beneficiaries. There are flagrant or repeated violations of laws and regulations and significant departures from sound fiduciary principles. Management is unwilling or unable to operate within the scope of laws and regulations or within the terms of governing instruments, and efforts to obtain voluntary compliance have been unsuccessful. The severity of noncompliance presents an imminent monetary threat to account beneficiaries and creates significant legal and financial exposure to the institution. Problems and significant risks are inadequately identified, measured, monitored, or controlled and now threaten the ability of management to continue engaging in fiduciary activities.

Asset Management

The asset-management rating reflects the risks associated with managing the assets (including cash) of others. Prudent portfolio management is based on an assessment of the needs and objectives of each account or portfolio. An evaluation of asset management should consider the adequacy of processes related to the investment of all discretionary accounts and portfolios, including collective investment funds, proprietary mutual funds, and investment advisory arrangements.

The institution's asset-management activities subject it to reputation, compliance, and strategic risks. In addition, each individual account or portfolio managed by the institution is subject to financial risks such as market, credit, liquidity, and interest-rate risk, as well as transaction and compliance risk. The ability of management to identify, measure, monitor, and control these risks is reflected in this rating.

The asset-management rating is based on, but not limited to, an assessment of the following evaluation factors:

- the adequacy of overall policies, practices, and procedures governing asset management, considering the size, complexity, and risk profile of the institution's fiduciary activities
- the decision-making processes used for selection, retention, and preservation of discretionary assets, including adequacy of documentation, committee review and approval, and a system to review and approve exceptions
- the use of quantitative tools to measure the various financial risks in investment accounts and portfolios
- the existence of policies and procedures addressing the use of derivatives or other complex investment products
- the adequacy of procedures related to the purchase or retention of miscellaneous assets, including real estate, notes, closely held companies, limited partnerships, mineral interests, insurance, and other unique assets
- the extent and adequacy of periodic reviews of investment performance, taking into consideration the needs and objectives of each account or portfolio
- the monitoring of changes in the composition of fiduciary assets for trends and related risk exposure
- the quality of investment research used in the decision-making process and documentation of the research
- the due-diligence process for evaluating investment advice received from vendors or brokers (including approved or focus lists of securities)
- the due-diligence process for reviewing and approving brokers or counterparties used by the institution

This rating may not be applicable for some institutions because their operations do not include activities involving the management of any discretionary assets. Functions of this type would include, but not necessarily be limited to, directed-agency relationships, securities clearing, nonfiduciary custody relationships, and transfer-agent and registrar activities. In institutions of this type, the rating for asset management may be omitted by the examiner in accordance with the examining agency's implementing guidelines. However, this component should be assigned when the institution provides investment advice, even though it does not have discretion over the account assets. An example of this type of activity would be where the institution selects or recommends the menu of mutual funds offered to participant-directed 401(k) plans.

Ratings of asset management. A rating of 1 indicates strong asset-management practices. Identified weaknesses are minor in nature. Risk exposure is modest in relation to management's abilities and the size and complexity of the assets managed.

A rating of 2 indicates satisfactory asset-management practices. Moderate weaknesses are present and are well within management's ability and willingness to correct. Risk exposure is commensurate with management's abilities and the size and complexity of the assets managed. Supervisory response is limited.

A rating of 3 indicates that asset-management practices are less than satisfactory in relation to the size and complexity of the assets managed. Weaknesses may range from moderate to severe; however, they are not of such significance as to generally pose a threat to the interests of account beneficiaries. Asset-management and risk-management practices generally need to be improved. An elevated level of supervision is normally required.

A rating of 4 indicates deficient asset-management practices in relation to the size and complexity of the assets managed. The levels of risk are significant and inadequately controlled. The problems pose a threat to account beneficiaries generally and, if left unchecked, may subject the institution to losses and could undermine the reputation of the institution.

A rating of 5 represents critically deficient asset-management practices and a flagrant disregard of fiduciary duties. These practices jeopardize the interests of account beneficiaries, subject the institution to losses, and may pose a threat to the soundness of the institution.

INTRODUCTION

Directors are placed in a position of trust by the bank's shareholders, and both statutes and common law place responsibility for the affairs of a bank firmly and squarely on the board of directors. The board of directors of a bank should delegate the day-to-day routine of conducting the bank's business to its officers and employees, but the board cannot delegate its responsibility for the consequences of unsound or imprudent policies and practices, whether they involve lending, investing, protecting against internal fraud, or any other banking activity. The board of directors is responsible to the bank's depositors, other creditors, and shareholders for safeguarding their interests through the lawful, informed, efficient, and able administration of the institution. In the exercise of their duties, directors are governed by federal and state banking, securities, and antitrust statutes, as well as by common law, which imposes a liability on directors of all corporations. Directors who fail to discharge their duties completely or who are negligent in protecting the interests of depositors or shareholders may be subject to removal from office, criminal prosecution, civil money penalties imposed by bank regulators, and civil liability. Title IX of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 and the Comprehensive Thrift and Bank Fraud Prosecution and Taxpayer Recovery Act of 1990 greatly enhanced the enforcement powers of the federal bank regulatory agencies, including the Federal Reserve Board. Section 5040 of this manual, "Formal Corrective Actions," describes those enforcement powers in greater detail.

DIRECTOR SELECTION

The affairs of each state member bank are overseen by its board of directors. The initial directors are elected by the shareholders at a meeting held before the bank is authorized to commence business. Thereafter, they are elected at meetings held at least annually on a day specified in the bank's bylaws. The directors hold office for a stated tenure, generally ranging from one to three years, or until their successors are elected and have qualified. No state member bank is to have less than five or more than 25 directors as specified in section 31 of the Banking Act of 1933. Various laws govern the election, number, qualifications, oath, liability, and removal of directors and officers, as well as the disclosure requirements for their outside business interests. Other laws pertain to certain restrictions, prohibitions, and penalties for securities dealers serving as directors, officers, or employees; director interlocks; purchases of assets from, or sales to, directors; commissions and gifts for procuring loans; embezzlement; abstraction; willful misapplication; false entries; political contributions; and other matters. The examiner must be familiar with these laws and the related regulations and interpretations.

DIRECTOR INDEPENDENCE

Directors must exercise their independent judgment when managing the bank's affairs. A responsible board will not merely rubber-stamp management's recommendations, but will review them carefully before deciding whether they are in the bank's best interests. A board that is excessively influenced by management, a single director, or a shareholder, or any combination thereof, may not be fulfilling its responsibilities to depositors, other creditors, and shareholders. Diversification of the board of directors is important and can be accomplished by including directors with no ownership or family-ownership interest in the bank and who are not employed by the bank.

A bank's board of directors may include one or more advisory directors. Advisory directors generally do not vote but may provide additional information or advice to the voting directors. An advisory director who functions in that capacity is generally not subject to the same regulatory requirements as voting members and has less liability for the board's actions. However, if an advisory director exercises a degree of influence or control over the board or the bank that is not commensurate with that status, it is appropriate for examiners to subject that individual to the same standards as voting directors. Such a person might also be subject to the same liability standards as a voting director.

DIRECTORS' RESPONSIBILITIES

Directors play a critical role in overseeing the affairs of the bank. Directors should understand that if they neglect to carry out their fiduciary duties and responsibilities, they may be financially liable if the bank fails or experiences loss. An examiner sometimes has to remind bank directors of the extent of their duties and responsibilities. Unless bank directors realize the importance of their positions and act accordingly, they are failing to discharge their obligations to the shareholders, depositors, other creditors, and the community.

Selection of Competent Executive Officers

One of the board's most important duties is to select and appoint executive officers who are qualified to administer the bank's affairs effectively and soundly. The board is also responsible for removing officers who do not meet reasonable standards of honesty, competency, executive ability, and efficiency. The responsibility for selecting executive officers also entails retaining them and ensuring that competent successors can be promoted or hired to fill unanticipated voids. The board is responsible for evaluating the performance of the chief executive officer and approving the CEO's compensation. In many banks, the board also approves compensation for other executive officers.

A state member bank that has been chartered or undergone a change of control within the last two years, that is not in compliance with the minimum capital adequacy guidelines or regulations of the Board, or that is in an otherwise troubled condition must provide 30 days' written notice to its regulating Reserve Bank before it can add a director, promote an internal staff member to senior executive officer, or employ a new senior executive officer.

Effective Supervision of Bank Affairs

The type and degree of supervision required of a bank's board of directors to ensure a bank is soundly managed involve reasonable business judgment and competence and sufficient time to become informed about the bank's affairs. Directors ultimately are responsible for the soundness of the bank. If negligence is involved, a director may be personally liable. The responsibility of directors to supervise the bank's affairs may not be delegated to the active executive officers or anyone else. Directors may delegate to executive officers certain authority, but not the primary responsibility of ensuring that the bank is operated in a sound and legal manner.

Adoption and Adherence to Sound Policies and Objectives

The directors' role is to provide a clear framework of objectives and policies within which the chief executive officer can operate and administer the bank's affairs. This framework is often accomplished through the use of strategic plans and budgets. The strategic plan would discuss long-term, and in some cases, short-term goals and objectives as well as how progress toward their achievement will be measured. The objectives and policies should cover all areas of the bank's operations. The board of directors is responsible for establishing the policies that govern and guide the day-to-day operations of the bank, so they should review and approve them from time to time. These policies are primarily intended to ensure that the risks undertaken by the banks are prudent and are being properly managed. This means that the board of directors must, as a group, have a fundamental understanding of the various types of risks associated with different aspects of the banking business, for example, credit risk, foreign-exchange risk, or interest-rate risk, and define the types of risks the bank will undertake. Some of the more important areas in which policies and objectives must be established include investments, loans, asset and liability management, profit planning and budgeting, capital planning, and personnel. Directors are also responsible for adopting policies and procedures required by law or regulation, such as real estate lending policies, a security program, an interbank liabilities policy, and a Bank Secrecy Act program. The examination of these policies is covered in other sections of this manual.

Avoidance of Self-Serving Practices

A bank's directors bear a greater than normal responsibility for upholding safe and sound practices in dealing with transactions involving other members of the directorate and their related interests. Directors' decisions must preclude the possibility of partiality or favored treatment. Unwarranted loans to a bank's directors or their interests can be a serious safety-and-soundness concern for the bank. Directors who become financially dependent on their bank normally lose their usefulness as directors. Other self-serving practices the examiner should watch for are—

- gratuities paid to directors to obtain their approval of financing arrangements or the use of particular services,
- the use of bank funds by directors, officers, or shareholders to obtain loans or transact other business (Directors should be especially critical of correspondent bank balances when officers, directors, or shareholders are borrowing from the depository bank. The Department of Justice's position is that certain interbank deposits connected with a loan to officers, directors, or shareholders of the depositing bank might constitute a misapplication of funds in violation of 18 USC 656), and
- transactions involving conflicts of interest (When board decisions involve a potential conflict of interest, the director with the potential conflict should fully disclose the nature of the conflict and abstain from voting on the matter. The abstention should be recorded in the minutes. The examiner should also be aware that ethical conflicts of interest can arise when a director or director-related firm performs professional services for the bank. For example, a director who is also the bank's legal counsel may not, in some situations, be able to advise or represent the bank objectively.).

Awareness of the Bank's Financial Condition and Management Policies

Management Information Systems

A management information system (MIS) provides the information, often originated from an institution's mainframe and microcomputers, necessary to manage an organization effectively. MIS should have clearly defined guidelines, policies, practices, standards, and procedures for the organization. These should be incorporated in the development, maintenance, and use of MIS throughout the institution.

MIS is used by all levels of bank staff to monitor various aspects of bank operations, up to and including its overall risk-management process. Therefore, MIS should be supportive of the institution's longer term strategic goals and objectives. At the other extreme, these everyday financial accounting systems also are used to ensure that basic control is maintained over financial recordkeeping activities. Since numerous decisions are based on MIS reports, appropriate control procedures must be set up to ensure that information is correct and relevant.

Audits

In May 1993, pursuant to requirements of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), the FDIC issued rules and guidelines that require all banks with total assets in excess of $500 million to have annual audits by an independent public accountant. Copies of these audit reports are to be sent to the FDIC and the appropriate Federal Reserve Bank. Furthermore, the Federal Reserve encourages banks with assets of $500 million or less to provide for annual audits by independent public accountants.

The board or a committee designated by the board should review the audit reports with the bank's management and the independent public accountants. The review should include—

- the scope of services required by the audit, significant accounting policies, and audit conclusions regarding significant accounting estimates;
- the adequacy of internal controls, and actions necessary to ensure the resolution of any problems or deficiencies; and
- the institution's compliance with applicable laws and regulations.

Many states have laws requiring directors' examinations of the bank. When the directors lack adequate knowledge of examination techniques and procedures, they are encouraged to employ a qualified accountant or other specialist to conduct all or part of this examination. The examining committee or the entire board should play an active role. Directors should obtain a clear understanding of the scope of the procedures to be employed, and the final report of the directors' examination should be reviewed by the board of directors.

Further guidance on the use of audit reports and the reliance placed upon the work of external and internal auditors in the examination process can be found in the ''Internal and External Audit Section'' of this manual.

Maintenance of Reasonable Capitalization

A board of directors has the responsibility for maintaining its bank on a sufficiently capitalized basis. Capital planning and capital adequacy are discussed in the manual section ''Assessment of Capital Adequacy,'' and the examiner should be familiar with this information.

Compliance with Banking Laws and Regulations

Directors must carefully observe that banking laws are not violated; they may be personally liable for losses arising out of illegal actions. In addition, civil money penalties can be assessed for unsafe and unsound actions that do not necessarily involve a violation of a banking law.

Guarantee of a Beneficial Influence on the Community's Economy

One reason for approving a newly chartered bank for Federal Reserve membership is to meet a specific community need. Directors, therefore, have a continuing responsibility to provide those banking services which meet the legitimate credit and other needs of the community being served. Directors should be certain that the bank attempts to satisfy all legitimate credit needs of the community.

BOARD MEETINGS

The board should conduct its business in meetings held as required by the bank's bylaws or state law. Regular meetings of the board should review statements showing the bank's financial condition and earnings; the investment portfolio; and loan activity, including past-due and nonaccrual loans, charged-off or recovered loans, large new loans, and loans to insiders. Directors should also review and approve all policies annually, and review and approve all insurance policies as they are obtained or renewed. They should also review audit and examination reports and initiate action to correct any deficiencies noted, review correspondence with regulatory agencies, review pending litigation, and keep informed of any major prospective undertakings, such as mergers, acquisitions, or new branches or construction.

Minutes of Board Meetings

The board should ensure that an accurate, adequate record of its actions is maintained. Such a record is usually kept in the form of minutes of the board meetings. The minutes should document the board's review of all regular items mentioned above as well as the review and discussion of all significant items that are not part of the regular meeting. Additionally, at a minimum, the minutes should record the attendance or absence of each director at each meeting, detail the establishment and composition of any committees, and note the abstention of any director from any vote. Examiners should review the minutes of board meetings, as well as a sample package prepared for a board meeting, to determine that directors are receiving adequate information to make informed, sound decisions. Meetings conducted by telephone, if allowable under state law, should be documented as thoroughly as regular meetings.

BOARD COMMITTEES

Many boards elect to delegate some of their workload to committees. The extent and nature of the bank's activities and the relative expertise of each board member play key roles in the board's determination of which committees to establish, who sits on them, and how much authority they have. Thus, there is no ideal committee structure. However, committees frequently found in state member banks include the following:

- *Executive Committee*—may be empowered to act when the full board is unable to meet, for

example, between regular meetings. An executive committee is usually found in large institutions, where it relieves the full board of the burden of reviewing the details of financial statements and operational activities.
- *Audit Committee*—typically monitors compliance with bank policies and procedures, and reviews internal and external audit reports and bank examination reports. Because it is responsible for ensuring compliance, accuracy, and integrity throughout the organization, the audit committee should consist only of outside directors. The audit committee may supervise the bank's internal auditor and his or her staff directly by hiring personnel, evaluating their performance, and setting their compensation.
- *Loan Committee*—may be established to monitor underwriting standards and loan quality, and to ensure that lending policies and procedures are adequate. In most banks with loan committees, all new loans are reviewed by the loan committee either before or after funding, with the threshold for prior approval being the amount of either the loan or the aggregate debt to the borrower. The loan committee may also be responsible for the loan review function and for maintaining an adequate reserve for loan losses.
- *Investment or Asset-Liability Management Committee*—monitors the bank's investment policies, procedures, and holdings portfolio to ensure that goals for diversification, credit quality, profitability, liquidity, community investment, pledging requirements, and regulatory compliance are met. In some banks whose complexity warrants it, asset-liability management committees have been established to replace or supplement investment committees. An asset-liability management committee monitors the bank's balance sheet and external forces, notably interest rates, to help coordinate asset acquisition and funding sources.
- *Other Committees*—depending on the nature and complexity of the bank's business, the board may establish other committees to monitor such areas as trust, branching, new facilities construction, personnel/human resources, electronic data processing, and consumer compliance.

Minutes of all major actions taken by committees that play a significant role in managing the bank should be kept and meet the same minimum standards used for minutes of meetings of the full board.

COMPLIANCE WITH FORMAL AND INFORMAL ADMINISTRATIVE ACTIONS

Bank directors must ensure that management corrects deficiencies found in the bank. Instructions to do so may come from the Federal Reserve as a formal or informal administrative action, depending on the severity of the problem.

Formal actions, which include cease-and-desist orders and written agreements, are normally exercised when banks have serious problems. For less serious problems, the Federal Reserve issues informal actions such as a "memorandum of understanding." Informal actions are an agreement between the Reserve Bank and the bank that sets forth the required corrective actions. The Reserve Banks are generally responsible for monitoring compliance with both types of administrative actions. To assist in that process, the Reserve Bank normally receives and evaluates periodic progress reports from the bank. In addition, information is provided by the examiner who checks the bank's compliance with the action. The Reserve Banks may initiate additional supervisory action against the bank or individuals associated with it when compliance is insufficient. Or, if the bank's compliance with the action is satisfactory, the Reserve Banks may recommend modifying or terminating the enforcement action.

Examiners should briefly discuss compliance with any enforcement actions on the Examination Conclusions and Comments page and direct the board of directors' attention to the Compliance with Enforcement Actions page of the examination report. The type and date of the action or resolutions and parties to the action should be listed. In addition, the examiner should generally list each provision requiring action by the bank and provide a comment addressing compliance with that provision. The examiner should comment on how the bank accomplished compliance or the problems that have prevented compliance. While certain information might be better discussed in the confidential section of the report, it is appropriate to make all salient negative comments on the Compliance with Enforcement Actions page to ensure that the directors are made aware of any deficiencies and/or exceptions that may exist.

The Reserve Bank may recommend termination or modification of a formal administrative action whenever it determines that such restraints have satisfactorily served their purpose and should be removed or modified. In these cases, the Reserve Bank will send a memorandum with the appropriate explanation to the Board's Division of Banking Supervision and Regulation (BS&R) for review and evaluation. BS&R and the Board's Legal Division, when appropriate, will prepare the documents necessary to terminate or modify the existing administrative action.

DEPOSITORY INSTITUTION MANAGEMENT INTERLOCKS ACT

Under the Depository Institution Management Interlocks Act (Interlocks Act) as implemented by Regulation L, interlocking relationships of management officials of various nonaffiliated depository institutions are prohibited, depending on the asset size and geographical proximity of the organizations. The enforcement of the interlock provisions of the Interlocks Act encompasses full cease-and-desist powers.

The intent of the Interlocks Act is to foster competition among various depository institutions by prohibiting interlocking relationships of management officials. The prohibitions, however, do not generally apply to the following organizations and their subsidiaries:

- a depository institution that does not do business in the United States except as an incident to its activities outside the United States;
- an Edge or agreement corporation;
- a depository organization in formal liquidation or a similar type situation;
- a credit union being served by a management official of another credit union;
- a state-chartered savings and loan guaranty corporation; or
- a Federal Home Loan Bank or other bank organized solely for the purpose of serving depository institutions or solely for the purpose of providing securities clearing services and related services related to other depository institutions.

In addition, five other exceptions are permitted, with Federal Reserve Board approval, based on the public benefit that is derived from the interlocking relationship and on the competitive nature of the institutions involved. These exceptions are for—

- institutions located in low-income areas or controlled or managed by members of a minority group or by women,
- newly chartered institutions,
- institutions facing conditions endangering safety and soundness,
- institutions sponsoring a credit union, and
- institutions affected by loss of management officials due to changes in circumstances.

Duties and Responsibilities of Directors
Examination Objectives
Effective date November 1995

Section 5000.2

1. To determine whether the board of directors fully understands its duties and responsibilities.
2. To determine if the board of directors is discharging its responsibilities in an appropriate manner.
3. To determine whether the board of directors has developed adequate objectives and policies.
4. To determine the existence of any conflicts of interest or self-dealing.
5. To determine compliance with laws and regulations.

1. Update the following and review for possible violations of law—
   a. A list of directors to include—
      - home address (If the director was appointed or elected since the previous examination, state the number of years residing at present address.),
      - date of birth,
      - years as a director of the bank,
      - approximate net worth,
      - occupation,
      - citizenship,
      - common stock ownership (beneficial, direct, and indirect), and
      - bonuses, fees, etc.
   b. A list of embezzlements, defalcations, misappropriations, mysterious disappearances, or thefts that have occurred since the last examination. That list should be signed by the chief executive officer or the auditor.
   c. A list of management officials (as defined in the Depository Institution Management Interlocks Act) of the bank, its holding company, and holding company affiliates who are management officials of other depository institutions.
   d. A list of the indebtedness of directors, executives officers, and principal shareholders to the bank examined and any other bank, along with a statement of the terms and conditions of each extension of credit.
2. Obtain or update a listing of all areas of the bank's operations that are administered under the provisions of written objectives and policies that have been developed by or with the approval of the board. Inform the examiners assigned to review those departments that a policy has been developed or an update has occurred.
3. Analyze the listing obtained in step 2, and note any area of banking activity for which policies should be developed.
4. Determine that the board has accepted its responsibility to effectively supervise the affairs of the bank and to be informed of the bank's condition by performing the following:
   a. Obtain a complete set of the latest reports furnished to directors at the last meeting, and list the areas of operation covered by the reports.
   b. Distribute copies of the reports to the examiners in other areas, and request that they determine if reports furnished to the board are prepared accurately, contain sufficient detail to allow the directors to make an intelligent decision, and are submitted on a timely basis.
   c. Prepare a list of areas not reporting or of reports the board does not receive that are considered necessary to maintain adequate supervision. As guidelines, consider the following reports:
      - A monthly statement of condition or balance sheet and a monthly statement of income. Those statements should be in reasonable detail and should be compared with the prior month, with the same month of a prior year, and with the budget. The directors should receive explanations for all large variances.
      - Monthly statements of changes in all capital and reserve accounts. Such statements should explain any changes.
      - Investment reports that group the securities by classifications; that reflect the book value, fair market value, and yield; and that include a summary of purchases and sales.
      - Loan reports that list significant past-due loans, trends in delinquencies, rate reductions, non-income-producing loans, and large new loans granted since the last report.
      - Audit and examination reports. Deficiencies in these reports should produce a prompt and efficient response from the board. The reports reviewed and actions taken should be reflected in minutes of the board of directors meetings.
      - A full report of all new executive-officer borrowing at any bank.
      - A monthly listing of type and amount of borrowing by the bank.
      - An annual presentation of bank insurance coverage.
      - All correspondence addressed to the board of directors from the Federal

Reserve and any other source.

- A monthly analysis of the bank's liquidity position.
- An annual projection of the bank's capital needs.
- A listing of any new litigation and a status report on existing litigation and potential exposure.
- A thorough report on any major bank endeavor that each bank director is expected to make a decision on, including branch applications and major building plans.

d. Determine the mechanism used to assign responsibility for correcting deficiencies noted in regulatory reports, internal audit reports, external audit reports, or any other reports to the board, and determine the board's system of determining compliance with such recommendations.

e. Determine how directors perform a director's examination, the frequency of such examinations, and what part the directors take in the process.

f. Review the bank's method of ensuring continued or resumed operations in the event of a disaster. Complete the emergency preparedness measures questionnaire for inclusion in the workpapers.

g. Review correspondence between the Federal Reserve and the bank to determine that it has been properly reported.

5. Determine evidence of conflicts of interest and self-dealing by—
   a. obtaining and summarizing information on the business interests of directors, executive officers, and principal shareholders;
   b. comparing that information to develop a list of directors who have business interests in common;
   c. analyzing the interests of directors to determine if the board consists of a variety of individuals;
   d. obtaining from the examiner assigned to assessment of capital adequacy a list of shareholders who own or control, either directly or indirectly, 5 percent or more of any class of voting security;
   e. distributing a list of the insiders (directors, officers, and shareholders whose ownership of voting securities in the institution is more than 10 percent) and their related interests to the appropriate examining personnel to ascertain the extent of loans to or transactions with insiders and their interests (Those examiners should be alert for any relationships with insiders' interests that are not included on the list.);
   f. requesting that the appropriate examiners determine if any transactions with insiders are on terms more favorable than those offered to other customers (If so, determine whether the board has approved such transactions.);
   g. determining that directors have reviewed their correspondent bank accounts in relation to possible conflicts of interest arising from directors', officers', or shareholders' borrowing from depository banks; and
   h. correlating all information on insider transactions, and preparing appropriate report comments.
6. Obtain the minutes of the meetings of the board of directors, the charter, the bylaws, and the minutes of shareholders meetings.
   a. Review and summarize the bylaws and charter of the organization, including any specific provisions on the requirements of directors. The resulting material should become a permanent part of the workpapers and should be updated at subsequent examinations.
   b. Read and summarize the minutes of all meetings of the board since the last examination, making certain to—
      - list any actions taken in contravention of the bylaws;
      - record major actions taken by the board that are not a part of a normal monthly meeting;
      - record any resolution or discussion covering the development of or entrance into a new area, such as a geographic area, customer service, asset category, or liability category;
      - record the creation of any special committee and the area with which it is designed to deal;
      - determine that actions taken by standing committees are reviewed and ratified by the full board;
      - if the minutes specify any transactions with directors or their interests, determine that the abstention of any interested director from voting on the mat-

ters is noted;
- if the minutes do not mention any director-related transactions that have been uncovered during the examination, inquire if the interested director did refrain from voting.

c. Read and summarize the minutes of the board's annual organization meeting and—
- list standing committees and their members,
- have examiners who are examining areas that have standing-committee supervision read and summarize the minutes of those committees, and
- prepare a list of major areas of operation that are not monitored by specific committees.

d. Read and summarize the minutes of any stockholders meetings. The summary should include a list of directors elected at the annual meeting, the number of shares present and voted, individuals acting as proxies, and specific action approved by shareholders.

e. Ascertain during the review of shareholders meeting minutes that (1) shareholders' approval has been received; (2) the bank's charter has been amended, if necessary; and (3) compliance with appropriate state or federal statutes has been met for the following:
- any establishment of or change of a branch location
- any issuance of preferred stock
- any increase in capital stock, either through sale or a stock dividend
- any reduction in capital stock (and ascertain whether the resultant capital is not below what is required by the capital adequacy guidelines)
- any stock split
- any bank pension plan established since the preceding examination
- any bank involvement in a conversion, merger, or consolidation
- all other matters subject to vote

f. Determine the date of the annual shareholders meeting and if it was in compliance with the bylaws.

g. Review the charter and/or bylaws for quorum requirements of shareholder meetings. Ascertain that, at any meeting, the quorum requirements were satisfied according to recorded requirements or by having more than one-half of the eligible shareholders represented.

h. Review any stock option or stock purchase plan adopted since the preceding examination, and review such action for compliance with the various conditions involving charter and shareholder approval.

i. Determine if any candidate was nominated for director, other than the slate nominated by bank management, and review for compliance with the appropriate state statute.

7. Determine that the directors have accepted their responsibility for selecting competent officers by—
   a. determining that the board or a committee thereof reviews, at least annually, the chief executive officer's performance in attaining or progressing toward attaining specific objectives or goals set by the board,
   b. determining if a policy statement on personnel exists, and ascertaining what provisions the board has made for successor management,
   c. determining if any management contracts exist and, if one does, obtaining a copy, summarizing the pertinent points, and determining the reasonableness of terms,
   d. determining by inquiry how the remuneration of executive officers is set and who makes decisions concerning executive salaries, and
   e. listing any titled individual who, by action of the board, is specifically excluded from being an executive officer.
8. Determine compliance with laws and regulations by—
   a. reviewing workpapers of other examination areas or discussing compliance with other examiners to determine any violations of laws or regulations concerning directors that were disclosed in these examination areas,
   b. reviewing the nature and extent of violations discovered at prior examinations to determine if similar violations have occurred at this examination, and
   c. correlating information obtained from the minutes of board meetings to the reports of officer borrowings that have been prepared at and forwarded from other banks to determine that all such

borrowings have been reported to the board.

9. Determine compliance with the Foreign Corrupt Practices Act (15 USC 78dd-1 and -2) by—
   a. reviewing the bank's policy prohibiting improper or illegal payments, bribes, kickbacks, etc., to any foreign government official or other person or organization covered by the law;
   b. determining how that policy has been communicated to officers, employees, or agents of the bank;
   c. reviewing any investigation or study done by, or on behalf of, the board of directors on the bank's policies and operations concerning the advance of funds in possible violation of the act;
   d. reviewing the work done by the examiner assigned to internal control to determine whether internal or external auditors have established routines to discover improper or illegal payments;
   e. analyzing the general level of internal control to determine whether there is sufficient protection against the inaccurate recording of improper or illegal payments on the bank's books;
   f. requesting that examiners working in other areas of the bank be alert for any transactions that might violate the provisions of the act;
   g. compiling any information discovered throughout the examination on possible violations; and
   h. performing procedures on suspected criminal violations as outlined in section 5020.3, "Overall Conclusions Regarding Condition of the Bank: Examination Procedures."
10. Answer the following questions. (This questionnaire is intended to be a quick review for determining that all laws and regulations pertaining to directors have been complied with. Questions should be answered "no" and sub-questions should be answered "yes." Any deviation from this pattern indicates a violation or potential violation. Situations that are not judged to be violations require comments stating the basis for that judgment.)
    a. Is the number of directors less than 5 or greater than 25 (section 31, Banking Act of June 16, 1933)?
    b. Have any directors failed to qualify by reason of insufficient stock ownership (12 USC 72)?
    c. Are any directors noncitizens of the United States (12 USC 72)? If so, has the citizenship requirement been waived?
    d. Do more than one-third of the directors fail to reside in the state, territory, or district in which the bank is located, or within 100 miles of the bank's head office (12 USC 72)?
    e. Did more than one-third of the directors fail to reside in the state, territory or district in which the bank is located, or within 100 miles of the bank's head office, for one year before election (12 USC 72)?
    f. Are any transactions with directors or their related interests on more favorable terms than those offered to other customers (Regulation O (12 CFR 215))?
    g. Do the deposit accounts of directors receive greater interest than those of other customers (section 22(e), Federal Reserve Act (12 USC 376))?
    h. Have any provisions of a cease-and-desist agreement or order been violated (Rules of Practice for Hearings (12 CFR 263))?
    i. Has any director, officer, or employee been convicted of a crime involving a breach of trust or act of dishonesty (section 8(g) of the Federal Deposit Insurance Act (12 USC 1829))? If so, has the FDIC approved his or her membership on the board or employment?
    j. Have any tie-ins of services been authorized by the board (Regulation Y (12 CFR 225.7))?
    k. Were any loans to bank examiners disclosed (Criminal Code—18 USC 212 and 213)?
    l. Has the bank made any political contributions (Federal Election Campaign Act (12 USC 441b))?
    m. Have any employees been found to have misappropriated funds, made false entries, or otherwise defrauded the bank (18 USC 656)?
    n. Has an officer of the bank failed to make appropriate written reports when an embezzlement, misapplication, or similar transaction occurred (SR-579)?
    o. Have any extortionate extensions of credit been discovered (18 USC 892–894)?
    p. Have any checks been certified against

uncollected funds (18 USC 1004)?

q. Have unauthorized obligations of the bank been issued (18 USC 1005 and 1006)?
r. Has there been a change in control (Regulation Y (12 CFR 225.41–225.43))? If so, was the Federal Reserve notified and was the application approved?
s. Have any purchase-money loans been made that are secured by 25 percent or more of the stock of another secured bank (Regulation Y (12 CFR 225.41))? If so, have the appropriate authorities been notified?
t. Has the bank failed to maintain records of directors, executive officers, and principal shareholders and their related interests (Regulation O (12 CFR 215.8))?
u. Are management officials of the bank, or its holding company or holding company affiliates, also management officials of an unaffiliated depository institution or depository holding company (Regulation L (12 CFR 212))? If so—
   - was such relationship established prior to November 10, 1978, and previously permitted by section 8, Clayton Anti-Trust Act (15 USC 19)?
   - was prior approval of the Federal Reserve obtained for a relationship that was developed since November 10, 1978?
   - does the interlocking relationship meet the criteria of one of the exceptions permitted by Regulation L (12 CFR 212)?
   - is the management relationship with an institution whose—
     — principal offices or branches, excluding electronic terminals, are located in a different RMSA from the bank's or its holding company's offices or branches (does not apply if either institution has assets of less than $20 million) (12 CFR 212.3(b))?
     — principal offices or branches, excluding electronic terminals, are located in another city, town, or village not contiguous or adjacent and 10 miles or more apart?
   - if the bank or its holding company has assets exceeding $2.5 billion, does the interlocking management relationship exist with a nonaffiliated depository institution holding company with assets of $1.5 billion or less?
v. Have any loans to executive officers been uncovered that were not reported to the board (Regulation O (12 CFR 215) and 12 USC 503)?
w. Has a majority of the board failed to preapprove extensions of credit to any of the bank's executive officers, directors, or principal shareholders and their related interests when the total loans to the individual exceed the amount prescribed in Regulation O?
x. Has the bank notified executive officers and principal shareholders of their reporting requirements (Regulation O (12 CFR 215))?

11. Determine compliance with administrative actions by—
    a. reviewing provisions of the document and
    b. reviewing bank records and performing necessary procedures to isolate noncompliance.
12. Evaluate the bank's compliance with formal or informal administrative actions and prepare comments for page one of the examination report (SR-02-17 and SR-92-21). (See also section 5040.1.)
13. Determine compliance with conditions imposed in the approvals of corporate filings for—
    a. branches and relocation applications, including—
       - capital plans or capital injections,
       - fixed-asset limitations, and
       - CRA plans;
    b. subordinated debt, operating subsidiaries, and interim bank applications, including—
       - capital plans and
       - prior review and appropriate clearance of disclosures.
14. On the basis of the information obtained by performing the foregoing procedures, or any other procedures deemed appropriate, evaluate the adequacy and effectiveness of the board of directors. The evaluation should include, but is not limited to—
    a. the frequency and effectiveness of meetings;
    b. the effectiveness of board committees;
    c. the directors' role in establishing policy;
    d. the adequacy of the policies and major inconsistencies therein;

e. the quality of reports for directors, noting any deficiencies in information flows from operating management;
f. violations of laws and regulations;
g. whether any one person or group appears to control or dominate the board (if so, comment on any adverse effects on operating policies, procedures, or the overall financial condition of the bank); and
h. the board's responsiveness to recommendations from the auditors and supervisory authorities.

15. Update the workpapers with any information that will facilitate future examinations.

The purpose of this section is to guide the examiner in evaluating bank management. Although the directorate is an integral part of the overall management of a bank, the management appraisal examination program is concerned primarily with the active officers. A review of the quality of director guidance and supervision is covered in ‘‘Duties and Responsibilities of Directors.’’

It is the responsibility of directors to employ a competent chief executive officer. Thereafter, senior management normally assumes the responsibility to employ, maintain and educate a qualified staff. Since a direct relationship exists between the overall condition of a bank and the quality of management, the first priority in evaluating the condition of the bank is to make an accurate appraisal of the competency of the management team.

Management is responsible, not only for the operations of the bank and the quality of its assets on a day-to-day basis, but also for planning for the future. Senior management should be evaluated on its plans for maintaining or improving the condition of the bank in the future as well as on the bank’s present condition. The depth of planning and a general forward looking attitude of executive officers should be considered when projecting future management impact. This should include an evaluation of management’s efforts to provide for succession of senior bank officials.

The projection of future management impact involves an appraisal of the quality and quantity of senior and middle management. This assessment of course must be relative to the size and community circumstances of the bank. Examiners must not restrict their appraisals to the past and present. The past and present certainly are significant, requiring an in-depth analysis of financial condition, earnings and capital adequacy, both on an absolute basis and as a trend, but, the determination of what the management will do for the bank in the future is most significant. The System’s goal is to prevent problems from developing rather than waiting for future examinations to identify deteriorating conditions.

Bank management receives strong pressure from customers, stockholders and competitors. Customers demand more for their money, in the form of both interest and services, and stockholders demand higher returns on their investments, both in dividends and increased market value of their stock. No bank is completely free from the pressure of competition and, for most institutions, this is one of the strongest forces felt. In the midst of those pressures, the clear mandate to bank management is to ‘‘perform.’’ Performance is measured in terms of long-run profitability, liquidity and solvency. It is almost impossible for a bank to achieve those long-range goals unless careful planning and coordination bring efficiency to its activities. Management must recognize the bank’s position in the market and make plans which will achieve the objectives set for the institution by the directors. It must be constantly alert to the need for continually upgrading and expanding services and facilities to support and encourage the bank’s growth.

Both the directors and senior management have important roles in a bank’s program of internal control and internal audit. Although directors have overall audit responsibility and should require that the auditor report directly to them, senior management normally is charged with the duty of maintaining a strong system of internal control.

The entire examination procedure, as outlined throughout this manual, is designed to provide a clear picture of both the present and anticipated future condition of the bank under examination. As a result, the reports and workpapers generated by the examination process will serve as a major tool for examiners in their evaluation of management. Examination procedures for various balance sheet accounts and departmental areas are designed to effect a comprehensive evaluation of internal control and internal and/or external audit, and will provide the examiner with insight into the degree of compliance with the bank’s own written policies in such areas. Similarly, the examination procedures in ‘‘Loan Portfolio Management,’’ ‘‘Investment Securities,’’ ‘‘Funds Management,’’ ‘‘Assessment of Capital Adequacy,’’ and ‘‘Analytical Review and Income and Expense’’ are designed to lead to a detailed analysis of written objectives, policies and procedures in those management areas.

The examiner must take a practical approach to evaluating these features depending on the bank’s characteristics. The examiner can have greater confidence in the continuity of top and middle management when it is known that the bank has an inflow of new personnel at various levels and that training procedures and advancement policies will keep the organization viable and dynamic.

The examiner must be concerned with salary levels within the bank and must review information collected during the examination about the bank's employee benefits program. Salaries paid and benefits provided should be compared with those offered by an appropriate peer group, and inquiry should be made to determine the relationship between the bank's payroll structure and that offered by competitors for the same caliber personnel.

The examiner must judge the appropriateness of asset distribution in view of the bank's sources of funds. The examiner must evaluate the adequacy of the bank's capital position and expectations in view of asset quality and plans for growth and expansion. The overall management evaluation should be made by the examiner-in-charge, because he or she is in the best position to identify weaknesses and inconsistencies in policies. Although examiners-in-charge will rely heavily upon the information received from assisting examining personnel in various areas under review, it is their task to assemble all of such information into a composite picture of the quality of management.

Senior management is responsible for the quality of all bank personnel and for planning its own replacement. A bank's recruiting, training, and personnel development activities are vital to the development and continuity of a quality staff. The examiner must evaluate those areas to determine the quality of overall management. Some features of good personnel management are:

- An organizational structure.
- Detailed position descriptions.
- Carefully planned recruiting.
- Appropriate training.
- Performance review.
- Salary administration.
- Provision for communication.

The examiner should identify and interpret trends that can reveal flaws in policy either as written or as practiced. The examiner should question the quality of management in any area in which he or she finds serious shortcomings or makes significant criticisms.

The examiner should be alert for situations in which top management dominates the board or where top management acts solely at the direction of either the board or a dominant influence on the board. Although it is extremely important for the directors to assume their appropriate role in setting objectives and formulating policy consistent with their responsibilities to the depositors, shareholders and regulators, dialogue with top management must occur. In banks where both directors and senior management recognize and assume their appropriate duties and responsibilities, areas for conflict are greatly reduced.

1. To determine the consistency of written objectives, policies, and procedures in the various asset, liability, and operational areas.
2. To determine that policies are being adhered to throughout the system.
3. To determine that management plans adequately for future conditions and developments.
4. To evaluate the adequacy of the bank's personnel practices as they relate to management continuity.
5. To evaluate management experience and depth.
6. To determine that management has established systems which facilitate efficient operation and communication.
7. To evaluate the propriety and soundness of management decisions.
8. To project the impact of management on the future condition of the bank.

In the following procedural steps examiners should attempt to utilize already developed material from internal or external audit sources. Also, the examining resources and circumstances of the bank must be weighed in perspective to set the depth of scope for this area.

1. Obtain the following, if available:
   a. Organization chart.
   b. Management plan.
   c. Administrative and personal manuals.
   d. Marketing plan.
   e. Resumes for all executive officers and department or division heads which have not been obtained in previous examinations.
   f. A list of the salary of and other compensation paid to each executive officer.
   g. A list of the salary ranges for other officers of the bank broken down by position.
   h. A description of other employee benefits.
2. Become familiar with the quality of key personnel by:
   a. Updating management briefs for all executive officers and department or division heads.
   b. Distributing the updated management briefs to appropriate examining personnel and requesting that they be returned upon completion.
3. Review administrative manuals and:
   a. Extract any policy statements contained therein.
   b. Extract any general information considered relevant in appraising management.
   c. Analyze the manual(s), in general, as useful management tools.
4. Review management plan and extract information concerning:
   a. Areas of bank where increased or decreased officer staffing is planned.
   b. Number of officers to be added or removed.
   c. Qualification requirements for planned additional officers.
5. Establish the hierarchy of the organization by determining the functional responsibility levels of various officers and whether lines of authority are drawn in accordance with the organization chart.
6. Review the bank's marketing plan for specific programs being planned and general applicability to the institution.
7. Review the bank's schedule of salaries and make comparisons with similar information from an appropriate peer group. If deemed appropriate, compare salaries paid and benefits received in the bank to those of other institutions with which it competes directly. Determine whether the bank is paying salaries or bonuses to inactive officers or directors and, if so, determine that such payments have been disclosed to shareholders.
8. Determine whether any executive incentive compensation plans (performance bonuses) have been established and, if so;
   a. Review specific provisions of the plans and determine the beneficiaries.
   b. Review controls established to prevent the beneficiary(s) of the plan from understating noncash expenses (accrual expense accounts, provision for possible loan losses, etc.) or overstating noncash income (accrual income accounts).
9. Review the bank's activities with regard to developing personnel for senior management succession. At a minimum, this review should include:
   a. An assessment of the quality of lower levels of management and the potential for advancement.
   b. An assessment of the bank's officer hiring policies to determine that it is appropriate to meet the bank's current and future needs.
10. Obtain and analyze daily or other periodic reports submitted to executive management with the view of determining the usefulness of the reports in monitoring the condition and operation of the bank.
11. As the evaluation of the various areas of examination interest are being completed, discuss with assisting personnel:
    a. Any of their observations indicative of the general morale level.
    b. The technical proficiency of officers in their area.
    c. The level of direct impact that officers have on the condition of their areas.
12. Review the section on "Analytical Review

and Income and Expense" and extract any information related to financial planning that is considered relevant to evaluating management. Also consider the quality, depth and applicability of financial planning.

13. In conjunction with reviewing the work papers and comments generated during the examination:
    a. Familiarize yourself with the bank's written objectives and policies.
    b. Analyze those policies and determine any inconsistencies in management areas.
    c. Review any internal control and policy exceptions and any other criticisms made in connection with the examination of all areas of the bank.
    d. Determine the extent to which improper implementation is negating the effect of written policies and procedures.
    e. Review the appropriateness of asset distribution in view of the bank's sources of funds.
    f. Review the evaluation of the bank's capital position and expectations in view of asset quality and plans for growth and expansion.
14. In cases where previously obtained information is incomplete or where no records could be reviewed, interview appropriate management in order to judge quality and depth. The interview should be conducted in such a manner as to generate necessary information for determining:
    a. Sources of information used to keep current.
    b. Stengths and weaknesses of lower level personnel.
    c. Succession of management and replacement of key personnel.
    d. General management plan.
    e. Methods of control utilized.
    f. Workload factors and efficiency of personnel.
    g. Frequency of staff meetings and how the communications system works.
    h. Management projections for the institution over the next year.
    i. Any major new proposal being considered or changes in asset mix or services.
    j. The nature and degree of working relationship with directors.
    k. The existence of any time-consuming outside activities of executive management.
15. By reviewing the results of the preceding steps and performing any other procedures deemed appropriate, answer the following questions (normally these questions will serve as a summary of information obtained, thus compiling factual data to support your objective comments on management):
    a. Have overall management objectives been set?
    b. Does the bank forecast manpower requirements?
    c. Are qualified people advanced from within?
    d. Are supervisory personnel involved in the selection of new employees and given the right of acceptance or rejection?
    e. Is management training given to those persons likely to assume higher level positions?
    f. Are salaries competitive?
    g. Are employee benefit programs competitive?
16. Prepare comments on the quality of management supervision. The comments should, at a minimum, discuss the following:
    a. General and technical ability.
    b. Effectiveness.
    c. Experience.
    d. Any inconsistencies in written objectives, policies and procedures.
    e. Any serious or widespread lack of proper implementation of written procedures.
    f. An evaluation of the bank's salary structure.
    g. The promptness with which management addresses problems.
    h. The extent to which executive management delegates and demands accountability.
    i. Any evidence that executive management is more concerned with the operation of a functional area than with overall supervision of the bank.
    j. The potential for upward movement of existing management personnel.
    k. Management's commitment to effecting corrective action in problem areas.
    l. Unsafe or unsound management.
    m. Any situation which might require close monitoring or removal of management.
17. For banks that are subsidiaries of bank holding companies (BHCs), review the relative degree of centralized control by parent or the lead bank, and evaluate:

a. The general level of management's dependence on central BHC staff.
b. Independence on final credit decisions.
c. Independence on investment decisions.
d. Independence on operational practices or service fee arrangements.

While examiners may expect that economies of scale or optimization of tax, investment, or credit considerations on a consolidated basis may be beneficial to the entire organization, examiners must be alert to the danger of such considerations becoming overly burdensome or unfair to the subsidiary bank being examined. (Reference Federal Reserve Policy Statement on Intercorporate Income Tax Accounting Transactions of Bank Holding Companies and State Member Banks.)

18. Update the workpapers with any information that will facilitate future examinations.

1. Does the bank have an organizational chart?
2. If not, have lines of authority and reporting responsibility been formally established?
3. Does the bank have a full-time personnel manager?
4. Does the bank utilize written personnel manuals?
5. Does the bank utilize a system of written job descriptions, including descriptions for supervisory personnel?
6. Does the bank actively recruit personnel?
7. Does the bank perform background investigations of new employees?
8. Does the bank have a formal training program?
9. Does the bank utilize other than on-the-job training?
10. Does the bank utilize a graded salary scale?
11. Does the bank consider competition in preparing a salary range? If so, in what manner?
12. Does the top management at least annually review lower management?
13. Does the bank prepare or utilize a long-range forecast of economic conditions germane to its trade area?
14. Does top management consult with directors for their opinion of future condition?
15. Does the bank either employ an economist or utilize the services of an outside economic advisor?
16. Does senior management propose to the directors areas for policy decision?
17. Does the bank have a management succession plan?
18. Does the bank employ a marketing manager and/or outside marketing consultant?
19. Does senior management receive:
    a. A brief statement of condition daily?
    b. A daily liquidity report?
    c. A listing of assets subject to quality limitations at least monthly?
    d. An earnings statement on a comparative basis at least monthly?
20. Does the bank's auditing function audit the officer's adherence to general policy?
21. Are staff meetings held on a regular basis?
22. Are minutes kept for staff meetings?
23. Does the bank use a system of progress reports on specific projects?
24. Does the bank have a tax department or a tax consultant?

Throughout this manual, the examiner is encouraged to use objective criteria in evaluating various areas of the bank. However, there will always be a need for subjective judgment in an examination. Formulating an overall conclusion regarding the present and future condition of the bank requires the use of both objective criteria and subjective judgment. As experience is essential in evaluating information in areas requiring subjective judgment, the procedures in this section should be performed by the examiner-in-charge. In performing those procedures, the examiner's primary concerns are—

- to make the ultimate determination as to—
  - — the solvency of the bank and its ability to meet maturing and unusual demands in the ordinary course of business,
  - — adherence to safe and sound banking practice,
  - — adherence to the law, and
  - — the continued viability of the institution; and
- to communicate the results of the examination to the Federal Reserve System and the directors of the bank.

The evaluation of the overall condition of the bank is based on conditions found throughout the institution. Considerations include internal control and policy exceptions, violations of law and regulations, quality of management, adequacy of earnings and capital, quantities of criticized assets, and other identified deficiencies or irregularities. An evaluation of the future condition of the bank is based on the analysis of—

- management's plans as expressed by operating plans, the capital plan, and other projections,
- factors such as competition and economic conditions, and
- the overall present condition of the bank.

The primary information for evaluating the present condition of a bank is the findings and conclusions of the assisting personnel. The examiner-in-charge should weigh the importance and significance of all criticisms, exceptions, and deficiencies in attempting to discover any unfavorable trends or situations. Through review of the examination process, insight can be gained into such central issues as—

- present asset quality;
- current liquidity position;
- present capital adequacy;
- quality and performance of management;
- earnings performance, both past and present; and
- sources and applications of funds.

The examiner-in-charge usually will include remarks regarding those areas in the examination report. Although procedural areas of this manual deal specifically with each of those key items, the examiner-in-charge should use information from all phases of the examination. For example, when reviewing the bank's present capital position, the examiner-in-charge may use knowledge of the bank's asset and management quality to modify the conclusions of assisting personnel. The important point is that the examiner-in-charge is in the best position to assess all information provided by the examination process.

Factors affecting the future condition of the bank can generally be categorized as internal or external. The examiner's review of current condition flows naturally into an evaluation of internal factors affecting the institution's future prospects and condition. Among the items providing insight into future conditions are—

- earnings trends,
- successor management plans,
- the budget or profit plan,
- the capital plan, and
- any other internally generated projections or forecasts.

Many banks will not have formal written plans or projections. In such cases, the examiner-in-charge must obtain from senior management or the board of directors information on their plans for matters such as—

- growth and expansion,
- capital,
- changes in size and mix of assets, and
- changes in sources of funding.

In addition, examiners should remind senior management that any change in the general character of a bank's business or the scope of the corporate powers it exercises requires the prior approval of the Board under Regulation H.

The examiner should recommend that banks that do not have formal plans or projections take advantage of any externally available tools to aid them in formulating these plans. In today's competitive market, strategic planning is a necessity for almost all banks, but especially for banks that are losing their market share or in which inefficiencies are depressing profitability.

If banks prepare budgets or profit plans, insight can be gained into the accuracy of balance-sheet and earnings projections by comparing actual and projected account balances. It also is beneficial to compare original projections with current projections to determine that adjustments are made on a timely basis. When four- or five-year projections are made, banks often formulate several forecasts based on different sets of assumptions. In such a situation, the examiner should attempt to determine the bank's most likely future course.

The examiner should attempt to gain access to any official material or internal workpapers that document or illustrate the bank's rationale in planning its future. The goal is to review the institution's decision-making process.

Banks are turning increasingly to off-balance-sheet activities to deliver services, effect payments, generate income, and hedge interest-rate risks. Banks have introduced a wide variety of new products and services to complement their more traditional activities. Although such new activities are useful and profitable, they contain an element of risk. Many of these new activities involve a contingent liability or other risk that is not reflected on the bank's balance sheet and, indeed, may not even be fully recognized by the bank. The examiner should be aware of how the bank manages and controls its off-balance-sheet risks. Examples of off-balance-sheet activities include—

- electronic funds transfer systems,
- nontraditional lending activities (including the sale and servicing of mortgage- and government-guaranteed loans),
- innovative applications for standby letters of credit, and
- a wide variety of investment-security activities (including futures and forwards, puts and calls, and short sales).

Risk can be distinguished primarily as credit risk, funding risk, rate risk, or risk resulting from internal-control deficiencies. Examiners must be aware of the nature and extent of off-balance-sheet risks. The risks that affect capital, liquidity, and compliance with laws should be evaluated for their potential effect on the safety and soundness of the bank.

In judging such controversial areas as capital adequacy and liquidity, the examiner should remember that, under ideal circumstances, management should be the expert on the bank's capitalization and liquidity position. Judgments on such matters should be generated internally, based on insight only management can possess. It is management that should know the bank's competitive situation, the economics of the service area, and the anticipated impact of those and other factors on its plans for growth and expansion. It is also management that has the greatest interest in the success of the bank. Accordingly, management and the directorate should choose a level of capitalization and liquidity consistent with their perception of the bank's situation rather than reacting to competitors or relying on pressures from regulators. However, specific judgments by the examiner are required, particularly in situations where a capital or liquidity position has fallen below what examiners consider to be acceptable norms. Objective justification for lower levels of capital or liquidity must be obtained and analyzed.

To properly evaluate the future prospects of a bank, the examiner must review external factors affecting the institution. Significant among those factors are the characteristics of a bank's area. Area refers to the bank's primary service area, which is defined as that area from which the bank receives approximately 75 percent of its deposits. Demographics of the area generally are available, and every bank should accumulate such information to aid in analyzing its current operations and planning for future operations. The absence of such information in an up-to-date form should be considered a deficiency. Included under examination procedures for this section is a listing of minimum information required to ascertain the demographics of a service area. The examiner-in-charge should make sure that information is compiled and should analyze it to determine whether management expectations appear justifiable in the circumstances.

In dealing with competitive factors, the examiner should review or compute the share of market for the bank under examination. Continuing records in that area establish an analyzable trend. Consideration also should be given to changes in the bank's statutory and regulatory environment, such as—

- changes in branching laws,
- changes in tax structure, and
- changes in laws affecting competition with other financial institutions.

Once the examiner has reached specific conclusions about the present condition and future prospects of the bank, or has noted serious deficiencies or detrimental trends, his or her conclusions and suggestions should be communicated to bank senior management, the board of directors, and the Federal Reserve Bank on a timely basis.

In formulating discussion and written comments, the examiner should avoid the appearance of second-guessing management. Therefore, conclusions, judgments, and recommendations should be based on objective information generated throughout the entire examination process.

Before preparing examination report comments regarding the overall condition of the bank, the examiner-in-charge should consider the reporting objective. Once it is determined that problems exist in a bank, the underlying causes must be identified. Those underlying causes as well as specific problems or deficiencies should be covered in the comments. For example, if deficiencies in written lending objectives or policies or noncompliance with sound policies have resulted in the acquisition of sub-quality assets, the examiner's comments must address both cause and effect. The total of criticized assets should be cited as evidence of the underlying problem and appropriate remedies, such as changing objectives or policies, should be suggested.

Examiners should remember that their ability to reach accurate conclusions regarding the overall present condition and future prospects of the bank and their skill in communicating the conclusions to management orally and in reports, will, to a great extent, determine the effectiveness of the entire examination process.

The examiner's conclusions regarding the overall condition of the bank are summarized in a composite rating assigned in accordance with guidelines provided under the Uniform Interagency Bank Rating System (CAMELS). The composite rating represents an overall appraisal of six key assessment areas covered under the CAMELS rating system: Capital, Asset quality, Management, Earnings, Liquidity, and Sensitivity to market risk. The summary or composite rating, as well as each of the assessment areas, is delineated on a numerical scale of one to five, one being the highest or best possible score. Thus, a bank with a composite rating of one requires the lowest level of supervisory attention; while a five-rated bank has the most critically deficient level of performance and, therefore, requires the highest degree of supervisory attention. When appraising the six key assessment areas and when assigning a composite rating, the examiner weighs and evaluates all relevant factors. In general, these factors include the adequacy of the capital base, net worth, and reserves for supporting present operations and future growth plans; the quality of loans, investments, and other assets; the ability to generate earnings to maintain public confidence, cover losses, and provide adequate security and return to depositors; the ability to manage liquidity and funding; the ability to meet the community's legitimate needs for financial services and cover all maturing deposit obligations; and the ability of management to properly administer all aspects of the financial business and plan for future needs and changing circumstances. The assessment of management and administration includes the quality of internal controls, operating procedures, and all lending, investment and operating policies; compliance with relevant laws and regulations; and the involvement of the directors, shareholders, and officials.

Although the composite rating is based loosely on the average of the five component scores, the examiner's judgment can and should play a major role in its determination. Thus, the examiner must assess the severity, particularly the potential impact, of individual weaknesses on the present and future viability of the bank. Significant problems will provide sufficient basis for deviating from the numerical average approach to assigning the composite rating. However, whenever deviation from the numerical standards for the composite rating is necessary to reflect accurately the overall condition of the bank, the examiner must provide a full explanation of the reasons for such deviation.

Refer to the appendix for a complete discussion of the uniform rating system and considerations to be taken into account when using it to evaluate the condition of a bank.

SUBSIDIARIES OF BANK HOLDING COMPANIES

The composite rating of an individual subsidiary bank should be based on the condition of that single entity. The quality of management and financial condition of the consolidated organization will be useful in assessing the prospects and understanding the operations of the bank being examined. However, banks with weaknesses requiring corrective action should be identified as such. Then, appropriate supervisory focus can also be made at the consolidated level. Also, banks should be identified by type on an individual basis rather than by applying the consolidated organization's characteristic to each bank. For example, the capital and condition of a community bank should be judged by community bank standards, not by multinational or regional standards, even if owned by such an organization. This recognizes that two consolidated organizations of similar size may be composed of entirely different types of banks. Proper evaluation of each bank component should lead a bank holding company inspector to the most appropriate conclusion on the condition of the consolidated entity.

FORMAL AND INFORMAL SUPERVISORY ACTIONS

As a general rule, supervisory action should be considered when other more routine measures such as formal discussions with a bank's principals or directors, and normal follow-up procedures, have failed to resolve supervisory concerns. The Uniform Interagency Bank Rating System clearly identifies the more serious problem banks and distinguishes them from banks whose weaknesses or deficiencies are such as to warrant a lower degree of supervisory concern.

For example, the application of prompt and effective remedial action may keep the condition of a composite 3 bank from deteriorating and the bank from becoming a problem institution. To ensure problem areas receive adequate attention, all weaknesses should be clearly defined and corrective measures properly structured. This objective may best be achieved through the execution of a memorandum of understanding between the bank's board of directors and Reserve Bank officials. A memorandum of understanding is not a formal written agreement as prescribed in the Financial Institutions Supervisory Act of 1966; it is a good faith understanding between the bank's directorate and the Reserve Bank concerning the principal problems and the bank's proposed remedies.

Banks rated composite 4 or 5 are clearly problem institutions that require close and constant supervisory attention. Unless specific circumstances argue strongly to the contrary, such banks will be presumed to warrant formal supervisory action, that is, a written agreement or cease-and-desist order, as provided for in the Financial Institutions Supervisory Act of 1966. In addition, the Board of Governors is also authorized to suspend and remove offending officers and directors of banks for certain violations and activities.

Although the decision to pursue formal or informal supervisory actions belongs to the Board of Governors or the Reserve Bank, the initial consideration and determination of whether action is necessary usually results from the examination process. Accurate and complete report comments which carefully delineate both the bank's weaknesses and deficiencies and management's existing or planned corrective measures will allow the Reserve Bank to make the most informed decision concerning appropriate supervisory action.

CIVIL MONEY PENALTIES

Under provisions of the Financial Institutions Regulatory and Interest Rate Control Act of 1978 (FIRA) (P.L. 95–630), the Board of Governors is authorized to assess civil money penalties for violation of the terms of a final cease-and-desist order and violations of—

- sections 19, 22, and 23A of the Federal Reserve Act (respectively, reserve requirements and interest-rate limitations; limitations on loans by insured banks to their executive officers, directors, and principal shareholders; and limits on loans by insured banks to their affiliates);
- the prohibitions of title VIII of FIRA against preferential lending to bank executive officers, directors, and principal shareholders based upon a correspondent account relationship; and
- a willful violation of the change in Bank Control Act of 1978 (12 USC 1817(j)).

In determining the appropriateness of initiating a civil money penalty assessment proceeding, the Board has identified a number of relevant factors (see *FRRS*, 3–1605). In assessing a civil money penalty, the Board is required to consider the size of the financial resources and good faith of the respondent, the gravity of the violation, the history of previous violations, and such other matters as justice may require.

Examiners are responsible for the initial analyses on potential civil money penalties. Civil money penalties should be proposed for serious violations and for violations which, because of their frequency or recurring nature, show a general disregard for the law. After the examiner has reviewed the facts and decided to recommend a civil money penalty, he or she should contact the Reserve Bank for advice on proper documentation and any other assistance.

CRIMINAL REFERRAL PROCEDURES

On April 2, 1985, an agreement was signed by the federal financial institutions supervisory agencies and the U.S. Department of Justice that requires the agencies to work toward improving the federal government's response to white-collar crime in federally regulated financial institutions. The primary goal of the agreement is to ensure full cooperation in the sharing of relevant information among the agencies, subject to existing legal restrictions, so that all available information may be used in criminal, civil, and administrative proceedings. In keeping with that goal, the agreement sets forth procedures for the use of a uniform criminal referral form by all of the supervisory agencies and by the financial institutions regulated by them.

Summary of the Criminal Referral Form

The Federal Reserve System's version of the Criminal Referral Form, FR 2230, has been designed so that one form can be used for all reports. The form is to be used by all state member banks, bank holding companies, nonbank subsidiaries of bank holding companies, Edge Act and agreement corporations, U.S. branches and agencies of foreign banks, and Federal Reserve Banks in accordance with the Board's guidelines.

Suspected criminal violations of any section of the United States Code or state law (except bank robbery) involving less than $10,000 and not involving an executive officer, director, or principal shareholder of the institution can be reported by simply completing the first two pages of FR 2230. If the suspected criminal violation involves an actual or probable loss of $10,000 or more or, in any case, involves an executive officer, director, or principal shareholder of the institution, all items on the form must be completed. The instructions on the Criminal Referral Form direct the filing institution to send a copy to the local FBI office, the nearest office of the U.S. attorney, the Reserve Bank, and, in certain instances, the Secret Service.

The Criminal Referral Form describes the mandatory and optional reporting requirements, which, along with applicable dollar thresholds, have been changed. In outline form, they are as follows:

- A Criminal Referral Form must be filed—
  - — if a financial institution suspects criminal activity by its employee, officer, director, or agent (e.g., an insider) involving any amount;
  - — if a financial institution suspects criminal activity involving a loss of $1,000 or more, the financial institution can identify a suspect, and the suspect is not an employee, officer, director, or agent (e.g., a non-insider);
  - — if a financial institution suspects criminal activity involving a loss of $5,000 or more and it cannot identify a suspect; or
  - — if a financial institution suspects criminal activity involving a violation of the bank secrecy and related money laundering laws and regulations.
- A Criminal Referral Form may be, but is not required to be, filed—
  - — if a financial institution suspects criminal activity involving a loss of less than $1,000, the financial institution can identify a suspect, and the suspect is not an employee, officer, director, or agent of the financial institution (e.g., a non-insider); or
  - — if a financial institution suspects criminal activity involving a loss of less than $5,000 and it cannot identify a suspect.

The Enforcement Section of the Division of Banking Supervision and Regulation has primary responsibility for the criminal referral process, including coordination with Federal Reserve Banks, U.S. attorneys, the Department of Justice and the FBI, and tracking and recording of all criminal referrals. ‘‘SR’’ letters have been distributed within the Federal Reserve System, including SR-85-22 (FIS), SR-86-7 (FIS), and SR-88-9 (FIS), and reference should be made to them in connection with any inquiry in this area.

Examination Objectives

To determine if the institution has established internal procedures to ensure the prompt and accurate submission of all reports of suspected criminal activity to appropriate authorities.

Examination Procedures

1. Determine whether the institution has a policy of reporting suspected criminal activity.
2. Determine how the policy has been communicated to officers and employees.
3. Determine whether a person(s) or department in the bank has been designated as being responsible for the filing of the Criminal Referral Form, FR 2230.

Reporting Suspected Criminal Violations

If, during the course of an examination, an examiner uncovers a situation that is known or suspected to involve a criminal violation of any section of the United States Code or state law and no referral of the matter has been made by the bank or an inadequate referral was made, details should be reported immediately to the Reserve Bank. If the situation warrants a telephone call to the Reserve Bank, this should be done and followed by a detailed report. The report should be in the form of a memorandum, and must be written in such a way as to fully apprise the Reserve Bank of the situation. All of the information contained in the Criminal Referral Form, FR 2230, should be embodied in the memorandum. Copies of the pertinent exhibits should be attached.

The examiner’s report should be confined to clear-cut statements of fact and must not contain opinions as to the probability of indictment, conviction, or related matters. In all reports and workpapers, the examiner should be as specific as possible (e.g., rather than indicating ‘‘it is reported’’ or ‘‘the bank indicates’’) and he or she should identify who reported the matter and how it occurred. On each transaction that is to be reported, copies of all documentation should be obtained and placed in a separate file detailing who handled the transaction in the bank. The reporting of the matter within the bank should be chronologically referenced throughout the documentation. The copies of documentation should be initialed and dated by the examiner in case the original is destroyed. The documentation is extremely important to proving a particular transaction.

The examiner’s initial notification of suspected criminal violations to the Reserve Bank and the transmittal of data should be accomplished without informing bank personnel. Only the Reserve Bank or a designated representative should inform bank personnel or its board of directors of a suspected criminal violation that had not been reported by the bank or inadequately reported by bank personnel.

After reviewing the information submitted by the examiner, the Reserve Bank will decide whether the facts support the examiner’s contention that a possible unreported violation of the criminal statutes exists. If the Reserve Bank discovers that in a particular instance a bank failed to report the suspected criminal violation using the Criminal Referral Form, FR 2230, or made an inadequate referral, and upon request, still fails to make a report, the Reserve Bank itself must then complete a Criminal Referral Form, FR 2230.

Appropriate comments relating to a bank’s failure, if any, to make all necessary criminal referrals in an accurate and timely manner should be made in the report of examination of the bank. Repeated or serious problems in this area should be directed through the Reserve Bank to the Enforcement Section of the Division of Banking Supervision and Regulation.

Overall Conclusions Regarding Condition of the Bank
Examination Objectives
Effective date March 1984

Section 5020.2

1. To reach conclusions regarding the present condition of the bank.
2. To reach conclusions regarding the future prospects of the bank.
3. To determine the bank’s ability to meet demands in the ordinary course of business or reasonably unusual circumstances.
4. To determine the bank’s adherence to safe and sound banking practices.
5. To formulate recommended action, when appropriate, based on those conclusions.
6. To communicate conclusions and recommendations both orally and in the examination report.

Inasmuch as the following procedures are largely dependent on information generated from all phases of the examination, the examiner-in-charge should complete this program during the final stages of the examination. The completion of this program generally can be best accomplished during the review of the workpapers.

1. Analyze any available information concerning the characteristics of the area in which the bank operates to determine the existence of any unusual situations, any significant trends, the potential impact on the bank of any expected changes or any other significant information which could be detrimental to the bank. The bank should be consulted for sources of information which might include the most recent census data or data generated by organizations, such as the Chamber of Commerce. In analyzing the bank's trade area:
   a. Consider density, income levels, general age group of the residents. Determine if there are significant changes in any of the above factors.
   b. Determine the predominant living accommodations in the area (owner occupied vs. rental), price/rent levels and availability of residential units. Determine whether there are any major residential construction projects, re-zoning or conversions of single to multiple units which will have a significant effect on the bank.
   c. Consider the types of industry and the number of firms in the area with emphasis on determining concentrations or seasonality. Investigate any major labor contract expirations, competitive factors or other significant factors which could have a negative effect on the community.
   d. Consider the types of major products, available markets and present and projected prices for the products.
   e. Consider any expected changes in street facilities which will significantly affect bank's accessibility/convenience. Determine the availability of public transportation.
   f. Review the number and types of institutions that provide similar financial services in the community. Consider the aggressiveness, hours of business and additional services offered by competitor institutions.
   g. Determine the effect of government employment or dependence on government contracts on the community.
   h. Consider the condition of the national economy with particular attention to the rate of inflation, national vs. local unemployment, current interest rates and government fiscal and monetary policy. Specific problems, peculiar to a particular area should be investigated more thoroughly.
2. Review comments and conclusions contained in the workpapers which were generated throughout the examination and perform the following:
   a. Compile all criticisms, exceptions and deficiencies.
   b. Determine the existence of contradictory conclusions.
   c. Consider the relative significance of criticisms, exceptions, deficiencies and conclusions and segregate important criticisms for the final review with management and for incorporation into the report of examination.
3. Based on procedures performed and conclusions contained in the workpapers, answer the following specific questions. These questions are intended as guidelines to the examiner-in-charge in formulating overall conclusions regarding the condition of the bank and should be augmented by the examiner's knowledge of the bank. "Yes" answers, in many instances, evidence the existence of a "leading" indicator of deterioration of bank soundness. For any question with a "yes" answer, specify any mitigating circumstances in the comments column. Sub-question answers are for information purposes.

a. *Asset Quality*

- Is there an increasing ratio of criticized assets to total capital?
  — If so, is it indicative of adverse economic conditions, poor credit

judgment, or other factors (specify)?

- Has there been a material increase in the quantity of non-earning assets?
- Is there any abnormally increasing trend of past-due loans and/or interest earned but not collected?
  - — If so, is it indicative of general economic conditions in the bank's trade area
  - — Is the trend indicative of a weakening of collection policies and procedures, a slackening of credit standards, the bank's failure to recognize an asset which should be in a non-earning category, or is it caused by some other factor?
- Has a trend developed wherein the bank assumes increased risk without receiving increased rewards?
- Do the portfolios exhibit high concentrations in specific industries?
  - — If so, do the concentrations represent a significant actual or contingent problem?
- Has the overall quality of assets deteriorated since the last examination?
  - — If so, is the deterioration recognized by management and the board of directors? Can the deterioration be attributed to factors beyond the control of management or the board of directors, such as a change in the general economic conditions of the bank's service area?
  - — If deterioration results from internal factors, such as lowering of credit standards or poor credit judgment, have steps been taken by management to effectively reverse negative trends?

b. *Quality of Management*

- Has the executive management changed since the last examination?
  - — If so, is the change detrimental to the bank?
- Has there been any change in the general banking philosophy of executive management?
  - — If so, is that detrimental to the bank?
- Do key bank officers have educational and/or experience levels below that considered minimal in the circumstances?
- Is there any tendency toward over reliance on essentially untrained and unskilled clerical staffs?
- Is there a large disparity between the compensation level of the chief executive officer and other members of executive management?
  - — If so, is that disparity an objective indication of disproportional domination of the bank's affairs?
- Has the bank instituted any systems which directly reward managers for increasing bank income from assets or services subject to their control?
  - — If so, has the bank failed to institute necessary control and audit procedures to prevent abuses?
- Has the bank failed to institute any programs which would give officers a vested interest in remaining with the bank?
  - — If so, would the institution of such a program offer a workable solution to an actual or potential officer turnover problem?
- Is the bank's strategic and operational planning inadequate?
- Is the board of directors unresponsive to internal or external suggestions for improvement in the bank?
- Are the following conditions present?
  - — Infrequent meetings of board of directors.
  - — Infrequent meetings of committees of the board.
  - — Infrequent management committee meetings.
  - — A directorate which is split into distinct voting groups.
  - — If so, are directors viewed as failing to perform their functions adequately?
- Is the quality of management deemed inadequate to conduct the affairs of the bank in a reasonable and safe manner?
- Are training programs and compensation increments deemed inadequate to attract and retain a staff capable of providing management succession?

c. *Earnings*

- Are earnings static or moving downward as a percentage of total resources?
- Is there a trend of decreasing income before security gains and losses as a percentage of total revenues?
  - — If so, is such a trend expected to continue?
  - — If so, has management determined causes for any deterioration and taken action to reverse the negative trend?
- Has the ratio of operating expenses to operating revenues been increasing?
- Are earnings trends consistent?
- Has a decreasing spread between interest earned and interest paid developed?
- Are the bank's earnings significantly vulnerable to changes in interest rate levels?
  - — If so, what are management's plans and prospects for altering the vulnerability?
- Are there any significant structural changes in the balance sheet which may impact earnings?
- Has the bank experienced increasing actual loan losses and/or loan loss provisions?
- Is there any evidence that sources of interest and other revenues have changed since that last examination?
  - — If so, is that attributed to an unsound emphasis for increased earnings?
- Are earnings deemed inadequate to provide increased capitalization commensurate with the bank's growth?

d. *Capital*

- Has the bank been unable to maintain a normal growth rate for capital?
- Do the ratios of loans to capital, deposits to capital or total assets to capital exhibit a trend to abnormal increases?
- Is capital deemed inadequate to support the present volume of business, including the volume of off-balance-sheet activities, in view of the amount of criticized assets, the competency of management, etc.?

e. *Liquidity*

- Is there a trend toward decreasing bank liquidity?
- Has the bank been forced to increase abnormally dependence on borrowed funds to support existing assets?
- Does the bank depend excessively on purchased funds?
- Is there a trend toward investing interest sensitive liabilities in non-interest sensitive assets?
- Do the present quantity and maturity of non-interest sensitive assets represent a dangerous or potentially dangerous situation?

f. *Off-Balance-Sheet Risk*

Loans Sold or Serviced

- Is the bank involved as the lead or agent in loan participations, syndications, or servicing activities to the extent that management expertise is inadequate, or to the extent that the volume exceeds the level which management can capably handle?
- Does the bank's record of pending or threatened litigation indicate any instances where the bank, as lead or agent in a loan participation or syndication, has willfully misrepresented the credit to the other participants, or otherwise acted with gross negligence in handling the credit?
  - — If so, is there any indication that the participants intend to hold the bank liable for any loss incurred on the credit?
- Did the examination reveal a practice of improper origination and packaging of loans sold or serviced which could cause:
  - — The bank being compelled to repurchase the package, or
  - — In the case of government guaranteed loans, the complete or partial dishonor of the guaranty?

- Has the bank previously repurchased participations when a loss was incurred, although it was not legally required to do so?

Letters of Credit

- Is there a trend toward increasing the issuance of standby letters of credit or other similar credit instruments?
  - If so, has the bank failed to consider the full impact of funding a significant percentage of those instruments?
- Are letters of credit excluded from the bank's internal loan review program?
- Does the internal evaluation of letters of credit include consideration of country and currency risk as well as credit risk?
- Is there a declining trend in the credit quality of letters of credit?
- Are standby letters of credit issued for purposes not covered in the bank's lending policy, or for which management does not have the expertise to handle?
- If not authorized in the bank's lending policy, were proper approvals obtained prior to issuance?

Wire Transfer Department

- Do internal control deficiencies in the wire transfer department pose a threat for large potential losses through fraud or error?
- Are there internal control deficiencies in the receiving and conveying of messages for other parties which may expose the bank to litigation for improper handling of the messages?

Data Processing Department

- Are internal controls inadequate in the bank's data processing area?
  - Are control deficiencies such that the accuracy and/or timeliness of data is questionable?
  - Are deficiencies such that the bank, in performing data processing services for others, could be liable for misplacement or other improper handling of source data?
- Are the bank's computer hardware and software systems inadequate to support the present and anticipated level of operations?
  - Are deficiencies such that hardware and systems will require replacement or upgrading in the short term?

Settlement Procedures

- If the bank is a member of CHIPS, Fedwire or other clearinghouse system, are procedures inadequate for the proper monitoring of incoming and outgoing wire transfers so that the bank is occasionally unprepared for settlement?
  - Would earnings be significantly affected if the immediate acquisition of funds is required to meet settlement?
  - Is the bank aware of the creditworthiness and ability of the other clearinghouse participants to make settlement?
- Are customers' daylight overdrafts allowed to exceed established credit limits or are they otherwise being improperly monitored?
- Is there a history of daylight overdrafts which have not been covered before the close of business?

Investment Securities

- Are there significant internal control deficiencies associated with the bank's handling of "when issued" trades, futures contracts and forward placements?
  - Is management's knowledge of interest rate hedging techniques insufficient to support such activity?
- Does the bank act as agent on securities or repurchase agreement transactions?
  - If so, does the customer agreement specifically designate liability for failure or performance?

Miscellaneous

- Did the analytical review of income and expenses disclose any additional off balance sheet activities for which management does not exhibit the necessary expertise and does not have adequate internal controls to handle the service?
- Does a review of legal actions against the bank indicate any pattern of practices which are caused by deficient internal controls?
  - — If so, have the deficiencies been corrected?
- Is the potential liability arising from pending litigation considered significant in terms of capital adequacy and liquidity, considering the level of other contingent liabilities?
- Are any of the bank's affiliates or subsidiaries experiencing unprofitability or liquidity problems which may affect the soundness of the bank?
- Are operating lease liabilities and annual lease payments significant in terms of the bank's other funding requirements?
- Is potential restitution resulting from Truth in Lending Act violations significant relative to capital and liquidity?
- Is the bank's level of loan commitments, standby letters of credit, commitments to purchase securities and futures/forward contracts imprudent in light of overall circumstances within the bank?

g. *Internal Controls and Audit Procedures*

- Have internal controls deteriorated since the last examination?
- Do any of the following exist at the bank?
  - — Low compensation level of internal auditors.
  - — Internal or external auditor who reports directly to other than the board of directors or a committee thereof.
  - — Internal auditors who perform original work versus monitoring the efforts of others.
  - — Abnormally low percentage of internal auditors to total personnel.
  - — Inadequate training or supervision of internal auditors.
  - — Questionable independence of external auditors.
  - — Inadequate management response to deficiencies cited by auditors.

  If so, do these or other pertinent factors indicate a less than adequate situation in internal or external audit?
- Are internal controls and audit programs deemed inadequate?

h. *Ownership*

- Have there been significant changes in ownership since the last examination?
  - — If so, could the change be detrimental to the soundness of the bank?
- Does any situation exist wherein one individual is capable of controlling the bank?
  - — If so, is that detrimental to the bank's soundness?
- Is there any evidence of an impending proxy fight?
- Are ownership interests using borrowed funds to carry the bank's stock?
  - — If so, is there an indication that undue pressure for increased earnings is being applied by the owners?
  - — If such pressure is being applied, does that have a detrimental impact on the general characteristics of asset composition, as it exists, and asset composition, as it is expected to develop?

i. *Miscellaneous*

- Does the bank exhibit a high dependence on purchasing or participating in loans originated and managed by others?
  - — If so, is that attributable to a lack of local loan demand or to a failure of the bank to service its trade area?
- Is there an increasing trend toward making loans and/or accepting deposits from outside of areas in which the bank maintains offices?

  - — If so, does management and the board fully understand the risks inherent in such activity?
- Has a trend toward increasing advances to affiliated companies developed?
  - — If so, does that presently represent a dangerous situation?
- Has the bank experienced an abnormally fast rate of growth?
  - — If so, is that growth reasonable and does it therefore, have no significant impact on future soundness, based on:
    - Economic conditions within the trade area?
    - The bank's increased marketing efforts?
    - Offering improved services to the community?
    - Other factors?
  - — If so, is the bank's management team capable of adequately administering the growth?
- Does the bank have an imprudent investment in fixed assets?
- Does the bank depend to an excessive degree on a small, local economy, which is subject to cyclical swings due to local conditions and industries, as opposed to mirroring national economic trends?
  - — If so, is that a source of criticism or does it represent a potentially dangerous situation?
- Are there large fluctuations in the stock price of the bank or its parent?
  - — If so, is management unable to discern a cause for such fluctuations?
- Is management giving inadequate attention to compliance with laws and regulations?

4. Have all questions raised by the UBPR specialist been explored?
5. Complete workpapers.
6. Organize general conclusions regarding the present condition of the bank and:
   a. Correlate plans, projections, forecasts, and budgets with present conditional aspects, area characteristics, and management capability to determine which of the goals the bank has set you believe to be unattainable.
   b. Project the future condition of the bank based on its present financial condition, the economic expectations of the bank, the quality of management, director supervision and any other relevant factors.
   c. Formulate recommendations for management to consider when they initiate corrective or preventative action.
7. Conduct a final summary discussion with management to include:
   a. Criticisms noted during the examination.
   b. Conclusions reached about the bank in general.
   c. Expected future condition:
      - Management's view.
      - Examiner's view.
   d. Review of other potential problems.
   e. Planned corrective action:
      - Examiner recommendations.
      - Management commitments.
8. Update "Management Assessment" conclusion to add any relevant information obtained as a result of procedures performed in this program.
9. Prepare recommendations for any necessary supervisory action.
10. Perform the following steps for suspected violations of criminal statutes:
    a. Determine that a Criminal Referral Form, FR 2230, has been filed, if appropriate.
    b. Notify the Reserve Bank by telephone immediately if warranted by the type and seriousness of the suspected violation.
    c. Prepare a separate memorandum to the Reserve Bank containing sufficient detail to be fully informative.
    d. Prepare brief comments for the confidential section of the report of examination citing the date of the memorandum to the Reserve Bank.
    e. Segregate, identify, initial and date all appropriate workpapers and transmit them to the Reserve Bank making certain that the workpapers are factual, complete and do not contain expressions of examiner opinion.
11. Write, in appropriate report form, all comments and conclusions to be included in the confidential section of the examination report.
12. Update the workpapers with any information that will facilitate future examinations.

INTRODUCTION

The board of directors plays an essential role in the management of a bank's operations and is directly responsible for the soundness of the bank. As a result, in some cases, it is useful for Federal Reserve examiners and/or officers to meet with boards of directors. These meetings provide examiners with the opportunity to inform directors of examination findings, discuss the bank's plans and prospects with the board, and highlight important supervisory issues, particularly in cases that may require initiation of informal or formal supervisory actions. Meetings with boards of directors also provide examiners with a limited opportunity to ascertain the directors' knowledge of and interest in the bank's operations.

If Federal Reserve examiners believe it is necessary or desirable, they may conduct meetings with directors immediately after the on-site portion of an examination and before an examination report is completed and distributed. Such meetings are particularly encouraged when they can be conducted as part of regularly scheduled board meetings that coincide with the on-site examination.

When a bank is determined to be a problem or has exhibited significant deterioration, Federal Reserve examiners must conduct meetings with the directors. Such meetings require the participation of Federal Reserve officers and are typically conducted after the report of examination has been distributed.

GENERAL GUIDELINES

Meetings with boards of directors must be tailored to the individual circumstances of each bank, as well as to the Reserve Bank's supervisory objectives. As a result, uniform procedures for the conduct of these meetings cannot be specified. Nonetheless, the following guidelines should be considered when planning and conducting meetings with bank directors.

Content of Meetings

When participating in meetings with bank boards, examiners should present only information needed by, or relevant to, the directorate. This information varies depending on the bank's circumstances; however, examiners should inform the board of the examiner's assessment of the bank's condition; highlight any deficiencies requiring the board's attention; and solicit the board's views on the bank's condition, operations, and prospects. In addition, examiners should obtain the board's commitment to address promptly the deficiencies identified in the examination. Examiners should encourage inquiries and discussions with the directors to learn more about the directors' roles and performance and to foster a good working relationship with them.

Data supporting the examiner's conclusions and comments should be prepared and presented to board members in a professional manner. Slides, handouts, and other visual aids are encouraged. Comparative figures and ratios from previous and present examinations should be reviewed prior to the meeting, with handouts and visual aids highlighting adverse trends.

Outlines for Meetings

Examiners should prepare detailed outlines of each meeting's discussion points and goals. Following is a sample outline that examiners may use as a guide to prepare for meetings with directors. It is not all-inclusive, and examiners should not be limited by its content in developing their own presentations. Generally, comments on these items are warranted when concerns have arisen during the current examination, or when significant changes—positive or negative—have occurred since the last examination.

I. Introductory remarks by Federal Reserve Bank official or examiner
   A. Federal Reserve Bank policy regarding board meeting
   B. Purpose of the meeting

II. Examiner's presentation
   A. Duties and responsibilities of directors
      1. Effectively supervise the bank's affairs
      2. Select competent management
      3. Adopt and follow sound, written policies and objectives

4. Avoid self-serving practices
5. Be informed of the bank's financial condition and management policies
6. Maintain reasonable capitalization
7. Observe banking laws and regulations

B. Adequacy and effectiveness of policies and procedures
1. Lending
2. Investments
3. Asset/liability management
4. Personnel
5. Operations

C. Adequacy and accuracy of bank's reporting systems
1. Reports of the board and committees
2. Management reports to the board
3. Management information systems
4. Regulatory reports

D. Condition of the bank/results of the examination
1. Asset quality
2. Violations of law, evidence of self-dealing
3. Capital
4. Management
5. Liquidity
6. Earnings
7. Internal controls and audit coverage
8. Future prospects
9. Relationships with bank holding company

E. Required corrective action on problems and board commitment

III. Summary of overall conclusions

IV. Questions from the board

Procedural Issues

In general, meetings with the full board are preferable. In certain cases, however, a Reserve Bank may determine that meeting with a board committee, such as the executive or audit committee, will fulfill the Reserve Bank's supervisory objectives. Any person connected with the bank, such as an attorney, auditor, or holding company representative, may attend the board of directors meeting at which the overall findings and conclusions of the examination are discussed. The attendance of any such party should be noted in the minutes of the meeting. However, the examiner may excuse such persons during any portion of his or her presentation if deemed appropriate. Attendance by honorary directors to participate in discussions and review the examination report is also permitted.

Generally, at least one member of a Reserve Bank's official staff is expected to represent the Federal Reserve at meetings with directors of banks. However, for meetings with the directors of banks that have less than $500 million in assets, Reserve Banks are granted the discretion to have senior examination staff represent the Reserve Bank. The participation of Reserve Bank presidents in meetings with directors is left to the discretion of the Reserve Bank.

To the extent possible, meetings with the boards of directors of state member banks should include representatives of the relevant state banking authority. A meeting with the directors of a bank that is owned by a holding company may be held at the same time as a meeting with the directors of the holding company, when appropriate.

Whenever a meeting is held between an examiner and a board, the examiner should prepare written comments on the meeting for examination workpapers.

MEETINGS WITH BOARDS OF PROBLEM BANKS AND BANKS EXHIBITING SIGNIFICANT DETERIORATION

When an examination reveals that a bank has significant problems, Federal Reserve policy requires that a meeting be held with its board of directors. The policy further requires that a written summary of examination findings—separate from the complete examination report—be distributed to each director in such cases. A senior Reserve Bank official also must participate in communicating and presenting examination findings on problem banks to their boards of directors. This policy's objective is to ensure that each director of a state member bank considered to be a problem or to have a significant weakness clearly understands the nature and dimension of the problems, as well as the joint and several responsibility of the directors to effect correction.

Criteria Requiring Meetings with Problem Banks

A meeting with the board of directors is to be held after any full-scope examination in which a state member bank is assigned a CAMELS composite rating of 4 or 5. A meeting is also required if a bank is rated composite 3 and its condition appears to be deteriorating or has shown little improvement since a previous examination in which it received a composite 3 rating. Furthermore, a meeting should be held after a targeted examination if deemed appropriate and desirable by the Reserve Bank. An official of the Reserve Bank and the examiner-in-charge should also meet with a board if any of the following conditions exist:

- The bank is entering into a formal written agreement with the Federal Reserve, a cease-and-desist order is being issued, or the bank is being placed under a memorandum of understanding.
- The bank is already operating under a supervisory action but is in noncompliance with significant provisions or has experienced significant deterioration since the action was initiated.
- Self-serving activities or other unsafe and unsound practices exist in the bank.
- Any other condition or practice that places, or could place, the bank in a seriously weakened or extended condition has been identified during the examination.

Additional Guidelines

Senior Reserve Bank officials are expected to participate in meetings with the directors of problem banks, with the seniority of the participating official determined by the condition and size of the bank. The larger the organization or the more serious its problems, the more senior the Federal Reserve official should be.

A meeting with the board of directors of a problem or deteriorating bank should include a formal, structured presentation with a clear statement that the bank is considered a "problem institution" or is about to become a problem institution if existing conditions deteriorate. The presentation should further make clear the nature of problems confronting the bank, citing examination findings such as the following:

- deficiencies in capital, asset quality, earnings, or liquidity
- violations of law
- inadequacies in policies, practices, and reporting systems necessary for proper risk management and organizational administration
- lack of well-documented lending, collection, investment, asset/liability management, and risk-management policies or the failure to ensure that such policies are being followed
- failure of management to address previously discussed deficiencies
- lack of reporting systems sufficient to keep senior management and the board of directors fully informed
- failure of the board of directors to ensure the active management of the organization

MEETINGS WITH BOARDS OF MULTINATIONAL AND MAJOR REGIONAL BANKS

A meeting with the board of directors is required after every full-scope examination of a multinational organization or major regional organization with assets in excess of $5 billion. Reserve Banks also are encouraged to conduct such meetings after every full-scope examination of a regional bank with assets in excess of $1 billion.

MEETINGS WITH BOARDS OF DE NOVO BANKS

After the approval of a membership application, but before a de novo bank is opened, Reserve Bank staff should meet with the full board of directors to discuss applicable statutes, regulations, policies, and supervisory procedures. As with all meetings with directors, the agenda for this meeting should be tailored to the individual circumstances of the bank. At a minimum, the Reserve Bank should apprise the directors of their responsibilities and emphasize their need to adhere to sound operating policies.

DIRECTOR'S SUMMARY OF EXAMINATION FINDINGS

In addition to the report of examination, Federal Reserve Banks must provide written reports to directors summarizing the examination findings for all banks rated composite 3, 4, or 5, and for those rated composite 1 or 2 that show signs of significant deterioration in condition or apparent violations of law. The summary reports should focus on identified problems—rather than on the strength of the organization—and present the bank's deficiencies succinctly and clearly. In all cases, the types of actions directors and management should take to address identified problems should be specifically stated. Directors of institutions rated 4 or 5 are to be told their banks are ''problem'' institutions that warrant ''special supervisory attention.'' Directors of banks rated 3 are to be informed that the bank's condition is ''not satisfactory,'' that the bank is subject to ''more-than-normal supervision,'' and that the bank may become a ''problem'' if weaknesses are not addressed adequately.

Summary reports should emphasize the responsibilities of the directors to ensure that corrective actions are taken to address all deficiencies noted in the pages of the full bank examination report entitled ''Matters Requiring Board Attention'' and ''Examination Conclusions and Comments.'' In addition, the organization, style, and content of the summary report should be similar, if not identical, to the text of these report pages.

Summary reports should be sent directly to the bank's management for distribution to each director. The transmittal letter to the bank should state the report is a summary of identified problems and contemplated supervisory actions and direct bank management to distribute the summary report to each director. The letter should further instruct each director to read the report, sign the introductory statement attesting to having read the report, and return the report to management. Management should keep copies of the directors' signed statements on file, but should destroy all but one file copy of the summary report itself.

The summary report must be completed and distributed before any meeting between Reserve Bank officials and the bank's board of directors, to provide the directors with prior notice of deficiencies to be discussed. Reserve Banks should also make every effort to distribute the complete examination report to management before meeting with a board of directors.

Meetings with Board of Directors
Examination Objectives
Effective date March 1984

1. To foster a better understanding of the respective roles of directors and examiners.
2. To inform the directors of the examination scope and the bank's condition.
3. To obtain information concerning future plans and proposed changes in bank policies that may have significant impact on the future condition of the bank.
4. To reach an agreement on any significant problems.
5. To obtain a commitment to initiate appropriate corrective action.

1. Inform management that a meeting will be held with the board of directors. State the Federal Reserve Bank's policy and the purpose of the meeting and establish a tentative date.
2. Finalize the time and place of the meeting when confident that a thorough understanding of the condition of the bank will be developed. If the meeting is to be a ''special meeting'' resulting from serious areas of concern, perform procedure 7.
3. Develop an outline of matters to be covered at the meeting by reviewing results of the examination.
4. Prepare supportive data for the meeting by:
   a. Compiling a list of comments and criticisms.
   b. Preparing schedules of comparative figures for discussion.
   c. Affirming that the bank has responded adequately to Reserve Bank requests.
   d. Preparing questions to elicit opinions and attitudes of individual board members.
5. Prepare a brief formal agenda for the meeting and reproduce enough copies to distribute to participants.
6. If it is decided that a meeting will be held:
   a. Communicate with Reserve Bank office to:
      • Notify office staff of the proposed date and place of the meeting. (Confirm time and place when final.)
      • Determine whether a Reserve Bank official will attend.
      • Determine whether the Reserve Bank official has suggestions for the agenda.
   b. Submit a copy of the agenda and outline in advance to the Reserve Bank official.
   c. Inform directors that the following must be submitted to the Reserve Bank office:
      • A copy of a board resolution stating corrective action.
      • A written plan for corrective action to be forwarded within a specified time period.
      • Periodic progress reports.
7. For ''special meetings'' resulting from serious problems:
   a. Communicate with the Reserve Bank to:
      • Notify office staff of the proposed date and place of the meeting.
      • Determine whether a Reserve Bank official will attend.
      • Determine whether the Reserve Bank official has suggestions for the agenda.
   b. Confirm the final time and place of the meeting with the Reserve Bank office.
   c. Prepare any special supporting data for the meeting, such as areas of noncompliance with memorandums of understanding or cease and desist agreements or orders.
8. Conduct the board meeting in accordance with the agenda and previously prepared outline, being certain to discuss:
   a. Major criticisms noted during the examination.
   b. Conclusions reached about the bank in general.
   c. Expected future conditions.
   d. Potential problems.
   e. Planned corrective action:
      • Examiner's recommendations.
      • Management's commitments.
      • Director's commitments.
9. Obtain a definite agreement or commitment from the board that appropriate corrective action will be taken.
10. Prepare a memorandum covering the meeting with the board to include, as a minimum:
    a. The time and place of the meeting.
    b. The directors and guests in attendance.
    c. The matters subject to criticism that were reviewed.
    d. A summary of the general discussion on the matters presented to the board.
    e. A summary of the director's reaction to the situation and any commitments obtained from them.
11. Request that copies of the minutes of the board meeting be forwarded to the Reserve Bank and the examiner-in-charge.

INTRODUCTION

The Federal Reserve Board has a broad range of enforcement powers over both domestic and foreign financial institutions and over the individuals associated with them. Generally, formal or informal enforcement actions are taken after the completion of an on-site bank examination. These examinations include commercial, trust, electronic data processing, consumer, or other types of examinations. Formal or informal enforcement actions may also be taken when a Reserve Bank becomes aware of a problem at a bank that warrants immediate attention and correction.

Many of the Board's enforcement powers were initiated or enhanced by title IX of the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) and by the Comprehensive Thrift and Bank Fraud Act (Bank Fraud Act).[1] The Board's jurisdiction over individuals associated with financial institutions, that is, ''institution-affiliated parties,'' includes any officer, director, employee, controlling shareholder, or agent of a financial institution, and any other person who has filed or is required to file a change-in-control notice. The term ''institution-affiliated party'' also includes any shareholder, consultant, joint venture partner, or any other person who participates in the conduct of the affairs of the financial institution, as well as any independent contractors, including attorneys, appraisers, and accountants, who knowingly or recklessly participate in any violation of law or regulation, breach of fiduciary duty, or unsafe or unsound practice that causes (or is likely to cause) more than a minimal financial loss to, or a significant adverse effect on, a financial institution.[2] The Board's jurisdiction over an institution-affiliated party extends for up to six years after the party's resignation, termination of employment, or separation caused by the closing of a financial institution, provided that any notice (such as a notice of intent to remove from office and of prohibition) is served on the party before the end of a six-year period.

1. The Financial Institutions Reform, Recovery, and Enforcement Act was enacted on August 9, 1989; the Comprehensive Thrift and Bank Fraud Act was enacted on November 27, 1990.

2. The Board is authorized to issue regulations further defining which individuals should be considered institution-affiliated parties. Similarly, the Board may determine whether an individual is an institution-affiliated party on a case-by-case basis. (See 12 USC 1813(u).)

FORMAL SUPERVISORY ACTIONS

The following statutory tools are available to the Board in the event formal supervisory action is warranted against a state member bank or any institution-affiliated party. The objective of formal action is to correct practices that the regulators believe to be unlawful, unsafe, or unsound.[3] The initial consideration and determination of whether formal action is required usually results from examination findings. It is important to provide adequate workpaper documentation to support all recommendations for both formal and informal actions.

Types of Corrective Actions

Generally, under 12 USC 1818, the Board may use its cease-and-desist authority and civil money penalty authority against any state member bank and any institution-affiliated party that meets the statutory criteria for issuing such an order. Prohibition and removal actions may be taken against any institution-affiliated party who meets the statutory criteria to bring such an action.

Cease-and-Desist Orders

Generally, under 12 USC 1818(b), the Board may use its cease-and-desist authority against a state member bank and any institution-affiliated party when it finds that a bank or party is engaging, has engaged, or is about to engage in (1) a violation of law, rule, or regulation; (2) a violation of a condition imposed in writing by the Board in connection with the granting of any application or any written agreement; or (3) an unsafe or unsound practice in conducting the business of the institution. Under 12 USC

3. An unsafe or unsound practice is defined as any action that is contrary to generally accepted standards of prudent operation, the possible consequences of which, if continued, would be abnormal risk or loss or damage to an institution, its shareholders, or the agencies administering the insurance fund.

1818(s), the Board must initiate a cease-and-desist action against a bank when it has failed to establish Bank Secrecy Act procedures required by the Board's Regulation H or has failed to correct any previously noted deficiencies related to these procedures.

A cease-and-desist order may require the bank or person subject to the order to (1) cease and desist from the practices or violations or (2) take affirmative action to correct the violations or practices. Affirmative actions might include returning the bank to its ''original condition'' before the practice or violation. Affirmative actions may also include restrictions on growth, debt, and dividends; the disposition of any loan or asset; rescission of agreements or contracts; employment of qualified officers or employees; restitution, reimbursement, indemnification, or guarantee against loss if the bank or person was unjustly enriched by the violation or practice, or if the violation or practice involved a reckless disregard for the law or applicable regulations or a prior order; and any other action the Board determines to be appropriate.

When Board staff, in conjunction with the appropriate Reserve Bank, determine that a cease-and-desist action is necessary, the bank or person is generally given an opportunity to consent to the issuance of a cease-and-desist order without the need for the issuance of a notice of charges and a contested administrative hearing. Generally, Board staff draft a proposed cease-and-desist order and, with Reserve Bank staff, present it to the bank or individual for consent before submitting the case to the Board. Banks or individuals are advised that they may have legal counsel present at all meetings with Board or Reserve Bank staff concerning formal corrective actions. If the parties voluntarily agree to settle the case by the issuance of a consent cease-and-desist order, the proposed consent order will be presented to Board officials for ratification and formal issuance of the order, at which time the order will be final and binding.

When a bank or person fails to consent to a cease-and-desist order, the Board may issue a notice of charges and of hearing to the bank or party. The notice of charges contains a detailed statement describing the facts constituting the alleged violations or unsafe or unsound practices. The issuance of the notice of charges and of hearing starts a formal process that includes the convening of a public administrative hearing[4] conducted before an administrative law judge, appointed by the Board. After the hearing, the judge makes a recommended decision to the Board. A hearing must be held within 30 to 60 days of service of the notice of charges, unless a later date is set by the administrative law judge. After the Board considers the record of the proceeding, including the administrative law judge's recommended decision, it determines whether to issue a final cease-and-desist order. Banks and individuals who are subject to cease-and-desist orders that were issued as a result of contested proceedings may appeal the order to the appropriate federal court of appeals.

Temporary Cease-and-Desist Orders

If a violation or threatened violation of law, rule, or regulation, or if engagement in an unsafe or unsound practice specified in the notice of charges, is likely to cause the bank's insolvency, cause significant dissipation of the bank's assets or earnings, weaken the bank's condition, or otherwise prejudice the interests of depositors before the completion of the proceedings (initiated by the issuance of the notice of charges), the Board may, in conjunction with issuing a notice of charges, issue a temporary cease-and-desist order against the bank or any institution-affiliated party to effect immediate correction (pursuant to 12 USC 1818(c)). The Board may also issue a temporary order if it determines that the bank's books and records are so incomplete or inaccurate that the Board is unable to determine, through the normal supervisory process, the bank's financial condition or the details or purpose of any transaction that may have a material effect on its condition. The temporary order may require the same corrections as a formal cease-and-desist order. The advantage of issuing a temporary cease-and-desist order is that it becomes effective immediately after it is served on the entity or individual. Within 10 days after being served with a temporary order, however, the entity or individual may appeal to a U.S. district court for relief from the order. Unless set aside by the district court, the temporary order stays in effect until the Board issues a final cease-and-desist order or dismisses the action.

4. A private hearing may be held if the Board determines that holding a public hearing would be contrary to the public interest.

Written Agreements

When circumstances warrant a less severe form of formal supervisory action, a written agreement may be used. A written agreement may be with either the Board or with the Reserve Bank under delegated authority (12 CFR 265.11(a)(15)). All written agreements must be approved by the Board's director of the Division of Banking Supervision and Regulation and the general counsel. The provisions of a written agreement may relate to any of the problems found at the bank or to any problems involving institution-affiliated parties.

Prohibition and Removal Authority

The Board is authorized by 12 USC 1818(e) to remove any current institution-affiliated party of a bank for certain violations and misconduct and to prohibit permanently from the banking industry any current or former institution-affiliated party from future involvement with any insured depository institution, bank or thrift holding company, and nonbank subsidiary.[5]

The Board is authorized to initiate removal or prohibition actions when—

- the institution-affiliated party has directly or indirectly—
  - — violated any law, regulation, cease-and-desist order, condition imposed in writing, or written agreement;
  - — engaged in any unsafe or unsound practice; or
  - — breached a fiduciary duty;
- the Board determines that, because of the violation, unsafe or unsound practice, or breach—
  - — the institution has suffered or will probably suffer financial loss or other damage;
  - — the interests of depositors have been or could be prejudiced by the violation, practice, or breach; or
  - — the institution-affiliated party has received financial gain or other benefit from the violation, practice, or breach; and
- the violation, practice, or breach—
  - — involves personal dishonesty or
  - — demonstrates a willful or continuing disregard for the safety or soundness of the institution.

The statute also authorizes the Board to initiate removal or prohibition actions against (1) any institution-affiliated party who has committed a violation of any provision of the Bank Secrecy Act that was not inadvertent or unintentional, (2) any officer or director of a bank who has knowledge that an institution-affiliated party has violated the money-laundering statutes and did not take appropriate action to stop or prevent the reoccurrence of such a violation, or (3) any officer or director of a bank who violates the prohibitions on management interlocks. These removal or prohibition actions do not require a finding of gain to the individual, loss to the institution, personal dishonesty, or willful or continuing disregard for the safety or soundness of the institution.[6] Like a cease-and-desist order, a removal or prohibition order may be issued either by consent or after an administrative process initiated by the issuance of a notice of intent to remove and prohibit.

If an institution-affiliated party's actions warrant immediate removal from a state member bank, the Board is authorized to suspend the person temporarily from that bank pending the outcome of the complete administrative process. An institution-affiliated party presently associated with a bank may also be suspended or removed for cause based on actions taken while formerly associated with a different insured depository institution, bank holding company, or "business institution." Business institution is not specifically defined in the statute so that it may be interpreted to include any other business interests of the institution-affiliated party.

Under 12 USC 1818(g), the Board is authorized to suspend from office or prohibit from further participation any institution-affiliated party charged or indicted for the commission of a crime involving personal dishonesty or breach of trust that is punishable by imprisonment for a term exceeding one year under state or federal law, if the continued participation might threaten either the interests of depositors or public confidence in the bank. The Board may also suspend or prohibit any individual charged with a violation of the money-laundering statutes. The suspension can remain in effect until the criminal action is disposed of or until the suspension

5. This authority is distinct from the Board's authority under prompt corrective action to dismiss senior officers from a particular bank.

6. See 12 USC 1818(e)(2).

is terminated by the Board. The Board may also initiate a removal or prohibition action against an institution-affiliated party who has been convicted of, or pleaded to, a crime involving personal dishonesty or breach of trust if his or her continued service would threaten the interests of the depositor or impair public confidence in the institution. The Board is required to issue such an order against any institution-affiliated party who has been convicted of, or pleaded to, a violation of the money-laundering statutes.

Furthermore, 12 USC 1829 prohibits any individual who has been convicted of a crime involving dishonesty, breach of trust, or money laundering from (1) serving as an institution-affiliated party of, (2) directly or indirectly participating in the affairs of, and (3) owning or controlling, directly or indirectly, an insured depository institution without the FDIC's prior approval. Under certain circumstances, the statute also prohibits a convicted person from holding a position at a bank holding company or nonbank affiliate of a bank without the FDIC's prior approval. The penalty for violation of this law is a potential fine for a knowing violation of up to $1 million per day, imprisonment for up to five years, or both. The criminal penalty applies to both the individual and the employing institution.

Violations of Final Orders and Written Agreements

When any final order or temporary cease-and-desist order has been violated, the Board may apply to a U.S. district court for enforcement of the action. The court may order and require compliance.

Violations of final orders and written agreements may also give rise to the assessment of civil money penalties against the offending bank or institution-affiliated party, as circumstances warrant. The civil money penalty is assessed in the same manner as described in the "Civil Money Penalties" subsection below. Any institution-affiliated party who violates a suspension or removal order is subject to a criminal fine of up to $1 million, imprisonment for up to five years, or both.

Civil Money Penalties

The Board may assess civil money penalties of up to $5,000 per day against any institution or institution-affiliated party for any violation of (1) law or regulation; (2) a final cease-and-desist, temporary cease-and-desist, suspension, removal, or prohibition order or for failure to comply with a prompt-corrective-action-directive;[7] (3) a condition imposed in writing by the Board in connection with the granting of an application or other request; and (4) a written agreement.

A fine of up to $25,000 per day can be assessed for a violation, an unsafe or unsound practice recklessly engaged in, or a breach of fiduciary duty when the violation, practice, or breach is part of a pattern of misconduct, causes or is likely to cause more than a minimal loss to the bank, or results in pecuniary gain or other benefit for the offender. A civil money penalty of up to $1 million per day can be assessed for any knowing violation, unsafe or unsound practice, or breach of any fiduciary duty when the offender knowingly or recklessly caused a substantial loss to the financial institution or received a substantial pecuniary gain or other benefit. Civil money penalties may also be assessed, under the three-tier penalty framework described above, for any violation of the Change in Bank Control Act and for violations of the anti-tying provisions of federal banking law, among other provisions.[8]

The Board may also assess civil money penalties for the submission of any late, false, or misleading call reports. If a financial institution maintains procedures that are reasonably adapted to avoid inadvertent errors, but unintentionally fails to publish any report, submits any false or misleading report or information, or is minimally late with the report, it can be assessed a fine of up to $2,000 per day. The financial institution has the burden of proving that the error was inadvertent under these circumstances. If the error was not inadvertent or the bank lacked the appropriate procedures, a penalty of up to $20,000 per day can be assessed for all false or misleading reports or information submitted to the Board. If the submission was

7. Prompt-corrective-action directives may be enforced in the federal courts, and they may cause any bank, company, or bank-affiliated party that violates the directive to be subject to civil money penalties. The failure of a bank to implement a capital-restoration plan, or the failure of a company having control of a state member bank to fulfill a guarantee that the company has given in connection with a capital plan accepted by the Federal Reserve, could subject the bank or company or any of their bank-affiliated parties to a civil money penalty assessment. (See section 4133.1.)

8. See 12 USC 1972.

done in a knowing manner or with reckless disregard for the law, a fine of up to $1 million or 1 percent of the institution's assets, whichever is less, can be assessed for each day of the violation. Under its general civil money penalty authority, the Board may also assess civil money penalties against any institution-affiliated party who participates in a bank's filing of late, false, or misleading call reports.

Administration of Formal Actions

Publication of Final Orders

Under 12 USC 1818(u), the Board is required to publish and make publicly available any final order issued for any administrative enforcement proceeding it initiates. These orders include cease-and-desist, removal, prohibition, and civil money penalties. The Board is also required to publish and make publicly available any written agreement or other written statement that it may enforce, unless the Board determines that publication would be contrary to the public interest.

Public Hearings

Under 12 USC 1818(u), all formal hearings, including contested cease-and-desist, removal, and civil money penalty proceedings, are open to the public unless the Board determines that a public hearing would be contrary to the public interest. Transcripts of all testimony; copies of all documents submitted as evidence in the hearing, which could include examination or inspection reports and supporting documents (except those filed under seal); and all other documents, such as the notice and the administrative law judge's recommended decision, are available to the public.

Appointment of Directors and Senior Executive Officers

Under section 32 of the Federal Deposit Insurance Act (12 USC 1831i) and subpart H of Regulation Y (12 CFR 225.71 et seq.), any state member bank or bank holding company that is in a troubled condition[9] or does not meet minimum capital standards must provide 30 days' written notice to the Board of Governors before appointing any new director or senior executive officer.[10] This requirement also applies to any change in the responsibilities of any current senior executive officer who is proposing to assume a different senior officer position. Subpart H of Regulation Y details the procedures for filing and the content of the notice. The Board may disapprove a notice if it finds that the competence, experience, character, or integrity of the proposed individual indicates that his or her service would not be in the best interest of the institution's depositors or the public. A disapproved individual or the institution that filed the notice may appeal the Federal Reserve's notice of disapproval under the procedures detailed in Regulation Y. The individual may not serve as a director or senior executive officer while the appeal is pending. In the event that a state member bank or bank holding company that is in a troubled condition appoints a director or senior officer without the required 30 days' prior written notice, appropriate follow-up supervisory action should be taken.

Interagency Notification

Under interagency agreements, any federal banking regulatory agency that proposes to take a formal enforcement action (such as a cease-and-desist order, civil money penalty, or removal) must notify the other federal financial institution regulatory agencies (including the OTS) of the action. For informal enforcement actions, such as memoranda of understanding, notifications must be made when there is an affiliation or interinstitution relationship. Notifications are to be made to a designated contact person specified by each agency. To foster federal–state agency coordination, the Federal Reserve provides the appropriate state supervisory authority with

9. As defined in section 225.71 of the Board's Regulation Y, a state menber bank or holding company is in troubled condition if it (1) has a composite rating, determined at its most recent examination, of 4 or 5; (2) is subject to a cease-and-desist order or formal written agreement that requires action to improve the bank's financial condition; or (3) is expressly informed by the Board or Reserve Bank that it is in troubled condition.

10. The Board or Reserve Bank may permit, under extraordinary circumstances, an individual to serve as a director or senior executive officer before a notice is provided; however, this permission does not affect the Federal Reserve's authority to disapprove a notice within 30 days of its filing. The Board may extend the review period to a maximum of 90 days if needed to process the notice.

notice of its intent to institute a formal corrective action against a bank or its institution-affiliated parties, pursuant to 12 USC 1818(m).[11]

INFORMAL SUPERVISORY ACTIONS

Informal supervisory tools are used when circumstances warrant a less severe form of action than the formal supervisory actions described above. Informal actions are not enforceable, and their violation cannot serve as a basis for assessing a civil money penalty or initiating a removal and prohibition action. Informal actions are not published or publicly available. These informal actions include the following:

- *Commitments* are generally used to correct minor problems or to request periodic reports addressing certain aspects of a bank's operations. Commitments may be used when there are no significant violations of law or unsafe or unsound practices and when the bank and its officers and directors are expected to cooperate and comply.[12] Commitments are generally obtained by the Reserve Bank's sending a letter to the bank outlining the request and asking for a response and an indication that the commitments are accepted.

- *Board resolutions* generally represent a number of commitments made by the bank's directors and are incorporated into the bank's corporate minutes. The Reserve Bank may request board resolutions in the examination transmittal letter, which asks the bank to provide it with a signed copy of the corporate resolution.

- *Memoranda of understanding (MOU)* are highly structured written, but informal, agreements that are signed by both the Reserve Bank and the bank's board of directors. An MOU is generally used when a bank has multiple deficiencies that the Reserve Bank believes can be corrected by the present management. Although an informal action, imposition of an MOU may require disclosure to the Securities and Exchange Commission and to the bank's liability bond issuer.

INDEMNIFICATION PAYMENTS AND GOLDEN PARACHUTE PAYMENTS

In general, an indemnification payment is a payment that reimburses an insider for a specified liability or cost that the person incurred (for example, a bank might indemnify a director for the cost of legal fees or even, theoretically, penalties in connection with a Federal Reserve investigation or enforcement action). Golden parachute payments are severance payments or agreements to make severance payments that are paid or entered into at a time when the bank or holding company is in a troubled condition. These payments require the prior written approval of the institution's primary regulator and the FDIC. A golden parachute payment may include a glorified severance payment to a former insider that is paid under specified circumstances. Although both types of payments fall under the same statute, section 18(k) of the Federal Deposit Insurance Act (the FDI Act) (12 USC 1828(k)), the two types of payments are quite different and distinct. However, some of the restrictions on these payments are the same or similar.

Indemnification Agreements and Payments

State member banks may seek to indemnify their officers, directors, and employees from any judgments, fines, claims, or settlements, whether civil, criminal, or administrative. The bylaws of some state member banks may have broadly worded indemnification provisions, or the bank may have entered into separate indemnification agreements that cover the ongoing activities of its own institution-affiliated parties. Such indemnification provisions may be inconsistent with federal banking law and regulations, as well as with safe and sound banking practices.

Supervisory and examiner staff should be alert to the limitations and prohibitions on indemnification imposed by section 18(k) of the

11. The procedures for notification to state agencies and other federal banking regulatory agencies are outlined in SR-97-5, "Policy Statement on Interagency Notification and Coordination of Enforcement Action."

12. Informal commitments are distinct from conditions imposed in writing in connection with the grant of an application or other request by an institution, which may be enforced through the imposition of a civil money penalty.

FDI Act[13] and the regulations issued thereunder by the FDIC. The law and regulations apply to indemnification agreements and payments made by any bank to any institution-affiliated party, regardless of the condition of the financial institution. The purpose of the law and regulations is to preserve the deterrent effects of administrative enforcement actions (by ensuring that individuals subject to final enforcement actions bear the costs of any judgments, fines, and associated legal expenses) and to safeguard the assets of financial institutions.

A prohibited indemnification payment includes any payment (or agreement to make a payment) by a bank to an institution-affiliated party to pay or reimburse such person for any liability or legal expense in any federal banking agency administrative proceeding that results in a final order or settlement in which the institution-affiliated party is assessed a civil money penalty, is removed or prohibited from banking, or is required to cease an action or take any affirmative action, including making restitution, with respect to the bank.[14] In cases in which the institution-afilliated party prevails, the institution can make a payment if the board of directors determines that it is in the best interest of the institution and the payment does not materially adversely affect the institution's safety and soundness.

The law and the FDIC's regulations apply to all state member banks. They reinforce the Federal Reserve's longstanding policy that an institution-affiliated party who engages in misconduct *should not* be insulated from the consequences of his or her misconduct. From a safety-and-soundness perspective, a state member bank should not divert its assets to pay a fine or other final judgment issued against an institution-affiliated party for misconduct that presumably violates the bank's policy of compliance with applicable law, especially in cases where the individual's misconduct has already harmed the bank.

State member banks should review their bylaws and any outstanding indemnification agreements, as well as insurance policies, to ensure that they conform with the requirements of federal law and regulations. If a state member bank fails to take appropriate action to bring its indemnification provisions into compliance with federal laws and regulations, appropriate follow-up supervisory action may be taken. As part of the supervisory process, which will include merger and acquistion applications, the Federal Reserve's supervisory and examiner staff will review identified agreements having indemnification-related issues for compliance with federal law and regulations. (See SR-02-17.)

13. See 12 USC 1828(k).
14. See 12 CFR 359.

Golden Parachute Payments

"Golden parachute" payment restrictions were enacted as part of the Crime Control Act of 1990.[15] The law added section 18(k) to the Federal Deposit Insurance Act (12 USC 1828(k)) and authorized the FDIC to issue implementing regulations. The FDIC's golden parachute regulations may apply to an insured depository institution if the institution is in a troubled condition as defined in Regulation Y. The purposes of the law and regulations include safeguarding the assets of financial institutions and limiting rewards to institution-affiliated parties who may have contributed to the institution's condition.

In general, the FDIC's regulations prohibit insured depository institutions and their holding companies from making golden parachute payments except in certain circumstances.[16] A golden parachute payment means any payment in the nature of compensation (or agreement to make such a payment) for the benefit of any current or former institution-affiliated party of an insured depository institution or its holding company that meets three criteria. First, the payment or agreement must be contingent on the termination of the institution-affiliated party's employment or association. Second, the payment or agreement is received on or after, or made in contemplation of, among other things, a determination that the institution or holding company is in a troubled condition under the regulations of the applicable banking agency. Third, the payment or agreement must be payable to an institution-affiliated party who is terminated when the institution or holding company meets certain specific conditions, including being subject to a determination that it is in a troubled condition.

15. SR-90-38 generally describes the provisions of the Crime Control Act of 1990.
16. See the FDIC's golden parachute regulations in 12 CFR 359.

The definition of a golden parachute payment also covers a payment made by a bank holding company that is not in a troubled condition to an institution-affiliated party of an insured depository institution subsidiary that is in a troubled condition, if the other criteria in the definition are met. This circumstance may arise when a bank holding company, as part of an agreement to acquire a troubled bank or savings association, proposes to make payments to the troubled institution's institution-affiliated parties that are conditioned on their termination of employment.[17]

A state member bank or bank holding company may make or enter into an agreement to make a golden parachute payment only (1) if the Federal Reserve, with the written concurrence of the FDIC, determines that the payment or agreement is permissible; (2) as part of an agreement to hire competent management in certain conditions, with the consent of the Federal Reserve and the FDIC as to the amount and terms of the proposed payment; or (3) pursuant to an agreement to provide a reasonable severance not to exceed 12 months' salary in the event of an unassisted change in control of the depository institution, with the consent of the Federal Reserve. In determining the permissibility of the payment, the Federal Reserve may consider a variety of factors, including the individual's degree of managerial responsibilities and length of service, the reasonableness of the payment, and any other factors or circumstances that would indicate that the proposed payment would be contrary to the purposes of the statute or regulations.

A state member bank or bank holding company requesting approval to make a golden parachute payment or enter into an agreement to make such a payment should submit its request simultaneously to the appropriate FDIC regional office and Federal Reserve Bank. The request must detail the proposed payments and demonstrate that the state member bank or bank holding company does not possess and is not aware of any evidence that there is reasonable basis to believe, at the time that the payment is proposed to be made, that the institution-affiliated party receiving such a payment has committed any fraud, breach of fiduciary duty, or insider abuse or has materially violated any applicable banking law or regulation that had or is likely to have a material adverse effect on the bank or company; that the individual is substantially responsible for the institution's insolvency or troubled condition; and that the individual has violated specified banking or criminal laws.

If a state member bank or bank holding company makes or enters into an agreement to make a golden parachute payment without prior regulatory approval when such an approval is required, appropriate follow-up supervisory action should be taken. This follow-up could include an enforcement action requiring the offending institution-affiliated party to reimburse the institution for the amount of the prohibited payment. When state member banks or bank holding companies are identified as having golden parachute–related issues in the supervisory process, those issues should be carefully reviewed for compliance with the law and the FDIC's regulations. The appropriate Reserve Bank supervisory staff and the appropriate staff of the Board's Division of Banking Supervision and Regulation should be notified and consulted on the golden parachute–related issues. (See SR-03-06.)

17. The FDIC's regulations exclude from the definition of a golden parachute payment several types of payments, such as payments made pursuant to a qualified pension or retirement plan; a benefit plan or bona fide deferred compensation plan (which are further defined in the FDIC's regulations); or a severance plan that provides benefits to all eligible employees, does not exceed the base compensation paid over the preceding 12 months, and otherwise meets the regulatory definition of nondiscriminatory and other conditions in the FDIC's regulations.

INTRODUCTION

The Uniform Commercial Bank Report of Examination was approved by the Federal Financial Institutions Examination Council and mandated for use by the Federal Reserve System, Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency in their examinations of commercial banks. The report is also available for use by state banking departments in their examinations of state-chartered institutions.

Certain report pages are mandatory for all full-scope bank examination reports prepared by Federal Reserve examiners. Some of these pages are required as the result of the four federal banking and thrift regulatory agencies' approval of a uniform interagency report of examination. These pages address the examiner's conclusions and provide information on capital, asset quality, management, earnings, liquidity, and sensitivity to market risk (CAMELS). Headings on specific report pages for the examiner's assessment of specific CAMELS components provide a series of considerations for the examiner to address in the evaluation of each component. The Federal Reserve has supplemented the interagency report by mandating the use of additional report pages and by designating a third group of pages as optional for Federal Reserve purposes. This section will provide the examiner with guidance on both when to include certain report pages in the report and how to prepare required and optional report pages. Instructions for optional pages describe situations that warrant their inclusion in full-scope Federal Reserve reports.

FEDERAL RESERVE SYSTEM REPORT INSTRUCTIONS

The following instructions provide general guidance to the examiner in evaluating certain aspects of a bank's operations and in completing the report; they are not intended to constitute a technical manual on conducting examinations and completing reports, nor are they designed to set forth all of the factors, considerations, and issues that examiners must address and evaluate when they conduct examinations. In addition, these instructions are not intended to address legal and compliance questions; rather, examiners should consult appropriate laws, regulations, and examiner guidelines. Questions on completing the report that are not covered by these instructions should be referred to Reserve Bank management or Board staff.

Instructions for specific pages follow in the order recommended for their inclusion in full-scope examination reports. The header at the top of each section of instructions indicates whether the report page is mandatory or optional.

The interagency instructions and report-page formats do not provide for the use of peer-group data for analytical purposes. The Federal Reserve System advocates the use of peer-group data for financial analysis. Examiners should routinely consider using peer information in report narratives or in charts and tables within narratives to support their conclusions. Comparisons to subsets of the national peer group may also be meaningful. If the examiner uses other than national UBPR peer information for comparison purposes, the substitute peer group should be clearly identified.

General Instructions for Financial Information

The following terms are used on many report pages containing financial information. Guidance on the requirements and options available for each term is provided here.

Examination Date (or Exam Date). The date of the financial data used for the examination activity or the ending date of the period reviewed. If the date of the asset-quality review is different from the exam date, any required use of "exam date" in connection with asset quality should refer to the date of the asset-quality review.

Period Ended. No specific timeframe is designated. These columns reflect information for a time period deemed most appropriate by the examiner to support conclusions presented in the Report of Examination. For comparative purposes, this column may reflect financial data from the same period of the prior year as the examination date, the prior quarter, or the most recent year-end.

The examiner-in-charge is responsible for selecting dates deemed most appropriate to present the examination findings. All amounts should be consistent with instructions for the Consolidated Report of Condition and Income (call report). If call report amendments have been made, the amended numbers should appear. If a bank's management has made any significant misclassifications that have caused examiners to amend any financial statements, the examiners' numbers should be shown in the report and used to calculate any ratios used in the report. Columns titled ''Period Ended'' should usually detail previous year-end information. However, the examiner may substitute different dates, such as those of the previous examination, when desired. Ratios should generally be computed according to the instructions in the User's Guide to the Uniform Bank Performance Report. Care should be taken in computing all ratios to ensure that ratios are accurate and consistent throughout the report.

Federal Reserve Examination Report Page List

The following table lists the Federal Reserve's report pages in the order in which they would usually appear, along with a notation of whether their inclusion in the report is mandatory or optional.

Mandatory/ Optional	*Report Page Title*
	OPEN SECTION
Mandatory	Table of Contents
Mandatory	Scope
Mandatory	Matters Requiring Board Attention
Mandatory	Examination Conclusions and Comments
Optional*	Compliance with Enforcement Actions
Mandatory	Comparative Statements of Financial Condition
Mandatory	Capital Adequacy
Mandatory	Capital Calculations
Mandatory	Asset Quality
Mandatory	Summary of Items Subject to Adverse Classification/Summary of Items Listed as Special Mention
Mandatory	Loans and Lease-Financing Receivables/Past-Due and Nonaccrual Loans and Leases
Mandatory	Management/Administration
Mandatory	Violations of Laws and Regulations
Mandatory	Earnings
Mandatory	Analysis of Earnings
Mandatory	Liquidity/Asset Liability Management
Mandatory	Sensitivity to Market Risk
Optional	Other Matters
Optional	Concentrations
Optional*	Items Subject to Adverse Classification
Optional*	Items Listed for Special Mention
Optional	Assets with Credit-Data or Collateral-Documentation Exceptions
Mandatory	Signature of Directors
	CONFIDENTIAL SECTION
Mandatory	Directors
Mandatory	Executive Officers
Mandatory	Management and Control
Mandatory	Ratings and General Information

* Some optional pages are mandatory if the circumstances relevant to the page apply. For example, "Compliance with Enforcement Actions" is mandatory if the bank is subject to corrective action. Optional pages to list classified and special-mention assets are mandatory if items are classified or special mentioned.

These pages may be augmented with supplemental information as needed or required by the Federal Reserve System. Additional supporting schedules and visual aids (for example, graphs and charts) may also be included in the report to communicate and support the examiner's findings.

Sample Report Pages

This section includes samples of most of the report pages. Because each Reserve Bank may use different methods for preparing the report, differences in typographic styles may exist between the pages presented here and those at any particular Reserve Bank.

Several report pages are blank except for the title, allowing the examiner almost total discretion in choosing how to present the information. Samples of these report pages are not included although instructions for their use are. Report pages for which samples are not included are identified below:

- Scope
- Matters Requiring Board Attention

- Compliance with Enforcement Actions
- Violations of Laws and Regulations
- Other Matters
- Concentrations

Combined Reports

Reserve Banks may issue a combined report for a bank holding company and its lead state member bank subsidiary when (1) a bank holding company's lead bank subsidiary is a state member bank and (2) the holding company's board formally approves the release of a combined report to its lead state member bank subsidiary. In cases where the company has more than one state member bank, separate examination reports should be prepared for all other state member bank subsidiaries. At a minimum, a combined report will contain all examination report pages required by SR-93-71, ''Final Interagency Examination Report Instructions,'' as well as information on the parent company, its subsidiaries, and the consolidated organization.

The Reserve Bank should send a letter to a qualified holding company that explains its option of receiving a combined report. If the holding company's board wishes to receive a combined report, it should formally approve the release of the combined report to its lead state member bank subsidiary by board resolution.

REPORT PAGE INSTRUCTIONS

Table of Contents (Mandatory)

The table of contents indicates the pages included in full-scope reports. All mandatory pages are to be included in each full-scope Federal Reserve bank examination report. Optional pages will be added to the report as necessary in the order outlined herein, followed by the mandatory Signature of Directors page. Additional supplemental pages to support examiner findings may also be added to the report at the examiner's discretion.

Page numbers are included only for the sake of completeness. The actual page-numbering system used may vary among Reserve Banks.

Scope (Mandatory)

The Scope page is used to list areas reviewed during the examination and describes the extent of those reviews. The examiner should generally address the following:

- the date of examination (commencement and conclusion)
- the type of examination (full-scope, targeted, joint, concurrent, combined (bank holding company and bank))
- the agency or agencies conducting the examination
- areas reviewed and analyzed (If the examination is targeted, the examiner should identify specific areas reviewed.)
- the percentage and type of loans reviewed
- a confirmation that examination results were discussed with the organization and a list of those attending the meeting
- identification of the bank's peer group
- if necessary, recognition that the bank is operating under a formal or informal supervisory action (If so, state that the provisions of the action were reviewed and compliance was assessed.)

Matters Requiring Board Attention (Mandatory)

The Matters Requiring Board Attention page is used to inform the bank's board of directors of the most significant issues identified during the examination. It should summarize the most important examination/inspection findings. The Matters Requiring Board Attention page is intended to complement the complete Report of Examination findings prepared for use by bank management and directors. This page is to focus on identified problems, rather than on strengths of the organization, and present them succinctly and unmistakably clearly. In all cases, the types of actions to be taken by the directors and management to address these problems should be specifically noted. Institutions rated 4 or 5 are to be told they are problem institutions that warrant special supervisory attention. Institutions rated 3 are to be informed that their condition is not satisfactory, that they are subject to more-than-normal supervision, and that they may become problems if their weaknesses are not addressed adequately.

This page should also discuss significant weaknesses in 1- or 2-rated institutions. In institutions where no specific matters are identified as requiring board attention, this page should provide a brief summary of the institution's condition. In all cases, this page should contain a concluding statement reminding the directorate of its responsibility to review the entire Report of Examination and instructing each director to sign the Signature of Directors page.

Examination Conclusions and Comments (Mandatory)

The report page should list the composite rating for the current examination and for the two previous examinations at the top of the page. In addition to the composite ratings, the numeric ratings of the six components will be disclosed for examinations beginning after January 1, 1997. This listing should be followed by the uniform definition of the assigned composite rating. The uniform definitions of the component ratings assigned need not be included in reports; however, they should be made available to bank management and directors upon request.

This report page should summarize examination findings, particularly those of significance. The examiner should also provide an overview of the bank's financial condition. The examiner's major recommendations and management's plans for corrective actions should also be covered on this page in appropriate detail, with references to additional supporting information elsewhere in the report. The examiner's comments should also elaborate on the matters requiring board attention listed on the preceding page. All comments should be presented in order of importance. The comments should be primarily on an exception basis, describing areas of the bank's operations and aspects of its financial condition that display weaknesses, deficiencies, or vulnerability. This does not preclude the examiner from recognizing positive actions taken by management; however, laudatory or conclusive remarks and endorsements of specific management actions should be avoided.

Significant recommendations presented elsewhere in the report should be mentioned on this page. Significant violations should also be discussed briefly on this page and in greater detail on the Violations of Laws and Regulations page; less serious violations should be noted and reference made to the violations page. Compliance with any enforcement actions should be briefly discussed on this page (per SR-82-8) and state that details are provided on the Compliance with Enforcement Actions page.

The Examination Conclusions and Comments page and the Matters Requiring Board Attention page should not be duplicative and should be easily integrated if the issuance of a Director's Summary of Examination Findings proves necessary.

Compliance with Enforcement Actions (Optional)

The Compliance with Enforcement Actions page will be used if the bank is under any type of supervisory action or has ratified board resolutions at the request of the Federal Reserve or state banking authority. In all cases, the type and date of the action or resolutions and parties to the action should be listed. In addition, the examiner should generally list each provision requiring action and provide a comment addressing compliance with that provision. Specifically, the examiner should comment on how the bank accomplished compliance or the reason why the bank is not in compliance with a particular provision. These comments should be made at the examination when supervisory actions are initiated and at all subsequent examinations until the action is removed.

Comparative Statements of Financial Condition (Mandatory)

The left column titled ''Exam Date'' should coincide with the Consolidated Report of Condition for the period used—generally, the most recent quarter-end. If call report amendments have been made, the amended numbers should appear on this page. If a bank's management has made any significant misclassifications that have caused examiners to amend any financial statements, the examiner's numbers should appear on this page. The right column titled ''Period Ended'' should usually detail previous year-end information. However, the examiner may substitute a different date, such as a previous examination, when desired. All amounts listed in either column should conform to Consolidated Report of Condition instructions. This page also should reflect FASB 115 ''Accounting for Certain Investments in Debt and Equity Securities'' adjustments to capital. These adjustments are made according to Consolidated Report of Condition and Income instructions and are reflected on the line item ''common equity capital.''

Capital Adequacy (Mandatory)

Capital is assessed at each full-scope examination. Consideration is specifically given to risk identified within the bank, equity maintenance, and any growth the bank might be experiencing.

The bank's capital ratios should be presented as indicated on the report page. FASB 115 adjustments are not to be reflected in capital ratios. However, the effect of FASB 115 on stockholders' equity, if material, should be discussed in the narrative. In cases when the condition of the bank has changed significantly since the last quarter-end (for example, an equity offering) and/or when examination findings have a material impact on conclusions regarding capital adequacy, the examiner should reflect these changes and findings in these ratios. When adjustments are made, the examiner should identify the date of the new capital calculation (presumably subsequent to quarter-end). In any event, when examination findings result in a change in a bank's prompt-corrective-action designation, the ratios provided must be adjusted. The Capital Category line refers to the prompt-corrective-action (PCA) capital designation as described in the Federal Deposit Insurance Corporation Improvement Act. Report comments need to clearly convey that this designation is not the sole criterion for determining capital adequacy. If the bank is subject to restrictions under a PCA directive issued by the Board of Governors, a discussion of the directive's requirements and the related capital-restoration plan are to be included.

The examiner should consider the volume of classified assets and any meaningful asset-quality trends. It is appropriate to address capital ratios adjusted for significant examination classifications in the narrative to emphasize the impact of examination classifications on any valuation reserves and the impact of deficiencies in valuation reserves on the bank's capital adequacy.

The assessment of capital growth should include consideration of growth from various capital sources, including retained earnings and potential new capital-stock issues, and should be compared to growth in total assets, asset mix, market risk, concentration risk, risks associated with nontraditional activities, interest-rate risk, and off-balance-sheet risks. Risk-based capital guidelines factor in changes in balance-sheet composition and exposure to potential risk via growth of off-balance-sheet activities. Although the guidelines give consideration to the above, examiners still must exercise considerable judgment to evaluate all factors necessary to make an accurate assessment of capital adequacy.

The bank's capital plan should also be reviewed. The content, degree of formality, sophistication, and form of plan will vary with banks of different sizes and complexity. However, each bank should be monitoring its capital position in relation to the required guideline ratios and risk. In addition, consideration should be given to the bank's ability to obtain additional outside capital, including support provided by a parent holding company. Also, the bank's dividend history and plans should be considered in relationship to regulatory guidelines and anticipated profitability.

Capital Calculations (Mandatory)

The Capital Calculations page should be prepared using information as of the same date as the exam date shown on the Comparative Statements of Financial Condition page. When the condition of the bank has changed significantly since the exam date (for example, an equity offering) or when examination findings materially affect conclusions regarding capital adequacy, the examiner should reflect these changes and findings in the capital calculation. When adjustments are made, the examiner should identify the date of the new capital calculation. In any event, when examination findings result in a change in a bank's prompt-corrective-action designation, the capital calculations provided must be adjusted. Characteristics of any capital elements that are unusual or significant may require an explanation on the Capital Adequacy page, as may any limitations with regard to risk-based capital guidelines.

Ineligible intangibles to be deducted from tier 1 capital should include such items as ineligible purchased credit-card relationships (PCCRs) and mortgage-servicing rights, while the Other Adjustments line should include such items as disallowed deferred-tax assets. Under the risk-weighted assets calculations section, the examiner should ensure that requested data are calculated in accordance with risk-based capital guidelines. All items deducted from capital noted above should also be deducted from the risk-weighted assets calculation. FASB 115 adjustments are not to be reflected on this page. Adjusted average total assets is average total assets for the most recent quarter less all goodwill and other disallowed intangibles.

Asset Quality (Mandatory)

Federal Reserve examiners should specifically address the following areas on the Asset Quality page. If all conditions are satisfactory, a brief statement that addresses each factor and summarizes the examiner's conclusions will suffice.

- Assess (1) the quality of assets, including their level, distribution, severity, and the trend of problem, classified, past-due, nonaccrual, restructured, and renegotiated loans not in compliance with modified terms for both on- and off-balance-sheet transactions; (2) the existence of asset concentrations; (3) the adequacy of loan policies and loan-administration, credit documentation, or lending practices; (4) the adequacy of workout procedures for problem credits; (5) the adequacy of the allowance for loan and lease losses; and (6) the adequacy of the bank's internal loan-review and grading systems, including significant differences between internal loan grades and examination classifications.
- Assess (1) the quality of investment securities and (2) the adequacy of investment policies.
- Comment on any off-balance-sheet items, such as unfunded commitments, credit derivatives, commercial and standby letters of credit, and lines of credit, with respect to (1) their volume in relation to total assets, capital, or other appropriate balance-sheet categories; (2) the risks inherent in the activity; and (3) the adequacy of management and control of off-balance-sheet risks.
- Comment on the quality of management with respect to the lending function and management's awareness of problem loans. Examiners should also address the causes of existing credit problems and remedial actions agreed to by management for correction of deficiencies.
- Assess the adequacy of internal controls and management information systems.

Although the mandatory interagency Asset Quality page does not provide for a weighted-asset classification to capital ratio, the Federal Reserve System relies heavily on this measure of asset quality. Therefore, this page should include a line for the ratio of weighted classifications to tier 1 capital and for the allowance for loan losses without limitation. The sample page included in this manual contains a line for this ratio.

Assets listed for special mention should not be included in the classifications total, nor should they be referred to as adversely classified in the narrative. Although classified and special-mentioned asset totals should not be commingled, those two categories will display and possibly share underwriting, documentation, or other weaknesses or characteristics to be reported by the examiner.

The examiner should consider the total of other transfer risk problems, if significant, and briefly discuss the volume and trend of such credits. The examiner should specifically assess whether there are concentrations of credit in any particular economic sectors, the extent that problem credits may be centered in these sectors, and concentrations of transfer risk warranting special comment. Examiners should also address the loan-loss reserve methodology and the adequacy of the allowance for loan and lease losses. Examiners should comment on the quality of investment securities and trading-account activities and address credit risk associated with off-balance-sheet items.

Examiners should assess the adequacy of policies and procedures relating to loans, investments, and off-balance-sheet activities. Also, examiners should address policies and procedures regarding financial futures and foreign-exchange trading.

When assessing loan policies, loan administration, and lending practices, consideration should be given to internal loan approval, internal review and monitoring, and grading systems and control procedures; the organization and completeness of the credit files; collateral administration and evaluation procedures; collection procedures; procedures for renewing or extending loans and placing loans on nonaccrual status; the accrual and capitalization of past-due interest and prepaid interest; and any other unfavorable practice that may result in or from poor asset quality.

Deficiencies relating to the lack of written policies in any critical area should be noted in discussing management's adherence to policies on the Management/Administration page. Also, if excessive management turnover, weaknesses in middle management, or inadequate internal promulgation of policies affects adherence to or implementation of policies, these areas should also be addressed under Management/ Administration.

Examination ratios in this section are to be derived from information obtained during the current and two most recent on-site examinations. The examiner may include in the narrative additional ratios, if necessary, to highlight a particular financial factor. Reserve Banks that are engaged in alternate examination programs with state banking departments should use classified asset totals from state reports in completing and analyzing the trend in asset-quality data on this page.

For the Asset Quality page, the tier 1 capital numbers to be used should come from the Capital Adequacy and Capital Calculations pages. However, the examiner may substitute a different date when desired. The total adversely classified assets numbers and total assets numbers should be relevant to the date of the asset-quality review. This will reflect information for the period deemed most appropriate by the examiner-in-charge.

Capital is based on the guideline definition of tier 1 capital. Weighted and total classifications are to be compared with tier 1 capital plus the allowance for loan losses, both for purposes of this page and for the asset-quality rating under the CAMELS rating system. Total adversely classified items includes total adversely classified assets plus classified off-balance-sheet items, while total adversely classified assets does not include classified off-balance-sheet items. The past-due and nonaccrual ratio should be consistent with the information contained in the past-due and nonaccrual schedule on the Loans and Lease-Financing Receivables/ Past-Due and Nonaccrual Loans and Leases page.

Summary of Items Subject to Adverse Classification/Summary of Items Listed as Special Mention (Mandatory)

Summary of Items Subject to Adverse Classification

The Summary of Items Subject to Adverse Classification page summarizes items classified by the examiner as of the examination date (for this page, considered the date relevant to the asset-quality review). Total classifications are also presented for the previous examination. Reserve Banks that are engaged in alternate examination programs should provide totals contained in the previous examination report prepared by the state when applicable. The examiner should also consider creating a schedule on the Asset Quality page to detail classifications from additional prior examinations if meaningful trend information is noted. The examiner should also present in the report narrative classifications trends for certain asset categories if the analysis is meaningful.

The report format does not contain provisions for other transfer risk problems or value-impaired assets. For examination of banks engaged in international lending, Reserve Bank examiners should provide additional information to include categories for other transfer risk problems and value-impaired assets. The format for this page will also require adjustments for U.S. addressees and non-U.S. addressees.

For banks with foreign activity, the distinction between U.S. and non-U.S. addressees follows the definition set forth in the instructions for the Consolidated Report of Condition: whether a customer is U.S. or non-U.S. is determined by the customer's principal address, that is, by its domicile. A U.S. address would be in the 50 states of the United States, the District of Columbia, Puerto Rico, and U.S. territories and possessions. Non-U.S. addressees include all other geographic areas.

The examiner should list in the appropriate category the amounts of all credits classified due to transfer risk. The value of credits shown as value-impaired should be computed after deducting any allocated transfer risk reserve established against an asset. In determining total classified assets, examiners should arrive at a net assets classified due to country risk. Examiners should identify any credits classified due to transfer risk which have received the same or more severe classification due to credit risk and are listed above in the summary of classified items due to credit risk. The sum of such assets should be listed in the appropriate column and then deducted to arrive at net assets classified due to country risk. For the purpose of this page, any credits classified as value-impaired for transfer risk purposes should not be included in the summary of credits classified due to credit risk, unless the credits are classified loss.

For the purpose of arriving at total classified assets, add the amount classified due to credit risk to net assets classified due to transfer risk for each category. When computing weighted classifications, the residual portion of any value-impaired assets should be assigned the same weight as substandard classifications. However, the residual exposure still remains value-impaired for examination and classification purposes. Value-impaired assets held in the trading account should also be included in total classified assets, but should not be considered classified assets when computing weighted classifications.

Summary of Items Listed as Special Mention

The Summary of Items Listed as Special Mention page presents the total of assets listed for special mention. The summary includes special-mention totals for the current and one previous examination. Assets listed for special mention are not included when computing classification ratios. Reserve Banks that are engaged in alternate examination programs should rely on the previous state examination's special-mention total when applicable.

Loans and Lease-Financing Receivables/ Past-Due and Nonaccrual Loans and Leases (Mandatory)

The examiner has the flexibility to use the same or different dates for the Loans and Lease-Financing Receivables and the Past-Due and Nonaccrual Loans and Leases schedules. The Loans and Lease-Financing Receivables schedule will usually be as of the most recent quarter-end. The Past-Due and Nonaccrual Loans and Leases schedule will usually be as of the asset-quality review date. Based on examination findings, the examiner-in-charge should determine if other "as of" dates best reflect the condition of the institution. For example, the Loans and Lease-Financing Receivables schedule may be presented as of the asset-quality review date if the examiner identifies significant changes since the last quarter-end that need to be incorporated.

The format of the Loans and Lease-Financing Receivables schedule is similar to that used in the Consolidated Report of Condition. The definitions of the loan categories as contained in the Instructions for the Consolidated Report of Condition should be used in completing the schedule. For examinations of banks engaged in international lending, Reserve Bank examiners should adjust the format of this schedule for U.S. addressees and non-U.S. addressees.

For examinations of banks engaged in international lending, Reserve Bank examiners should adjust the format of the Past-Due and Nonaccrual Loans and Leases schedule for U.S. addressees and non-U.S. addressees. The definitions of past-due and nonaccrual loans and leases as contained in the Instructions for the Consolidated Report of Condition should be used in completing this schedule, unless the bank's policy is more conservative, in which case the bank's definition may be used. If so, or if state law requires the bank to apply different definitions, the examiner should discuss the bank's policy or state law in the Comments section following the past-due and nonaccrual schedule. The Memorandum section should include the amount of restructured loans and leases included in the totals. Relevant issues pertaining to past-due and nonaccrual loans and leases should be briefly discussed in the Comments section. More significant issues should be discussed on the Asset Quality page.

Management/Administration (Mandatory)

The report-page heading states that management is evaluated against all factors necessary to operate the institution in a safe and sound manner and in accordance with acceptable practices. Consideration is given to technical competence, leadership, and administrative ability; compliance with regulations and statutes; ability to plan and respond to changing circumstances; effectiveness of management information systems; tendencies toward self-dealing; demonstrated willingness to serve the legitimate banking needs of the community; and management depth and succession. In addition, consideration is given to the extent that management is affected by or susceptible to dominant influence or concentration of authority.

In preparation for making report comments, examiners should consider the following:

- the adequacy of supervision by the board of directors, including its role in establishing policies and its responsiveness to recommendations from auditors and supervisory authorities
- compliance with supervisory agreements
- compliance with banking laws and regulations
- management's timeliness in recognizing and resolving problems
- the adequacy of the institution's policies necessary to operate the bank in a safe and sound manner and in compliance with applicable statutes and regulations (Examiners should review the mechanism for formulating, approving, reviewing, and updating policies; determine if the policies are in writing and are properly communicated to all appropriate personnel; and determine if all policies are followed.)
- management's adherence to policies as established by the board of directors
- management information systems and controls used to monitor and control risks throughout the bank and ensure compliance with established policies, statutes, and regulations (Examiners should also address the adequacy of the overall internal accounting-control system and the audit function employed by the bank. Deficiencies in internal accounting-control systems and the audit function should be discussed in detail.)
- the adequacy and effectiveness of the planning function, including planning and budgeting and the role of management in each process
- the business strategy and policies and procedures for avoiding conflicts of interest
- significant findings and conclusions noted in specialty examinations (for example, trust, EDP, CRA, and consumer) conducted since the previous full-scope commercial examination
- management depth and succession
- the extent that the board of directors and management are affected by or susceptible to dominant influence or concentration of authority
- demonstrated willingness to serve the legitimate banking needs of the community

While topics in this section may appear to overlap with other areas of the report, the discussion in this section should focus on the role of the bank's directors, the bank's internal administration, management supervision and policy development, and management's adherence to operating policies and procedures. This section should not repeat financial assessments set forth elsewhere in the report.

Violations of Laws and Regulations (Mandatory)

The Violations of Laws and Regulations page should be included in every Federal Reserve examination; if there are no apparent violations, write "None." When violations of federal or state banking laws and regulations are found, they should be listed in detail on this page. Violations of the Bank Secrecy Act should also be listed on this page in detail.

The format for listing violations should be consistent. A heading for each violation listed should name the applicable regulation and section and provide a brief description of what the law covers. This should be followed by a brief description of the requirements of the regulation or statute and a discussion of how or why the violation occurred. The examiner should describe any plans or recommendations for correction. If a review of the Bank Secrecy Act is conducted separately, or as part of another examination, a statement to this fact should be included on the Other Matters page.

Earnings (Mandatory)

The exam-date column on the Earnings page should be prepared using information as of the same date as the exam date shown on the Comparative Statements of Financial Condition page. Ratios required on this page are available in the UBPR or may be calculated from the Consolidated Report of Condition and Income or the bank's records.

On this page, the examiner should address, at a minimum, the following:

- the level of earnings, including trends and stability
- the quality of earnings (for example, strength of the net interest margin, the amount of non-interest income and expense, reliance on unusual or nonrecurring gains or losses, and adequacy of provisions for loan losses)
- plans for correcting any earnings deficiencies
- the bank's budget and expense controls, such as management's earnings projections with regard to reasonableness of assumptions, actual results versus projections, and reasons for significant differences between projected and actual earnings
- the vulnerability of the bank's earnings to interest-rate and other risks (However, full discussion should be in the Liquidity/Asset Liability Management section of the report).
- the ability to provide for adequate capital through retained earnings

When assessing the quality of net income, the examiner should also consider the amount of interest accrued but not collected and other areas for possible overstatement of income. This amount may be reflected in other assets as income earned or not collected, or in the loan account as capitalized interest (interest added to the loan balance). The examiner should also consider the composition, reasonableness, and extent of management's control over operating expenses.

Analysis of Earnings (Mandatory)

The exam-date columns on the Analysis of Earnings page should be prepared using information as of the same date as the exam date shown on the Comparative Statements of Financial Condition page. The different sections of this page are described below:

Comparative Statement of Income (Institution Only or Consolidated)

Indicate whether this section is for the institution only or is consolidated. For the line item Other Increases/Decreases, reflect the period-to-period change in FASB 115 adjustments (gains/losses on available-for-sale securities).

Reconcilement of Allowance for Loan and Lease Losses

Information for reconcilement of the allowance for loan and lease losses is available from bank records or call reports. The December 31 Consolidated Report of Income for all banks includes a reconcilement of this account on Schedule RI-B.

Other Component Ratios and Trends

Ratios for this section can be obtained from information in the Consolidated Reports of Condition and Income, the most recent UBPR, or bank records. The ratio Nonperforming/ALLL refers to noncurrent loans/ALLL as represented in the UBPR.

Liquidity/Asset Liability Management (Mandatory)

The Liquidity/Asset Liability Management page addresses both overall bank liquidity and balance-sheet interest-rate sensitivity. Liquidity refers to the ability to meet maturing obligations and commitments and incorporates considerations such as availability of funding and the degree of reliance on volatile or concentrated funding sources. Interest sensitivity considers the overall matching of rate sensitivities of assets and liabilities and the responsiveness of asset yields, interest expense, and interest margins to changes in market interest rates.

The examiner should consider the level and/or percentages of core and/or volatile deposits, including the composition and stability of deposits. In particular, the level of volatile deposits should be closely scrutinized, and the examiner should consider if the bank must pay premium rates to attract those funds. Volatile deposits are generally composed of certificates of deposit greater than $100,000 and brokered deposits. Report comments should thoroughly discuss the bank's use of brokered deposits and evaluate the compliance of brokered deposit activity with regulatory guidelines. Report comments should also consider deposit and other liability concentrations and the extent of the bank's reliance on those concentrations. The examiner should also consider vulnerability of the institution's funding to adverse publicity and lowered credit ratings.

The report should consider the level and types of liquid assets. These assets include cash and due from banks, U.S. government and agency securities, federal funds sold, and securities purchased under agreements to resell. Liquid assets should be maintained at a sufficient level to cover maturing obligations and allow extended commitments to be fulfilled. The level of temporary investments (federal funds sold, securities purchased under agreement to resell, interest-bearing bank balances, trading-account assets, and debt securities with remaining maturities or earliest pricing opportunities of one year or less) should also be considered. The examiner should also keep in mind the percentage of the bank's securities that are pledged against liabilities and be mindful of whether they are available for sale, as well as any market appreciation or depreciation in the investment portfolio.

To further analyze liquidity, a history of the bank's borrowings, such as federal funds purchased and repurchase agreements, and excess funds sold since the previous examination should be considered. Also, consideration should be given to the bank's ability to obtain borrowings from outside sources, should that be consistent with the bank's funding strategy.

The examiner needs to consider the bank's interest-rate risk exposure. The examiner should assess how the bank is monitoring exposure, any weaknesses inherent in the bank's system, and management's plans to correct any inappropriately mismatched positions. The volume and impact of any derivative contracts should also be considered.

Examiners should assess the adequacy and reasonableness of the bank's policies regarding liquidity, interest-rate risk, and funding, as well as management's compliance with those policies. The examiner should also consider augmenting the discussion of the organization's liquidity and asset/liability management with gap information or other meaningful financial data presented in supporting schedules.

Sensitivity to Market Risk (Mandatory)

This section reflects the degree to which changes in interest rates, foreign-exchange rates, commodity prices, or equity prices can affect a bank's earnings or economic capital. When evaluating, the examiner should consider management's ability to identify, measure, monitor, and control market risk; the bank's size and the nature and complexity of its activities; and the adequacy of the bank's capital and earnings in relation to its level of market-risk exposure.

For many banks, the primary source of market risk arises from nontrading position and their sensitivity to changes in interest rates. In some larger banks, foreign operations can be a significant source of market risk. For some banks, trading activities are a major source of market risk. To analyze a bank's market risk, an assessment of the following evaluation factors should be made:

- the sensitivity of the bank's earnings or the economic value of its capital to adverse changes in interest rates, foreign-exchange rates, commodity prices, or equity prices
- the ability of management to identify, measure, monitor, and control exposure to market risk given the bank's size, complexity, and risk profile
- the nature and complexity of interest-rate risk exposure arising from nontrading positions
- where appropriate, the nature and complexity of market-risk exposure arising from trading and foreign operations

Other Matters (Optional)

Examiners should use the Other Matters report page to discuss other significant issues that have not been mentioned elsewhere in the report or significant matters mentioned elsewhere that require further explanation, such as the type, scope, and volume of any new activity in which the bank is engaged. Examiners should use this report page to make comments on the following specific areas if issues or concerns are noted:

- accounting, audit, and internal controls
- affiliate relationships
- criminal referral procedures
- emergency preparedness
- financial recordkeeping and reporting regulations
- insurance
- investment in bank premises
- litigation

- security and controls against external crimes
- payments system risk
- nontraditional banking activities (for example, mortgage warehousing or data processing services)
- supervisory reporting
- nondeposit investment products

Other examination matters may also warrant comments on this report page.

Concentrations (Optional)

The Concentrations page is to be used only when concentrations are noted. A brief paragraph at the beginning of the page should be included to inform the reader that the listing is generally for informational purposes and does not necessarily represent criticism unless otherwise specifically stated. This paragraph should also mention that a concentration includes obligations, direct or indirect, of the same or affiliated interests that represent 25 percent or more of the bank's capital structure. The reader should also be informed that, for the purposes of this page, the capital structure is defined as tier 1 capital plus the allowance for loan and lease losses.

When determining and calculating concentrations, the amount of loan commitments and other off-balance-sheet risk items should be considered. The listing should include all types of loans, overdrafts, cash items, suspense resources, securities, leases, acceptances, advances, letters of credit, and all other items due to the bank, as well as loans endorsed, guaranteed, or cosigned by related individuals and their related interests.

Concentrations by industry, transfer risk, product line, type of collateral, and others are detailed where appropriate. The listing also includes amounts due from depository institutions, federal funds sold, and other assets where payment is dependent on one financial institution or affiliated group and the total represents 25 percent or more of the bank's capital structure. Treasury securities, obligations of U.S. government agencies and corporations, and any assets collateralized by these items are not included in the listing. The requirements of Regulation F should also be considered as they relate to concentrations involving correspondent banks.

Items Subject to Adverse Classification (Optional)

The Items Subject to Adverse Classification page is to be included in the report if any items are subject to adverse classification. The page should include all assets that are classified but should not include assets listed for special mention. However, for examinations of banks that are involved in international lending, Reserve Banks should develop supporting pages to address exposures warranting special comment, other transfer risk problems, and value-impaired credits. This page should be used by examiners for the individual write-ups for assets subject to classification, including any off-balance-sheet items. It should also be used to list assets subject to classification that do not require write-ups. Assets specially mentioned should be included on the page titled Items Listed for Special Mention.

Requirements for loan write-ups presented on this page are found in section 2060, ‘‘Classification of Credits.’’ Examiners should rely on the definitions of substandard, doubtful, and loss, as defined in this section, when classifying assets.

Items Listed for Special Mention (Optional)

The Items Listed for Special Mention page is to be used if any items are listed for special mention. Any assets so listed should meet the definition of special mention found in the ‘‘Classification of Credits’’ section of this manual. Specially mentioned assets must be written up if they exceed the loan review cutoff amount and if the bank's management disagrees with the examiner's findings with regard to the asset. Specially mentioned assets are not to be referred to as "criticized assets." Write-up guidelines for specially mentioned assets are the same as those for classified assets enumerated in the ‘‘Classification of Credits’’ section of this manual.

Assets with Credit-Data or Collateral-Documentation Exceptions (Optional)

The Assets with Credit-Data or Collateral-Documentation Exceptions page should be included in the report if a significant volume of documentation exceptions is noted. If credit-data or collateral-documentation exceptions are significant, this page should support a discussion of credit-documentation practices on the Asset Quality page. In addition to the six common documentation exceptions listed, the page heading provides space to list other exceptions noted at a particular examination.

Examiners should refrain from listing in this section any loans that bank management has elected to identify as exempt from certain documentation requirements under the ''Interagency Policy Statement on Documentation of Loans to Small and Medium-Sized Businesses and Farms'' (policy statement) or any other applicable guidelines. The policy statement is intended to eliminate unnecessary documentation on small and medium-sized business and farm loans for institutions that are highly rated and that are well or adequately capitalized. Under the provisions of the policy statement, these institutions are allowed to identify, within certain limits, an ''exempt portion'' of their small and medium-sized business and farm-loan portfolios that examiners are to evaluate solely on performance and are exempt from examiner criticism of documentation.

Signature of Directors (Mandatory)

The Signature of Directors page is to be signed by the directors of the bank upon receipt of the completed report and retained in the bank's records for review by examiners during subsequent examinations.

Confidential Section—Directors (Mandatory)

The Confidential Section—Directors should list all bank directors in alphabetical order. If the bank elects advisory directors, they should be listed alphabetically under a separate heading.

Information requested in the report-page header should be supplied for each director. Specific instructions for certain requested information is as follows:

- Under meetings missed, include all meetings a director has not attended between the previous (FRB or state) and current examination. If a director was elected since the previous examination, only list the number of meetings that he or she missed since the date of election.
- Under fees paid to each director, indicate whether the compensation is based on attendance.
- Under occupation or principal business affiliation, use concise and descriptive designations (for example, farmer, grocer, commercial real estate development).

For banks with active board committees, a code or legend for all committees should be prepared, indicating committee memberships for each director.

Confidential Section—Executive Officers (Mandatory)

The Confidential Section—Executive Officers page employs the Regulation O definition of executive officers, but other significant officers may be included at the discretion of the examiner. Information requested by the report page should be supplied.

Additional individuals to be reported may include persons without official designation that exercise considerable influence or executive officers excluded from the Regulation O definition by board resolution who actually maintain a high level of responsibility. Officers should be listed in order of title or position of responsibility, with dominant individuals shown first. Specific instructions for this requested information is as follows:

- Examples of areas of responsibility include administration, policy formulation, lending, operations, or branch manager.
- Salary should indicate the current annual salary, and bonus should show total bonuses for the previous year.

If executive officers receive any other pertinent forms of compensation beyond their listed salary and bonus (such as commission-based pay, employment contracts, stock options, unusually large benefit programs, or affiliated bank salaries and fees), these should be discussed in a narrative format below the listing of executive officers or on a separate page.

Confidential Section—Management and Control (Mandatory)

The examiner should respond to each listed question on the Confidential Section—Management and Control page. The following instructions are keyed to respective question numbers:

1—Generally, the examiner's assessment of management should be fully discussed in the open section of the report; however, this question provides a forum to discuss any supervisory matter regarding management that clearly requires confidential treatment.

2—Each principal shareholder's ability and willingness to offer support to a weakened bank should be assessed. Any other potential forms of support, such as a parent company, other affiliate, or third party desiring to acquire this bank should also be identified. The possibility or likelihood of forthcoming support should also be addressed.

3(a)—Each major shareholder of the bank should be listed, with footnotes for any indirect control, such as control over spousal or family trust shares. Finally, any special control arrangements, such as buy-sell agreements or control-group structures, should be noted.

3(b)—The degree of control or influence exercised by any one individual or group of individuals should be discussed and include an indication of whether this influence has been positive or detrimental to the bank.

3(c)—In addition to any abusive practices that should be discussed here, such as self-dealing, any other problems, such as incompetent management or other relevant factors, should be addressed.

3(d)—The volume of insider borrowings and the impact of those transactions on the bank should be commented on. If the bank is using the Regulation O small-bank exception regarding aggregate insider borrowings, it should be noted, including the presence of the required board resolution sanctioning that level.

4—Any filing of a criminal referral form or any bond claim relating to insiders should be commented on. The report question also requires the examiner to explain why legal authorities have not been informed of possible criminal activity.

Confidential Section—Ratings and General Information (Mandatory)

The examiner should respond to each listed question on the Confidential Section—Ratings and General Information page. The following instructions are keyed to the respective question numbers:

2—Items for possible discussion include the bank's trade area, major employers or primary industries, the area's economic condition and trend, and the bank's ability to operate satisfactorily within this environment. Other discussion topics could include competition, expansion plans, and strategic direction.

5—Individuals with EIC responsibilities should be listed, with primary work areas shown for all other examiners (that is, loans or operations). For joint examinations, the agency for non-FRB examiners should be listed. If an examiner was in training and required significant assistance, that person should be designated as a trainee.

COMMERCIAL BANK REPORT OF EXAMINATION

NAME OF BANK	STREET	CITY
COUNTY	STATE	ZIP CODE
________ JOINT	________ CONCURRENT	________ INDEPENDENT

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SIGNATURE OF DIRECTORS	*

Dollar amounts are in thousands unless otherwise indicated.
* Mandatory
** Optional pages, per interagency guidelines, become mandatory if the material is appropriate.

EXAMINATION CONCLUSIONS AND COMMENTS

Uniform Financial Institutions Rating System

	Current Exam	*Prior Exam*	*Prior Exam*
Exam date:			
Composite rating:			
Component ratings:			
Capital			
Asset Quality			
Management			
Earnings			
Liquidity			
Sensitivity to Market Risk			

Examiner-in-Charge ______________________________

Additional Sign-Off ______________________________

COMPARATIVE STATEMENTS OF FINANCIAL CONDITION
(Institution only or consolidated)

(Amounts reported in thousands)

	Exam Date	*Period Ended*
ASSETS		
Total loans and leases		
Less: allowance for loan and lease losses		
Loans and leases (net)		
Interest-bearing balances		
Federal funds sold		
Securities purchased under agreements to resell		
Trading-account assets		
Securities		
Total earning assets		
Cash and non-interest-bearing balances		
Premises and fixed assets		
Other real estate owned		
Intangibles		
Other assets		
Total assets		
LIABILITIES		
Deposits		
Federal funds purchased		
Securities sold under agreements to repurchase		
Other borrowed money		
Other liabilities		
Subordinated notes and debentures		
Total liabilities		
EQUITY CAPITAL		
Perpetual preferred stock		
Common equity capital		
Other equity capital		
Total equity capital		
Total liabilities and capital		
OFF-BALANCE-SHEET ITEMS		
Unused loan commitments		
Letters of credit		
Interest-rate contracts		
Other off-balance-sheet items		

CAPITAL ADEQUACY

Capital adequacy is evaluated in relation to supervisory guidelines, the nature and extent of risks to the organization, and the ability of management to address these risks. Consideration is given to the level and quality of capital and the overall financial condition of the bank; the nature, trend, and volume of problem assets and the adequacy of the allowance for loan and lease losses and other valuation reserves; risk exposures presented by off-balance-sheet activities; the quality and strength of earnings; balance-sheet composition, including the nature and amount of intangible assets, market risk, concentration risk, and nontraditional activity risk; growth experiences, plans, and prospects; the reasonableness of dividends; access to capital markets and other appropriate sources of financial assistance; and the ability of management to address emerging needs for additional capital.

Component Rating X

CAPITAL RATIOS AND TRENDS

Ratio	*Exam Date*	*Period Ended*	*Period Ended*
Total risk-based capital/ risk-weighted assets	%	%	%
Tier 1 risk-based capital/ risk-weighted assets	%	%	%
Tier 1 leverage capital/ average total assets	%	%	%
Tangible equity capital/ average total assets	%	%	%
Capital category			

CAPITAL CALCULATIONS

	$(000's)	*Date*
Tier 1 Capital		
Common stock		
Surplus		
Undivided profits and capital reserves		
Foreign-currency-translation adjustments		
Noncumulative perpetual preferred stock and surplus		
Minority interests		
Subtotal: tier 1 capital elements		
Less:		
Ineligible intangibles		
Other adjustments		
Tier 1 capital		
Tier 2 Capital		
Allowance for loan and lease losses*		
Mandatory convertible debt		
Agricultural loss deferral		
Cumulative perpetual preferred stock		
Subordinated debt		
Other		
Tier 2 capital (not to exceed 100% of tier 1 capital)		
Total Capital		
Tier 1 plus tier 2 capital		
Less: deductions		
Total capital		
Risk-Weighted Assets Calculation		
Risk-weighted balance-sheet assets		
Risk-weighted off-balance-sheet items		
Less: risk-weighted amounts deducted from capital		
Gross risk-weighted assets		
Less: excess ALLL and ATRR		
Total risk-weighted assets		
Adjusted average total assets		

* Limited to a maximum of 1.25 percent of gross risk-weighted assets.

ASSET QUALITY

Asset quality is evaluated in relation to the level, distribution, severity, and trend of problem, classified, delinquent, nonaccrual, nonperforming, and restructured assets, both on- and off-balance-sheet; the adequacy of the allowance for loan and lease losses and other valuation reserves; the demonstrated ability to identify, administer, and collect problem assets; the diversification and quality of loan and investment portfolios; the adequacy of loan and investment policies, procedures, and practices; the extent of securities underwriting activities and exposure to counterparties in trading activities; credit risk arising from or reduced by off-balance-sheet transactions; asset concentrations; the volume and nature of documentation exceptions; and the effectiveness of credit-administration procedures, underwriting standards, risk-identification practices, controls, and management information systems.

Component Rating X

ASSET-QUALITY RATIOS AND TRENDS

Ratio	*Exam Date*	*Prior Exam*	*Prior Exam*
Total adversely classified items/ tier 1 capital + allowance	%	%	%
Total adversely classified assets/ total assets	%	%	%
Past-due and nonaccrual loans and leases/ gross loans and leases	%	%	%
Weighted adversely classified items/ tier 1 capital + allowance	%	%	%

SUMMARY OF ITEMS SUBJECT TO ADVERSE CLASSIFICATION/ SUMMARY OF ITEMS LISTED AS SPECIAL MENTION

	Adversely Classified			
Asset Category	*Substandard*	*Doubtful*	*Loss*	*Total*
Loans/leases				
Securities				
Other real estate owned				
Other assets				
Totals at this exam (MM/DD/YY)				
Totals at prior exam (MM/DD/YY)				

SUMMARY OF ITEMS LISTED AS SPECIAL MENTION

	Exam Date	*Prior Exam*
Loans/leases		

LOANS AND LEASE-FINANCING RECEIVABLES

Date ________

Category	*Amount*	*Percent*
Real estate loans		
Installment loans		
Credit card and related plans		
Commercial loans		
All other loans and leases		
Gross loans and leases		

PAST-DUE AND NONACCRUAL LOANS AND LEASES

Date ________

Category	*Past Due 30 through 89 Days*	*Past Due 90 Days or More*	*Total Past-Due and Accruing*	*Percent*	*Non-accrual*	*Percent*
Real estate loans						
Installment loans						
Credit card and related plans						
Commercial and all other loans						
Totals						
MEMORANDUM						
"Restructured" loans and leases included in the above totals:						

COMMENTS

MANAGEMENT/ADMINISTRATION

Management and the board of directors are evaluated against all factors necessary to operate the institution in a safe and sound manner and their ability to identify, measure, monitor, and control the risks of the institution's activities. Consideration is given to the level and quality of oversight and support provided by management and the board; compliance with regulations and statutes; the ability to plan for and respond to risks that may arise from changing business conditions or initiation of new products or services; the accuracy, timeliness, and effectiveness of management information and risk-monitoring systems; the adequacy of and compliance with internal policies and controls; the adequacy of audit and internal control systems; the responsiveness to recommendations from auditors and supervisory authorities; the reasonableness of compensation policies and avoidance of self-dealing; a demonstrated understanding and willingness to serve the legitimate banking needs of the community; management depth and succession; the extent that management is affected by or susceptible to dominant influence or concentration of authority; and the overall performance of the institution and its risk profile.

Component Rating X

EARNINGS

Quality and quantity of earnings are evaluated in relation to the ability to provide for adequate capital through retained earnings; level, trend, and stability of earnings; quality and sources of earnings; level of expenses in relation to operations; vulnerability of earnings to market-risk exposures; adequacy of provisions to the allowance for loan and lease losses and other valuation reserves; reliance on unusual or nonrecurring gains or losses; contribution of extraordinary items, securities transactions, and tax effects to net income; and adequacy of budgeting systems, forecasting processes, and management information systems.

Component Rating X

COMPONENT RATIOS AND TRENDS

Ratio	*Exam Date*	*Period Ended*	*Period Ended*
Net income (after tax)/average assets	%	%	%
Net operating income (after tax)/ average assets	%	%	%

ANALYSIS OF EARNINGS

Comparative Statement of Income (Institution Only or Consolidated)

	Exam Date	*Period Ended*
Interest income		
Interest expense		
Net interest income		
Non-interest income		
Total non-interest expense		
Provision for loan & lease losses		
Provision for allocated transfer risk		
Securities gains (losses)		
Net operating income (pre-tax)		
Applicable income taxes		
Net operating income (after-tax)		
Extraordinary credits (charges), net		
Net income		
Other increases/decreases		
Cash dividends		
Net change in equity accounts		

Reconcilement of Allowance for Loan and Lease Losses

	Exam Date	*Period Ended*
Beginning balance		
Gross loan and lease losses		
Recoveries		
Provision for loan and lease losses		
Other increases (decreases)		
Ending balance		

Other Component Ratios and Trends

Ratio	*Exam Date*	*Period Ended*	*Period Ended*
Net interest income (TE)/average earning assets			
Total non-interest expense/average assets			
Net income/average total equity			
Net losses/average total loans and leases			
Earnings coverage of net losses (X)			
ALLL/total loans and leases			
Nonperforming/ALLL			

LIQUIDITY/ASSET LIABILITY MANAGEMENT

Liquidity and asset/liability management is evaluated in relation to the trend and stability of deposits; degree and reliance on short-term, volatile sources of funds, including any undue reliance on borrowings or brokered deposits to fund longer-term assets; availability of assets readily convertible to cash without undue loss; availability to securitize and sell certain pools of assets; access to money markets and other sources of funding; adequacy of liquidity sources and ability to meet liquidity needs; effectiveness of liquidity policies and practices, funds-management strategies, management information systems, and contingency-funding plans; capability of management to properly identify, measure, monitor, and control liquidity; and level of diversification of funding sources, both on- and off-balance-sheet.

Component Rating X

SENSITIVITY TO MARKET RISK

Sensitivity to market risk reflects the degree to which changes in interest rates, foreign-exchange rates, commodity prices, or equity prices can adversely affect earnings or the economic value of capital; the ability of management to identify, measure, monitor, and control exposures to market risk given the bank's size, complexity, and risk profile; the nature and complexity of interest-rate risk arising from nontrading positions; and, where appropriate, the nature and complexity of interest-rate risk arising from trading and foreign operations.

Component Rating X

ITEMS SUBJECT TO ADVERSE CLASSIFICATION

Includes assets and off-balance-sheet items which are detailed in the following categories:

Substandard Assets—A substandard asset is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

Doubtful Assets—An asset classified doubtful has all the weaknesses inherent in one classified substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.

Loss Assets—An asset classified loss is considered uncollectible and of such little value that continuance as a bankable asset is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be effected in the future.

	Category		
Amounts, Description, and Comments	*Substandard*	*Doubtful*	*Loss*

ITEMS LISTED FOR SPECIAL MENTION

Includes assets that are detailed as follows:

Special-Mention Assets—A special-mention asset has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the institution's credit position at some future date. Special-mention assets are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification.

Description	*Amount*

ASSETS WITH CREDIT-DATA OR COLLATERAL-DOCUMENTATION EXCEPTIONS

Includes assets with technical defects not corrected during the examination for which deficiency the appropriate number or description is noted in the Deficiency column.

1—Appraisal	5—Insurance
2—Title Search or Legal Opinion	6—Collateral Assignment
3—Borrowing Authorization	7—
4—Recordation	8—

Name or Description	*Amount*	*Date of Most Recent Financial Statement*	*Deficiency Number(s) or Description*

SIGNATURE OF DIRECTORS

We, the undersigned directors of ______________________________ , have personally reviewed the contents of the report of examination dated ___________________________ .

Signature of Directors	*Date*
____________________	____________________
____________________	____________________
____________________	____________________
____________________	____________________
____________________	____________________
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____________________	____________________
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____________________	____________________
____________________	____________________

NOTE: This form should remain attached to the Report of Examination and be retained in the institution's file for review during subsequent examinations. The signature of committee members will suffice only if the committee includes outside directors and a resolution has been passed by the full board delegating the review to such committee.

CONFIDENTIAL SECTION
DIRECTORS

Name	*	*Year of Birth*	*Year Elected to Board*	*Occupation or Principal Business Affiliation*

* Number of meetings missed of a total of ________ held since the previous examination.

Regular schedule of directors' meetings:

Fee paid each director:

CONFIDENTIAL SECTION
EXECUTIVE OFFICERS

Name and Title	*Area of Responsi-bility*	*Year of Birth*	*Years with Bank*	*Years in Present Position*	*Compen-sation (Bonus)*

CONFIDENTIAL SECTION
MANAGEMENT AND CONTROL

1. DISCUSS ANY OTHER RELEVANT MATTERS REGARDING THE BANK'S MANAGEMENT NOT PREVIOUSLY ADDRESSED.

2. IF THE BANK IS IN A WEAKENED OR EXTENDED CONDITION, WHAT AID MAY BE EXPECTED FROM SHAREHOLDERS OR OTHERS?

3. (A) LIST EACH MAJOR SHAREHOLDER (5 PERCENT OR MORE) OF THE BANK AND THE RESPECTIVE PERCENTAGE OF OWNERSHIP. WHEN THE MAJOR SHAREHOLDER IS A BANK HOLDING COMPANY, LIST ITS MAJOR SHAREHOLDERS AND THE PERCENT CONTROLLED.

Shareholders	*Percentage Owned*

   (B) COMMENT ON THE EXTENT TO WHICH A PARTICULAR DIRECTOR(S), SHAREHOLDER(S), OR EXECUTIVE OFFICER(S) CONTROLS OR DOMINATES THE BANK'S POLICIES AND OPERATIONS.

   (C) COMMENT ON ANY ADVERSE EFFECTS OF INSIDERS ON OPERATING POLICIES, PROCEDURES, OR OVERALL FINANCIAL CONDITION OF THE BANK.

   (D) PROVIDE THE AGGREGATE AMOUNT OF BORROWINGS BY DIRECTORS, EXECUTIVE OFFICERS, PRINCIPAL SHAREHOLDERS, AND THEIR RELATED INTERESTS (AS DEFINED IN REGULATION O). DESCRIBE ANY MATERIAL LOANS OR OTHER TRANSACTIONS BETWEEN THE BANK AND ITS EXECUTIVE OFFICERS, DIRECTORS, OR ITS DIRECT OR INDIRECT PRINCIPAL SHAREHOLDER(S) AND THEIR INTEREST(S), AND ASSESS THE IMPACT OF THE TRANSACTIONS ON THE BANK. (AN INTEREST WOULD INCLUDE ANY HOLDING COMPANY AFFILIATE OR OUTSIDE BUSINESS INTEREST OR A BANK OR HOLDING COMPANY INSIDER IN WHICH 25 PERCENT OR MORE IS CONTROLLED.)

4. HAS ANY DIRECTOR, OFFICER, OR EMPLOYEE ALLEGEDLY EMBEZZLED, ABSTRACTED, OR OTHERWISE CRIMINALLY MISUSED THE FUNDS OF THE BANK SINCE THE PREVIOUS EXAMINATION? IF SO, HAVE PROPER AUTHORITIES BEEN NOTIFIED? IF PROPER AUTHORITIES HAVE NOT BEEN NOTIFIED, EXPLAIN WHY.

CONFIDENTIAL SECTION
RATING AND GENERAL INFORMATION

1. STATE THE BANK'S RATING AT THIS EXAMINATION AND THE DATE OF AND RATING AT THE LAST EXAMINATION. BRIEFLY DISCUSS THE RATIONALE FOR THE RATING AND REASONS FOR ANY DEPARTURES FROM FEDERAL RESERVE IMPLEMENTING GUIDELINES WITH RESPECT TO THE CAMELS COMPONENT RATINGS AND THE COMPOSITE RATING.

2. DISCUSS PROSPECTS OF THE BANK.

3. WAS A MEETING HELD WITH THE FULL BOARD OF DIRECTORS TO DISCUSS MATTERS SUBJECT TO CRITICISM? IF NOT, GIVE NAMES OF DIRECTORS AND OFFICERS WITH WHOM THE BANK'S CONDITION WAS DISCUSSED.

4. PROVIDE THE COMPOSITE RATINGS AND DATES OF THE MOST RECENT BANK SPECIALTY EXAMINATIONS (EDP, TRUST, CONSUMER, CRA) AND BANK HOLDING COMPANY INSPECTION, IF APPLICABLE. IF ANY SPECIALTY EXAMINATION OR INSPECTION RESULTED IN A PROBLEM RATING, DISCUSS ANY ADVERSE IMPACT OF THOSE PARTICULAR WEAKNESSES ON THE OVERALL SAFETY AND SOUNDNESS OF THE BANK.

Bank Specialty Examinations	Date	Rating

5. INDICATE THE NUMBER OF FEDERAL RESERVE EXAMINER DAYS TO COMPLETE THE PRE-EXAMINATION, ON-SITE, AND POST-EXAMINATION WORK.

Name	On Premises	Off Premises

Examiner

This section deals specifically with System-wide Federal Reserve policies, practices, and procedures relating to the examination of domestic and international banking departments of state-chartered commercial banks that are members of the Federal Reserve System. The Federal Reserve also has certain supervisory and oversight responsibilities in other areas of banking, both domestic and international, for which it has developed specialized examination procedures, conducts on-site examinations, and completes separate examination reports. These areas are not covered in depth in this manual; Federal Reserve policies and examination procedures relating to each of them are covered in either separate manuals or supervisory letters (SR-letters) issued by the Federal Reserve Board.

BANK HOLDING COMPANIES

The Federal Reserve has the sole regulatory responsibility for supervising bank holding companies. These organizations control commercial banks that hold most of the insured commercial banking assets in the United States. Substantially all bank holding companies are subject to on-site inspection by the Federal Reserve System. The frequency and scope of inspections are determined by the composite rating, size, amount of debt, and complexity of the organization. Inspections cover both financial and managerial factors and include analysis at the parent, bank, nonbank, and consolidated levels.

INTERNATIONAL

Overseas Operations of U.S. Banking Organizations

Under provisions of the Federal Reserve Act and the Board's Regulation K, member banks may establish branches in foreign countries subject to, in most cases, the Board's prior approval. Examinations of the overseas operations of state member banks are generally conducted at the banking organization's head office in the United States, where the ultimate responsibility for the overseas facilities lies. To verify and supplement the results of the head-office examinations, on-site reviews of important overseas operations are performed at least every three years.

Edge Act and Agreement Corporations

Under sections 25 and 25A of the Federal Reserve Act, Edge Act and agreement corporations may engage in international banking and foreign financial transactions, and the Federal Reserve is responsible for conducting specialty examinations of these entities and their branches. Edge corporations are chartered by the Board to conduct an international banking business. Agreement corporations are state-chartered companies that enter into an agreement with the Board to limit their operations to international banking. These corporations, which are usually subsidiaries of member banks, provide their owner organizations with additional powers in two areas: (1) they may conduct a deposit and loan business in states other than that of the parent, provided that the business is strictly related to international transactions, and (2) they have somewhat broader foreign-investment powers than member banks, being able to invest in foreign financial organizations, such as finance companies and leasing companies, as well as in foreign banks.

U.S. Activities of Foreign Banking Organizations

During the 1970s and 1980s, foreign entities rapidly expanded their operations in the United States; today, they are a significant element in the U.S. banking system. Although the Federal Reserve previously had significant authority over foreign banking organizations (FBOs), its role was enhanced by the Foreign Bank Supervision Enhancement Act of 1991 (FBSEA). The Federal Reserve has broad oversight authority for the supervision and regulation of FBOs that engage in banking in the United States through branches, agencies, commercial lending companies, and subsidiary banks. In fulfilling this responsibility, the Federal Reserve conducts its own examinations and may also use reports of other agencies. FBSEA also requires Federal Reserve approval for establishment of new FBO offices in the United States, and it gives the

Federal Reserve the authority to terminate such offices.

ELECTRONIC DATA PROCESSING ACTIVITIES

The Federal Reserve is responsible for conducting examinations of electronic data processing (EDP) centers that provide EDP services to state member banks, FBOs, and Edge Act corporations. Section 3 of the Bank Service Corporation Act (12 USC 1863, redesignated as the Bank Service Company Act) generally authorizes bank service companies to perform significant clerical, bookkeeping, or accounting functions, such as demand-deposit accounting and loan processing. Section 7 of the Bank Service Company Act (12 USC 1867) empowers the appropriate federal regulatory agency to examine banking services and operations regardless of whether these services are performed on or off the premises of a particular financial institution. When a financial institution contracts with an external company to provide data processing services, the data processing company's activities that pertain to financial institutions are subject to examination. Larger companies that operate in more than one regulatory district or region are examined pursuant to the Multiregional Data Processing Servicer (MDPS) examination program. EDP examinations, whether of independent processing companies or a state member bank's own EDP functions, are operational in nature and focus on evaluations of internal controls and audit effectiveness. EDP examiners have specialized training that enables them to assess the performance of each data center in four critical functions: audit, management, systems development and programming, and computer operations.

TRUST DEPARTMENTS AND TRUST COMPANIES

The Federal Reserve examines trust departments of state member banks, trust companies that are members of the Federal Reserve System, and certain nondepository trust company subsidiaries of bank holding companies. These examinations determine whether the trust functions are conducted in accordance with applicable fiduciary principles and with other appropriate laws and regulations.

To supplement the supervision of the increasing number of nondepository trust companies that are subsidiaries of bank holding companies, the Federal Reserve has instituted a program of examinations for those trust companies not supervised by any other federal banking agency. In addition, a program of limited inspections of state member banks, bank holding companies, and Edge Act corporations that conduct foreign fiduciary activities has been instituted.

While the Federal Reserve's *Trust Examination Manual* and its *Transfer Agent Manual* provide detailed coverage of those specialized areas, there are activities sometimes viewed as ''trust'' matters that are not found solely in the bank's trust department. For example, this manual covers recordkeeping and confirmation rules applicable to customer-accommodation services, reporting and inquiry requirements under the Lost and Stolen Securities Program, the registration of transfer agents, employee benefit trusts, and international fiduciary activities.

To engage in providing trust or fiduciary services, a bank must have proper authorization under state or federal law. Under the laws of most states, this requires a specific approval of the state financial supervision agency. Similarly, pursuant to the Board's Regulation H section 208.3(d)(2), the Board's permission must be obtained before changing the general character of a bank's business.

TRANSFER-AGENT ACTIVITIES

Transfer agents countersign and monitor the issuance of securities, register transfers of securities, and exchange or convert securities. Federal Reserve examiners conduct separate examinations of and complete separate reports for the transfer-agency activities of those state member banks and bank holding companies that are registered with the Board of Governors as transfer agents.

MUNICIPAL SECURITIES DEALERS, GOVERNMENT SECURITIES DEALERS, AND CLEARING AGENCIES

As a result of the Securities Act Amendments of 1975, the Board is responsible for supervising state member banks and bank holding companies that act as municipal securities dealers or clearing agencies. Federal Reserve examiners conduct separate examinations of and complete separate reports for both of these activities. A bank, a separate department or division of a bank, or a bank holding company is required to register as a municipal securities dealer if it ‘‘engages in the business’’ of buying and selling municipal securities for its own account other than in a fiduciary capacity. Examiners should refer to SR-86-40 for examination procedures and report forms on municipal securities dealers.

The Government Securities Act of 1986 (GSA) gave the Federal Reserve responsibility for examining the government securities activities of a state member bank, foreign bank, state branch or state agency of a foreign bank, or commercial lending company owned or controlled by a foreign bank. The GSA requires all government securities brokers or dealers that were previously unregistered to register with the Securities and Exchange Commission. Brokers and dealers receive specialized examinations to determine compliance with the GSA. For banks with a lower level of government securities activities, compliance with the GSA is determined as part of the commercial examination. Examination procedures for the GSA are contained in SR-87-37 and several subsequent letters.

A clearing agency acts as a custodian of securities for the settlement of securities transactions by bookkeeping entries. Examiners should refer to the *Trust Examination Manual* for examination procedures for clearing agencies that are members of the Federal Reserve System.

CONSUMER EXAMINATIONS

Some banking laws, such as the Truth in Lending Act and the Truth in Savings Act, require banks to disclose information that helps consumers evaluate product options open to them. Other laws (for example, the Community Reinvestment Act and the Equal Credit Opportunity Act) require banks to help meet the credit needs in their communities and promote the availability of credit to all creditworthy applicants. Finally, laws such as the Fair Credit Reporting Act and the Fair Debt Collection Act provide consumer safeguards for the extension, collection, and reporting of consumer credit. At the Federal Reserve, specialized examiners conduct examinations to determine banks’ compliance with these laws and their implementing regulations.

Information on the international aspects of cash accounts, nostro accounts, foreign collections, investments, and borrowed funds has been incorporated into the applicable domestic sections:

- For foreign-currency cash accounts, see section 2000, ‘‘Cash Accounts.’’
- For due from foreign banks–demand (nostro accounts) and foreign collections (cash letters, return items), see section 2010, ’’Due from Banks.’’
- For foreign investments, see section 2020, “Acquisition and Management of Nontrading Securities and Derivative Products.’’
- For international borrowed funds, see section 3010, ‘‘Borrowed Funds.’’

Additional information on international activities can be found in the *Bank Holding Company Supervision Manual*, *Merchant and Investment Bank Examination Manual*, *Trading Activities Manual*, *Bank Secrecy Act Manual*, *Trust Activities Manual*, and *Electronic Data Processing Manual*.

Generally, the basic procedures used for the examination and verification of international operations are the same as those used for other domestic bank functions. There are, however, some modifications for different types of bank assets and liabilities and contingent accounts, as well as for the separate laws and regulations that may be applicable. Documentation and accounting procedures for international operations may also differ from those used in the domestic banking areas; however, the same examination objectives apply. The examination process may also include a review of international banking facilities (IBFs) and periodic visitations to selected foreign branches and subsidiaries to determine the safety and soundness of their operations and the adequacy of reporting procedures used by the head office or parent bank to monitor the foreign office.[1]

The increasingly global nature of economic activities has made international banking operations more important to bank customers, importers and exporters of goods and services, and domestic customers with overseas operations who require a source of international financial assistance. As service institutions, commercial banks provide this assistance through global networks of representative offices, branches, and affiliates, as well as through correspondent relationships. These foreign networks also allow banks to offer services outside their traditional market areas. Additionally, in 1981, the Board of Governors amended regulations to allow for the establishment of IBFs in the United States. The activities of these facilities are limited to accepting deposits from and extending credit to foreign residents (including banks), other IBFs, and the institution establishing the IBF.

Many domestic banking activities also are conducted internationally, including providing cash and collection services, placing and taking deposits, making investments, granting loans and overdrafts, and borrowing. The international examiner will use the appropriate examination procedures for domestic operations when reviewing these activities. The examination procedures for the international aspects of these and other activities are covered in the following international sections.

Similarly, other activities that are primarily international are similar to activities found in the domestic banking area. For example, a confirmed letter of credit represents a formal commitment to extend credit provided that certain collateral and documentary conditions exist. Foreign-exchange trading activities are similar to money-trading operations conducted at domestic funding desks. Foreign-exchange positions are similar to commodity inventories carried at book value that are exposed to fluctuating market prices. Separate international sections in this manual relate to these functions.

IBF activities are to be reviewed during the examination of international operations. The review of assets, internal controls, and operating procedures should be conducted using procedures similar to those used for offshore shell branches. In addition, reports required to be filed by IBFs should be reviewed to ensure that they are prepared properly and filed in a timely manner.

Additional international banking activities, such as direct lease financing, installment loans, real estate loans, real estate construction loans, ownership of bank premises and equipment, and other real estate owned are to be examined using the applicable procedures in section 2210, "Other Assets and Liabilities," and section 3020, "Assessment of Capital Adequacy." International examinations will also require reference to other sections of this manual. Guidelines for using these sections in international examinations are presented below under the title of each section.

WORKPAPERS

Workpapers should consist of written documentation of the examination procedures followed and the conclusions reached during the examination of international operations. The definition, purpose, quality standards, preparation, and organization of workpapers used in international examinations are the same as those discussed in section 1030, "Workpapers."

1. Separate specialized examination manuals, such as the *Merchant and Investment Bank Examination Manual*, *Trading and Capital-Markets Activities Manual,* and *Section 20 Manual*, are available to assist examiners in the examination of these foreign offices.

EXAMINATION STRATEGY

Careful planning and control are as important in international examinations as they are in domestic examinations. In this regard, a number of the procedures found in section 1000, ‘‘Examination Strategy and Risk-Focused Examinations,’’ also apply to international examinations.

When assigning work in the various examination areas, the examiner should consider the organization of the bank. For example, many banks have consolidated their foreign-exchange trading and money market operations into a single division that is responsible for the bank’s global money market operations. Similar situations may be encountered where other international-related functions are combined with domestic operations. Consequently, the examination assignments should address those situations.

In some examinations, the examiner may come across certain activities that are not addressed by any particular section of the international portion of this manual. In these instances, the examiner should extract the appropriate objectives, examination procedures, and internal control questionnaires from the domestic sections of this manual.

The examiner must be certain that all types of individual customer liabilities have been analyzed on a consolidated basis, regardless of the office where they are booked. However, since the procedures for the collection and consolidation of customer liabilities booked in overseas offices differ among banks, the examiner should determine whether the bank’s procedures are adequate.

INTERNAL CONTROL

The examiner should use section 1010, ‘‘Internal Control,’’ in the domestic portion of this manual to evaluate the objectives of and the work performed by internal and external auditors for the bank’s international operations. The internal control section sets forth general criteria to be considered in evaluating the work of internal and external auditors.

EXAMINATION PLANNING

Examiners assigned to review the international activities of the bank should work closely with commercial examiners, especially in those areas in which international and domestic activities have a direct relationship. This cooperation includes the pre-examination analysis of the bank and is intended to determine potential problem areas and provide for adequate staffing.

COMPUTER SERVICES

During an examination that covers electronic data processing (EDP) services, provided either in-house or externally, the examiner should review the contents of the EDP report of examination to determine which sections may be applicable to international operations. An EDP examiner will generally perform the procedures contained in this section and should be consulted on matters applicable to international operations.

ASSET AND LIABILITY MANAGEMENT

Asset and liability management and interest-rate risk management sections of the manual are completed by domestic examiners for the entire bank, based, in part, on information prepared by examiners assigned to various international banking activities. Whether applicable segments of these sections will be completed during overseas examinations depends on the type of overseas examination conducted.

BANK-RELATED ORGANIZATIONS

The domestic examiner assigned this section obtains and circulates lists and information to the international examiner concerning bank-related organizations involved in international activities. Besides determining the legality of the relationships, the international examiner should verify the accuracy and completeness of the information obtained.

REVIEW OF REGULATORY REPORTS

The domestic examiner assigned this section circulates the bank-prepared regulatory reports applicable to international operations. The international examiner will prepare any necessary comments on the appropriate report format and discuss them with bank management.

LITIGATION AND OTHER LEGAL MATTERS, EXAMINATION-RELATED SUBSEQUENT EVENTS

The international examiner should request from bank management a list of pending or threatened litigation and subsequent events applicable to international operations of the bank. Comments in the report should be limited to events or transactions that could materially affect the soundness of the bank.

MANAGEMENT ASSESSMENT

The overall evaluation of the management of international operations should be made by the examiner assigned to review international operations who is in a position to identify the strengths and weaknesses of the management team. An appraisal of local management should also be made during on-site examinations of foreign branches and subsidiaries.

OVERALL CONCLUSIONS REGARDING CONDITION OF THE BANK

This section is typically the responsibility of the domestic examiner-in-charge. However, the examiner assigned to review international operations must use judgment in deciding which steps in this section should be omitted. For example, certain examination procedures relating to earnings, liquidity, and ownership apply to the entire bank and not to the international area alone. However, international examiners should assist domestic examiners in developing report comments when international activities have a significant impact on the analysis of these areas.

Acceptance. A time draft (bill of exchange or usance draft) drawn by one party and acknowledged by a second party. The drawee, known as the ''acceptor,'' stamps or writes the word ''accepted'' on the face of the draft and, above his or her signature, the place and date of payment. Once the draft is accepted, it carries an unconditional obligation on the part of the acceptor to pay the drawer the amount of the draft on the date specified. A *bank acceptance* is a draft drawn on and accepted by a bank. A *trade acceptance* is a draft drawn by the seller of goods on the buyer and accepted by the buyer. See also *Banker's acceptance*.

Account-account dealing. Foreign-exchange dealing that involves settlement from bank to bank in the due from accounts. No third party (bank) is involved.

Account party. The party, usually the buyer, who instructs the bank to open a letter of credit and on whose behalf the bank agrees to make payment.

Ad valorem. A term meaning ''according to value,'' used for assessing customs duties that are fixed as a percentage of the value stated on an invoice.

Advance. (1) A drawing or payout of funds representing the disbursement of a loan, including disbursement in stages. (2) In international banking, an extension of credit, usually recurring, in which no instrument (other than a copy of the advice of an advance) is used as evidence of a specified indebtedness, except in special cases. A signed agreement must be on file in the department and state the conditions applicable to payments made to the borrower. This loan category does not include commercial account overdrafts, but an advance may be created to finance payments effected under a commercial letter of credit, to finance payments of collections, or to refinance a maturing loan.

Advance against documents. An advance made on the security of the documents covering a shipment.

Advised letter of credit. See *Letter of credit—advised.*

Advised line. A credit authorization that will be made known to the customer. See also *Guidance line.*

Affiliate. With regard to a member bank, any company (including corporate or other forms of a business entity) of which a member bank is a subsidiary or any other subsidiary of that company.

After sight. When a draft bears this name, the time to maturity begins at its presentation or acceptance.

Agent bank. The bank that leads and documents a syndicated loan.

Aggregate limit. The total volume of unliquidated foreign-exchange contracts allowed to be outstanding at any one time.

Agreement corporation. A company chartered or incorporated under state law that, like an Edge Act corporation, is principally engaged in international banking. See also *Edge Act.*

Allocated transfer-risk reserve (ATRR). The ATRR is a special reserve established and maintained for specified international assets pursuant to the International Lending Supervision Act of 1983.[1] At least annually, the Federal Reserve and the other federal banking agencies (federal banking agencies) determine jointly—

- which international assets that are subject to transfer risk warrant establishment of an ATRR,
- the amount of the ATRR for the specified assets, and
- whether an ATRR previously established for specified assets may be reduced.

When determining whether an ATRR is required for particular international assets, the federal banking agencies consider if the quality of a banking institution's assets has been impaired by a protracted inability of public or private obligors in a foreign country to make payments on their external indebtedness, as indicated by factors as to—

- whether such obligors have failed to make full interest payments on external indebtedness, or
- whether such obligors have failed to comply with the terms of any restructured indebtedness, or
- whether a foreign country has failed to comply with any International Monetary Fund or other suitable adjustment program, or
- whether no definite prospects exist for the orderly restoration of debt service.

1. See 12 USC 3904(a). See also the Board's January 9, 2003, approval of a revision to subpart D (on international lending supervision) of Regulation K (12 CFR 211), International Banking Operations (69 *Fed. Reg.* 1158–1161).

Also, when determining the amount of the ATRR, the federal banking agencies consider—

- the length of time the quality of the asset has been impaired,
- what recent actions have been taken to restore debt-service capability,
- the prospects for restored asset quality, and
- any other factors relevant to the quality of the asset.

The initial year's provision for the ATRR will be 10 percent of the principal amount of each specified international asset, or such greater or lesser percentage determined by the federal banking agencies. Additional provisions, if any, in subsequent years will be 15 percent of the principal amount of each specified international asset, or such greater or lesser percentage determined by the federal banking agencies.

The ATRR is established only by a charge to current income. The amounts charged cannot be included in the banking institution's capital or surplus. (For these and other requirements, as well as for certain other accounting procedures for the ATTR, the reporting and disclosure of international assets, and the accounting for fees on international loans, see sections 211.43, 211.44, and 211.45 of Regulation K.) A banking institution does not have to establish an ATRR if it writes down in the period in which the ATRR is required, or has written down in prior periods, the value of the specified international assets in the requisite amount for each such asset.

Amortizing swap. A transaction in which the notional value of the agreement declines over time.

Appreciation. A rise in the value of a currency relative to the market of another currency.

Arbitrage. Simultaneous buying and selling of foreign currencies, securities, or commodities to realize profits from discrepancies between exchange rates prevailing at the same time in different markets, between forward margins for different maturities, or between interest rates prevailing at the same time in different markets or currencies.

Asian currency unit. A foreign-exchange trading department of a bank located in Singapore that has received a license from the monetary authority in that country to deal in external currencies.

Asked price. The price sought by any prospective seller of an asset or the price at which a market maker of an asset will sell.

Assignment. The transfer in writing by one person to another of title to personal property. In banking, one bank may assign another the right to receive loan principal and interest from a borrower. The assignment of stocks or registered bonds may be effected by filling in the form printed on the reverse of the certificate.

Association of International Bond Dealers (AIBD). A private association founded in Zurich, Switzerland, in 1969 to establish uniform issuing and trading procedures in the international bond markets.

At sight. A term indicating that a negotiable instrument is payable upon presentation or demand.

At the money. A term used to refer to a call or put option whose strike price is equal (or virtually equal) to the current price of the asset on which the option is written.

Authority to pay. An advice from a buyer, sent by his or her bank to the seller's bank, authorizing the seller's bank to pay the seller's (exporter's) drafts up to a fixed amount. The seller has no protection against cancellation or modification of the instrument until the issuing bank pays the drafts drawn on it, in which case the seller is no longer liable to its bank. These instruments are usually not confirmed by the seller's American bank.

Authority to purchase. Similar to an authority to pay, except that drafts under an authority to purchase are drawn directly on the buyer. The correspondent bank purchases them with or without recourse against the drawer and, as in the case of the authority to pay, they are usually not confirmed by an American bank. This type of transaction is unique to Far Eastern trade.

Baker Plan. Proposed in 1985, this initiative encouraged banks, the International Monetary Fund, and the World Bank to jointly increase lending to less developed countries (LDCs) that were having difficulty servicing their debt, provided the countries undertook prudent measures to increase productive growth.

Balance of payments. A term indicating a nation's external cash flow (to other countries, whether positive or negative) for a given period of time, including trade, current financial, and capital inflows and outflows.

Balance of trade. The difference between a country's total imports and total exports for a given period of time. A "favorable" balance of trade exists when exports exceed imports.

Band. The maximum range that a currency may fluctuate from its parity with another currency or group of currencies by official agreement.

Bank for International Settlements (BIS). Established in 1930 in Basel, Switzerland, the BIS is the oldest functioning international financial organization. It provides a forum for frequent consultation among central bankers on a wide range of issues.

Banker's acceptance. A time draft that has been drawn on and accepted by a bank. The bank accepting the time bill becomes primarily liable for payment. See also *Acceptance*.

Banker's acceptance liability. The moment the draft is accepted by the bank, a direct liability is recorded in its ''Acceptances Executed'' account. The contra account on the asset side of the balance sheet is ''Customer's Liability on Acceptances.'' On the date of maturity of the banker's acceptance, the bank charges the customer's account and retires the acceptance by paying the beneficiary or drawee of the draft. The bank's liability records at this point are liquidated, and the transaction is completed.

Barter. The exchange of commodities using merchandise as consideration instead of money. This scheme has been employed in recent years by countries that have blocked currencies.

Base rate. A rate used as the basis or foundation for determining the current interest rate to be charged to a borrower, such as the prime rate or London Interbank Offered Rate (LIBOR).

Basel Capital Accord. An agreement among the central banks of leading industrialized countries, including those of Western Europe, Canada, the United States, and Japan, to impose common capital requirements on their internationally active banks to take into account bank risk exposure.

Basis. The cash or spot price minus the futures price.

Basis risk. The risk associated with nonparallel movement of interest rates. Banks face exposure in two situations. The first occurs when an operator uses, for example, a Treasury bill to hedge an interest-rate risk in Eurodollars. The interest rates for T-bills and Eurodollars do not always move exactly parallel to each other. The risk of this lack of parallel movement is basis risk. The second occurs when the period of time for which a financial risk exists is not identical with the period of time for which the hedge is arranged, for example, when a three-month interest risk in a revolving Eurodollar loan is hedged with a six-month futures contract in Eurodollars. A change in the shape of the yield curve can bring about nonparallel movements in interest rates for the two different maturities.

Basis swap. A transaction in which one participant pays a floating rate of interest based on one index, and the other party pays a floating rate of interest based on another interest-rate index.

Beneficiary. The person or company in whose favor a letter of credit is opened or a draft is drawn.

Bid-asked spread. The difference between a bid and the asked price, for example, the difference between 0.4210 and 0.4215 would be a spread of 0.0005 or 5 points.

Bid price. A buyer's quote for the purchase of a trading unit from a prospective seller.

Bid rate. The price at which the quoting party is prepared to purchase a currency or accept a deposit. If the bid rate is accepted by the party to whom it was quoted, then that party will sell currency or place or lend money at that price. The opposite transaction takes place at the offer rate.

Bilateral trade. Commerce between two countries, usually in accordance with specific agreements on amounts of commodities to be traded during a specific period of time. Balances due are remitted directly between the two nations.

Bill of exchange. An instrument by which the drawer orders another party (the drawee) to pay a certain sum to a third party (the payee) at a definite future time. The terms ''bill of exchange'' and ''draft'' are generally interchangeable.

Bill of lading. A receipt issued by a carrier to a shipper for merchandise delivered to the carrier for transportation from one point to another. A bill of lading serves as a receipt for the goods, document of title, and contract between the carrier and the shipper covering the delivery of the merchandise to a certain point or designated person. It is issued in two primary forms: an ''order bill of lading,'' which provides for the delivery of goods to a named person or to his or her order (designee), but only on proper endorsement and surrender of the bill of lading to the carrier or its agents, and a ''straight bill of lading,'' which provides for delivery of the goods only to the person designated by the bill of lading.

- *Clean bill of lading*. A bill of lading in which the described merchandise has been received in ''apparent good order and condition'' and without qualification.
- *Ocean bill of lading*. A document signed by the captain, agents, or owners of a vessel furnishing written evidence for the conveyance and delivery of merchandise sent by sea. It is both a receipt for merchandise and a contract to deliver it as freight.
- *Order bill of lading*. A bill of lading, usually drawn to the order of the shipper, that can be negotiated like any other negotiable instrument.
- *Order ''notify'' bill of lading*. A bill of lading usually drawn to the order of the shipper or a bank with the additional clause that the consignee is to be notified upon arrival of the merchandise. However, the mention of the consignee's name does not confer title to the merchandise.
- *Stale bill of lading*. A bill of lading that has not been presented under a letter of credit to the issuing bank within a reasonable time after its date, thus precluding its arrival at the port of discharge by the time the ship carrying the related shipment has arrived.
- *Straight bill of lading*. A bill of lading drawn directly to the consignee and therefore not negotiable.
- *Through bill of lading*. A bill of lading used when several carriers are used to transport merchandise, for example, from a train to a vessel or vice versa.
- *Unclean bill of lading*. A bill of lading across the face of which exceptions to the receipt of goods ''in apparent good order'' are noted. Examples of exceptions include burst bales, rusted goods, and smashed cases.

Black market. A private market that operates in contravention of government restrictions.

Blocked account. An account from which payments, transfers, withdrawals, or other dealings may not be made without Office of Foreign Asset Control (OFAC) or U.S. Treasury Department approval. Although the bank is prohibited from releasing funds from these accounts, deposits may be accepted. Banks are subject to significant fines for releasing funds from blocked accounts. See also *Office of Foreign Asset Control, Specially designated nationals*.

Blocked currency. A currency that is prohibited by law from being converted into another foreign currency.

Book-entry form. The method by which marketable securities are issued with the buyer receiving only a receipt rather than an engraved certificate, which indicates that the purchase is recorded on the issuer's books or recorded in another approved location.

Brady Plan. Proposed in 1989 and named after then U.S. Treasury Secretary Nicholas Brady, the Brady Plan sought to reduce the debt-service requirements of various developing countries and to provide new loans (Brady bonds) to service existing obligations.

Break-even exchange rate. The particular spot exchange rate that must prevail at the maturity of a deposit or debt in a foreign currency (which has not been covered in the forward market) so that there will be no advantage to any party from interest-rate differentials.

Bulldog bonds. British pound sterling–denominated foreign bonds issued in London.

Bullion. Unminted precious metals (gold, silver) of standard or stipulated fineness in the form of bars, ingots, or nuggets. The value of gold bullion, usually in bars, used in the settlement of international balances is determined by weight and degree of fineness.

Buyer's option contract. A contract in which the buyer has the right to settle a forward contract at any time within a specified period. See also *Option contracts*.

Buying rates. Rates at which foreign-exchange dealers will buy a foreign currency from other dealers in the market and at which potential sellers are able to sell foreign exchange to those dealers.

C & I loans. Commercial and industrial loans.

Cable. A message sent and delivered by an international record carrier via satellite or cable connections to a foreign country. ''Cable'' as used in the international sections also includes messages transmitted by bank telex. The terms ''cable'' and ''telex'' are generally used interchangeably.

Call money. Funds placed with a financial institution without a fixed maturity date. The money can be ''called'' (withdrawn) at any time by telephone. ''Same day'' call money means the call must (usually) be made before 10:00 a.m. In addition, ''24-hour,'' ''48-hour,'' and ''7-day'' call money means the money must be called one, two, or seven calendar days before the actual payment date. Although these are the most common varieties of call money, two parties can agree on different dates.

Call option. A contract giving the purchaser the right, but not the obligation, to buy an asset at a stated price on or before a stated date.

Capital controls. Governmental restrictions on the acquisition of foreign assets or foreign liabilities by domestic citizens or restrictions on the acquisition of domestic assets or domestic liabilities by foreign citizens.

Cedel. One of two main clearing systems in the Eurobond market, Cedel, based in Luxembourg, began operations in 1971 and recently established Cedel Bank, a clearing bank chartered in Luxembourg. See also *Euroclear*.

Central bank intervention. Direct action by a central bank to increase or decrease the supply of currency to stabilize prices in the spot or forward market or to move them in a desired direction. On occasion, the announcement of an intention to intervene might achieve the desired results.

Certificate of inspection. A document often required for shipment of perishable goods in which certification is made as to the good condition of the merchandise immediately before shipment.

Certificate of manufacture. A statement, sometimes notarized, by a producer who is usually also the seller of merchandise that manufacture has been completed and that goods are at the disposal of the buyer.

Certificate of origin. A document issued by the exporter certifying the place of origin of the merchandise to be exported. The information contained in this document is needed primarily to comply with tariff laws that may extend more favorable treatment to products of certain countries.

Chain. A method of calculating cross rates. For example, if a foreign-exchange trader knows the exchange rate for German marks against U.S. dollars and for French francs against U.S. dollars, the ''chain'' makes possible a calculation of the cross rates for German marks against French francs.

Charges forward. A banking term used when foreign and domestic bank commission charges, interest (if any), and government taxes in connection with the collection of a draft are for account of the drawee.

Charges here. A banking term used when foreign and domestic bank commission charges, interest (if any), and government taxes in connection with the collection of a draft are for account of the drawer.

Charter party. A contract, expressed in writing on a special form, between the owner of a vessel and the one (the charterer) desiring to employ the vessel, setting forth the terms of the arrangement, such as freight rate and ports involved in the trip contemplated.

Chicago Board of Trade (CBT). A futures exchange.

Chicago Board Options Exchange (CBOE). An options exchange in which European foreign-currency options on spot exchange are traded.

Chicago Mercantile Exchange (CME). A futures exchange.

Clean collection. A collection in which a draft or other demand for payment is presented without additional attached documentation.

Clean draft. A sight or time draft to which no other documents, such as shipping documents, bills of lading, or insurance certificates, are attached. This is to be distinguished from a documentary draft. See also *Documentary draft*.

Clean risk at liquidation. A type of credit risk that occurs when exchange contracts mature. There may be a brief interval (usually no more than a few hours) during which one of the parties to the contract has fulfilled its obligations, but the other party has not. During this period, the first party is subject to a 100 percent credit risk, on the chance that, in the interval, an event may prevent the second party from fulfilling its obligations under the contract.

Clearing corporation. A clearinghouse that exists as an independent corporation rather than as a subdivision of an exchange.

Clearinghouse. A subdivision of an exchange or an independent corporation through which all trades must be confirmed, matched, and settled daily until offset.

Clearinghouse funds. Funds used in settlement of a transaction that are available for use or that become good funds after one business day.

Clearing House Interbank Payments System (CHIPS). A computerized telecommunications network provided by the New York Clearing House Association (NYCHA), which serves as an automated clearinghouse for interbank funds transfers.

Closing a commitment. Allowing a covered foreign-exchange position to expire on maturity or reversing it before maturity by a swap operation.

Closing a position. Covering open long or short positions by means of a spot operation and/or outright forward operation.

Comanager. A bank ranking just below that of lead manager in a syndicated Eurocredit or an international bond issue. The status of comanager usually indicates a larger share in the loan or a larger bond allotment, and a larger share in the fees, than banks of lower rank. Comanagers may also assist the lead managers in assessing the market or determining terms of the loan.

Combined transport document. A through bill of lading that applies to more than one mode of transport.

Commercial paper. A short-term, unsecured debt instrument issued by a corporation and sold at a discount from its maturity value.

Commercial transaction. A transaction between a dealing bank and a nonbanking (commercial) party.

Commodities Futures Trading Commission (CFTC). A U.S. regulatory body that regulates exchange-based futures trading in the United States.

Commodity Credit Corporation (CCC). An instrument of the federal government whose principal purpose is to provide the necessary financial services to carry forward the public price-support activities, including government lending, purchasing, selling, storing, transporting, and subsidizing certain agricultural commodities.

Common carrier. An individual, partnership, or corporation, such as a shipping line, railroad, or airline, that undertakes for hire to transport persons or commodities from place to place. Governed by special laws, common carriers must accept all business offered them under their regulations.

Compromises. Occasions when both parties agree to alter the terms of an existing foreign-exchange contract. These alterations should be approved by an impartial bank officer and the operations personnel must be advised of each compromise to avoid settlement in accordance with the original terms.

Confirmation. The written communication to the counterparty in a foreign exchange, interbank deposit, or other money market transaction that recites all the relevant details agreed upon by phone or telex.

Confirmed letter of credit. See *Letter of credit*.

Consignment. The physical transfer of goods from a seller (consignor), with whom the title remains, to another legal entity (consignee), who acts as a selling agent, selling the goods and remitting the net proceeds to the consignor.

Consular documents. Bills of lading, certificates of origin, or special forms of invoice that carry the official signature of the consul of the country of destination.

Consular invoice. A detailed statement on the character of goods shipped, which is duly certified by the consul at the port of shipment. Required by certain countries, including the United States, its principal function is to accurately record the types of goods and their quantity, grade, and value for import duty and general statistical purposes.

Contract limit. A maximum limit on the total gross notional principal amount of outstanding contracts booked with one customer.

Contract risk (counterparty risk). Risk that the counterparty will default before settlement.

Convertibility. Freedom to exchange a currency, under certain circumstances, without government restrictions or controls.

Correspondent bank. A bank located in one geographic area that accepts deposits from a bank in another region and provides services on behalf of this other bank. Internationally, many banks maintain one account with a correspondent bank in each major country to be able to make payments in all major currencies. Correspondent banks are usually established on a reciprocal basis.

Cost, insurance, and freight (C.I.F.). A price quotation under which the seller defrays all expenses involved in the delivery of goods.

Counterpart funds. Local currencies deposited in a special account by recipient governments that represent grant aid extended by another government. Those funds, while remaining the property of the recipient government, can generally be used only by agreement of the donor government.

Country exposure. A measurement of the volume of assets and off-balance-sheet items considered to be subject to the risk of a given country. This measurement is based, in part, on identifying the country of domicile of the entity ultimately responsible for the credit risk of a particular transaction.

Country limit. The amount of money that a bank has established as the maximum it is willing to lend borrowers in a given country regardless of the type of borrower or the currencies involved.

Country risk. Refers to the spectrum of risks arising from the economic, social, and political environment of a given foreign country, which could have favorable or adverse consequences for foreigners' debt and/or equity investments in that country.

Cover. The execution of an offsetting foreign-exchange trade to close or eliminate an open exposure.

Covered interest arbitrage. The process of taking advantage of a disparity between the net accessible interest differential between two currencies and the forward exchange premium or discount on the two currencies against each other.

Crawling peg system. An exchange-rate system in which the exchange rate is adjusted every few weeks, usually to reflect prevailing inflation rates.

Credit risk. The possibility that the buyer or seller of foreign exchange or some other traded instrument may be unable to meet his or her obligation on maturity.

Credit swap. A link transaction wherein one party places a deposit in one currency (probably dollars) with a foreign bank during the period that the foreign bank lends another currency to a third party. The deposit serves as an inducement for the transaction, and its value is considered in pricing the loan.

Cross-border exposure. The risk that arises when an office of a bank, regardless of its location or currency, extends credit to a borrower that is located outside the booking unit's national border.

Cross-currency risk. The risk associated with maintaining exchange positions in two foreign currencies as the result of one transaction. For example, if a U.S. operator borrows Swiss francs at 5 percent and invests the proceeds in British pounds at 12 percent, the cross-currency risk is the chance that the pounds will depreciate in value against the Swiss francs to such an extent that there will be a loss on the transaction in spite of the favorable interest-rate differential.

Cross-default. A term used to describe a clause in a syndicated loan or bond contract that gives the lender the right to accelerate repayment of the loan if the borrower defaults on another loan.

Cross-hedging. The hedging of an asset with a futures contract of a different asset.

Cross rate. The ratio between the exchange rates of two foreign currencies in terms of a third currency.

Currency futures and options contracts. An agreement that allows businesses or individuals acquiring or selling foreign currencies to protect themselves against future fluctuations in currency prices by shifting currency risk to someone willing to bear that risk.

Currency liquidity. In a multicurrency investment portfolio, the liquidity of a given foreign currency has to be viewed in terms of exchange liquidity and instrument liquidity. Exchange liquidity depends on the ease with which a currency can be converted into and out of another major currency. Instrument liquidity depends on the ease with which a negotiable instrument denominated in that currency can be purchased and sold without noticeably affecting the market rate for that instrument.

Currency swap. A contractual obligation entered into by two parties to deliver a sum of money in one currency against a sum of money in another currency at stated intervals (or a stated interval) or according to negotiated terms. See *Swap*.

Current account. Those items in the balance of payments involving imports and exports of goods and services as well as unilateral transfers.

Customs union. An agreement between two or more countries in which they arrange to abolish tariffs and other import restrictions on each other's goods and to establish a common tariff for the imports of all other countries.

Date draft. A draft drawn to mature on a fixed date, regardless of its acceptance.

Daylight limit. The maximum net foreign-exchange position that a bank will allow during business hours.

Dealer (or trader). A person who executes foreign-exchange, interbank deposit, or other money market trades for a dealing bank.

Debt for equity swaps. Debt (usually LDC government debt) that is discounted and exchanged for equity in local businesses (often newly privatized).

Debt swaps. The exchange of LDC loans based on the prices quoted in the secondary market. Swaps are often used to decrease exposure to certain countries.

Default risk. The risk to the holder of debt securities that a borrower will not meet all promised payments at the times agreed upon.

Del credore agent. A sales agent who, for a certain percentage above his or her sales commission, guarantees payment to the person for whom he or she is selling on shipments made to the seller's customers.

Delivery. The offset of an obligation to buy or sell an asset by an actual transfer of title to the asset at a prearranged price. In the futures market, the transfer or receipt of a cash instrument against a short or long futures contract.

Delivery order. An order addressed to the holder of goods and issued by anyone who has authority to do so, that is, by one who has the legal right to order delivery of merchandise. A delivery order is not considered a good titled document.

Delivery risk. The possibility that a seller of foreign exchange, having collected the payment in local currency, may fail to deliver the exchange in the foreign center where it was sold. Also called settlement risk.

Delta of an option. The rate of change of the value of an option with respect to the price of the underlying asset, reference rate, or index evaluated at the current market price of that underlier.

Demand draft. A draft that is payable immediately upon presentation to the drawee. This type of draft is also termed a "sight" or "presentation" draft.

Deposit dealer. A term used in the United States for bank personnel responsible for lending and borrowing funds in the interbank market.

Deposit trader. A term used in Europe for bank personnel responsible for lending and borrowing funds in the interbank market.

Depreciation. A drop in the value of a currency relative to the value of another currency.

Depth of the market. The amount of currency that can be traded in the market at a given time without causing a price fluctuation. Thin markets are usually characterized by wide spreads and substantial price fluctuations during a short period of time. Strong markets tend to be characterized by relatively narrow spreads of stable prices.

Derivative instrument. An instrument that is based on or derived from the value of an underlying asset, reference rate, or index. For example, interest-rate futures are based on various types of securities trading in the cash market. Some interest-rate options are derived from interest-rate futures.

Devaluation. An official act wherein the official parity of a country's currency is adjusted downward to the dollar, gold, Special Drawing Rights (SDRs), or another currency. After a devaluation, there are more devalued currency units relative to the dollar, gold, SDRs, or other currency. See also *Revaluation*.

Development bank. A lending agency that provides assistance to encourage economic development.

Direct quote. The method of quoting fixed units of foreign exchange in variable numbers of the local currency unit. Also called a "fixed" or "certain" quotation.

Dirty float (or Managed float). A floating exchange-rate system in which some government intervention still takes place. A government may announce that it will let its currency float, that is, it will let the currency's value be determined by the forces of supply and demand in the market. The government, however, may secretly allow its central bank to intervene in the exchange market to avoid too much appreciation or depreciation of the currency.

Discount.

- *Lending*—To subtract from a loan, when it is first made, the amount of interest that will be due when it is repaid.
- *Foreign exchange*—The amount by which the forward exchange rate of one currency against another currency is less than the spot exchange rate between the two currencies.

- *Financial*—A deduction from the face value of commercial paper, such as bills of exchange and acceptances, in consideration of cash the seller has received before the maturity date. The rates of discount vary according to the state of the given money market, the financial standing of the persons involved, and other circumstances surrounding the transaction.
- *Commercial*—An allowance from the quoted price of goods, usually made by the deduction of a certain percentage from the invoice price.

Discount rate. Most commonly the rate at which a Federal Reserve Bank (or, in many instances, foreign central banks) is prepared to lend to financial institutions against eligible collateral.

Dishonor. Refusal on the part of the drawee to accept a draft or to pay it when due.

Divergence indicator system. One aspect of the European Monetary System that measures the departure of a country's economic policies from the European Union's "average." The measure of divergence is based exclusively on the movement of a country's exchange rate with respect to the European Currency Unit (ECU).

Dock receipt. A receipt issued by an ocean carrier or its agent for merchandise delivered at its dock or warehouse that is awaiting shipment.

Documentary collection. A collection in which a draft is accompanied by shipping or other documents.

Documentary credit. A commercial letter of credit providing for payment by a bank to the named beneficiary, who is usually the seller of merchandise, against delivery of documents specified in the credit.

Documentary draft. A draft to which documents are attached, that is delivered to the drawee upon acceptance or payment of the draft and that ordinarily controls title to the merchandise.

Documents. The shipping and other papers customarily attached to foreign drafts, consisting of ocean bills of lading, marine insurance certificates, and commercial invoices. Certificates of origin and consular invoices may also be required.

Documents against acceptance (D/A). Instructions given by an exporter to a bank that the documents attached to a draft for collection are deliverable to the drawee only against his or her acceptance of the draft.

Documents against payment (D/P). Instructions given by an exporter to his or her bank that the documents attached to a draft for collection are deliverable to the drawee only against his or her payment of the draft.

Domestic bond. A domestic debt security sold by an issuer in its own country and denominated in that country's currency.

Domicile. The place where a draft or acceptance is made payable.

Draft. An order in writing signed by one party (the drawer) requesting a second party (the drawee) to make payment at a determinable future time to a third party (the payee). It may be accompanied by a bill of lading, which the bank will surrender to the buyer upon payment of the draft. The buyer may then claim the goods at the office of the carrier who transported them to the buyer's place of business. See also *Sight draft* or *Time draft*.

Dragon bond. A bond issued by a foreign borrower in an Asian or Pacific country (excluding Japan—see *Samurai bond)*.

Drawee. The addressee of a draft, that is, the person on whom the draft is drawn.

Drawer. The issuer or signer of a draft.

Duration. A time-weighted present-value measure of the cash flow of a loan or security that takes into account the amount and timing of all promised interest and principal payments associated with that loan or security.

Duty. (1) Ad valorem duty (according to the value) is an assessment at a certain percentage rate on the actual value of an article. (2) Specific duty is an assessment on the weight or quantity of an article without reference to its monetary value or market price. (3) Drawback is a recovery in whole or in part of duty paid on imported merchandise at the time of reexportation, whether in the same or different form.

Edge Act. Incorporated as section 25A of the Federal Reserve Act, this act authorizes the Board of Governors to charter corporations (Edge corporations) for the purpose of engaging in international or foreign banking or in other international operations.

Eligible acceptance. A banker's acceptance that meets Federal Reserve requirements related to its financing purpose and term.

Eligible value date. A normal business day on which a payment to settle a money market transaction can be made. An eligible value date for a foreign-exchange transaction must be a business day in the home countries of both of the currencies involved.

Engineered swap transaction. A spot transaction and an offsetting forward transaction in which each of the two transactions is carried out with a different party.

Eurobank. A bank that regularly accepts foreign currency–denominated deposits and makes foreign-currency loans.

Eurobonds. Long-term debt securities denominated in a currency other than that of the country or countries where most or all of the security is sold.

Euroclear. Euroclear Clearance System Limited is one of two main clearing systems in the Eurobond market. Euroclear, which began operations in December 1968, is located in Brussels and managed by Morgan Guaranty. See also *Cedel*.

Eurocurrency. The nonresident ownership of one of the major western European currencies. Eurocurrencies, similar to Eurodollars, are frequently available for borrowing in the London Interbank Market.

Eurocurrency market. The money market for borrowing-and-lending currencies that are held in the form of deposits in banks located outside the countries in which those currencies are issued as legal tender.

Eurodollars. Dollar deposit claims on U.S. banks that are deposited in banks located outside the United States, including foreign branches of U.S. banks. These claims, in turn, may be redeposited with banks or lent to companies, individuals, or governments outside the United States.

Eurodollar deposit rate. The interest rate at which a quoting bank is willing to take wholesale Eurodollar funds with a particular maturity from other than an interbank participant. The rate is usually one-eighth to one-sixteenth of one percent lower than LIBOR.

European Currency Unit (ECU). A portfolio currency used in the European Monetary System as a community ‘‘average’’ exchange rate. It is also used in the private market as a means of payment and as a currency of denomination for lending, borrowing, and trade.

European Monetary System (EMS). An arrangement introduced in March 1979 for economic and monetary cooperation among the members of the European Union. The ultimate aim of the EMS is a single European Currency and the establishment of a European central bank.

European Union (EU). Formerly the European Community, an economic association of European countries founded by the Treaty of Rome in 1957. The goals of the EU are the removal of trade barriers among countries, the formation of a common commercial policy toward non-EU countries, and the removal of barriers restricting competition and the free mobility of factors of production. Members include Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden, and the United Kingdom.

Exchange contracts. Documents issued by foreign-exchange dealers, banks dealing in foreign exchange, and foreign-exchange brokers confirming foreign-exchange transactions.

Exchange control or restrictions. Limits on free dealings in foreign exchange or of free transfers of funds into other currencies and other countries.

Exchange control risk. The possibility of defaults on obligations by imposing or reinforcing exchange control.

Exchange-rate differential. The difference between two exchange rates in a swap transaction.

Exchange rates. The price of one currency in terms of another. See also *Spot exchange, Buying rates, Fixed rate of exchange, Floating rate,* and *Interbank rate of exchange.*

Exchange reserves. The total amount of freely convertible foreign currencies held by a country’s central bank.

Exchange risk. The possibility of a loss on an open position as a result of an appreciation or depreciation of the exchange.

Exercise. The use of the right given by an option: purchase (if a call) or sale (if a put) of an asset at the strike price stated in the option contract.

Exit bonds. Low-interest government bonds issued in LDCs that are equivalent to a portion of the country’s existing bank debt. Designed to facilitate debt management.

Expiration date. The last day on which an option may be exercised.

Export credit insurance. A system to insure the collection of credits extended by exporters against various contingencies. In some countries, only noncommercial risks can be insured.

Export declaration. A document required by the U.S. government for shipments abroad and used to maintain statistics on our exports.

Export-Import Bank of the United States (Eximbank). An institution that provides intermediate and long-term nonrecourse financing for U.S. exports when these facilities are not available from commercial banks. All of the Eximbank’s shares are held by the U.S. Treasury.

Export trading company (ETC). A company designed to facilitate U.S. exports. An ETC may be an affiliate of a bank holding company.

Fail. Nonperformance of an obligation on the specified day, for example, failure to make prompt settlement for either side of a foreign-exchange contract, usually due to a clerical or trader error. A fail usually leads to an interest adjustment for an overdraft in the paying or receiving bank.

F.A.S. See *Free alongside ship*.

Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). This act had various aims, including the least-cost resolution of troubled insured depository institutions, improvement of bank supervision and examinations, and provision of additional resources to the Bank Insurance Fund.

Federal funds. Deposits held by commercial banks at a Federal Reserve Bank. Since reserve requirements of commercial banks are satisfied by federal funds, banks with deposits in excess of required reserves will lend the excess deposits to banks with a reserve shortage at a market-determined interest rate, called the federal-funds rate.

Federal Reserve System. The central bank of the United States, created by the Federal Reserve Act of 1913, consisting of the Board of Governors in Washington, D.C., and 12 regional Federal Reserve Banks. The Federal Reserve controls the country's monetary base and has the power to set reserve requirements, conduct open-market operations, and lend directly to banks.

Fedwire. The large-value payment mechanism owned and operated by the Federal Reserve System. Fedwire provides depository institutions with real-time settlement in the central bank of funds transfers and book-entry securities transfers made for their own account or on behalf of their customers.

Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA). The purpose of this act was to reform, recapitalize, and consolidate the federal deposit insurance system and to enhance the regulatory and enforcement powers of federal financial institutions' regulatory agencies.

Fixed exchange-rate system. A system in which the exchange rate of a country's currency is tied to one major currency, such as the U.S. dollar.

Fixed rate of exchange. A rate of exchange set by a foreign government relative to the dollar, gold, another currency, or perhaps Special Drawing Rights. It remains in effect as long as that government is willing or able to buy and sell at the set rates.

Fixed-rate payer. A position applicable to a rate swap, in which the fixed payer pays the fixed rate and receives the floating rate.

Flexible rate of exchange. A rate of exchange subject to relatively frequent changes. It is determined by market forces but subject to various floors or ceilings relative to the dollar, gold, Special Drawing Rights, or another currency when the rate fluctuates beyond certain parameters.

Floating exchange-rate system. A system in which the values of the currencies of various countries relative to each other are established by supply and demand forces in the market without government intervention.

Floating rate. A rate of exchange that is determined completely by market forces with no floor or ceiling vis-a-vis the dollar, gold, Special Drawing Rights, or another currency.

Floating-rate notes. Bonds that pay interest at an agreed margin above a market reference rate. The interest rate varies according to variations in the market reference rate.

Floating-rate payer. A position applicable to a rate swap, in which the floating payer pays the floating rate and receives the fixed rate.

F.O.B. See *Free on board (destination* or *vessel)*.

Foreign Bank Supervision Enhancement Act (FBSEA). Part of the FDIC Improvement Act of 1991, FBSEA expanded the supervisory authority of the Federal Reserve over the U.S. operations of foreign banks.

Foreign bonds. Bonds issued by nonresidents but underwritten primarily by banks registered in the country where the issue is made.

Foreign Credit Insurance Association (FCIA). An insurance company established under the auspices of Eximbank. Insurers trade credits granted by U.S. suppliers of products to purchasers abroad who qualify as normal risks. The insurance protects the exporter, up to an agreed percentage, against any nonpayment resulting from commercial or political risks, or both. Eximbank provides reinsurance for the entire portion of the commercial credit risk and is the sole insurer of the political risk.

Foreign currency. The currency of any foreign country that is the authorized medium of circulation and the basis for recordkeeping in that country. Foreign currency is traded by banks either by the actual handling of currency and checks or by the establishment of balances in foreign currencies with banks in those countries.

Foreign deposits. Those deposits that are payable at a financial institution outside the jurisdiction of the U.S. government and in the currency of the country in which the depository is located. See also *Nostro account*.

Foreign draft. An official bank order drawn on a foreign correspondent bank to pay on demand to a designated payee a specific sum of foreign money or U.S. dollars at the drawee's buying rate.

Foreign exchange. The trading or exchange of a foreign currency in relation to another currency.

Foreign-exchange futures contracts. Standardized contracts traded on an organized futures exchange and settled through the clearinghouse of the exchange. Each contract defines the currencies, contract amounts, and delivery dates for its own contracts.

Foreign-exchange market. Communications between dealers and brokers to transact wholesale business in foreign exchange and Eurocurrencies.

Foreign-exchange rationing. A government requirement that all holders of bills of exchange relinquish them at a stipulated rate.

Foreign-exchange reserves (official). The reserves maintained by a central bank, which usually include gold and easily traded currencies of major industrial nations.

Foreign-exchange risk. The risk associated with exposure to fluctuation in spot exchange rates.

Foreign Investment Advisory Service (FIAS). Established in 1986, FIAS counsels developing countries on attracting foreign capital. FIAS operates under the aegis of the World Bank and its affiliates, the International Finance Corporation and the Multilateral Investment Guarantee Agency.

Foreign trade zone. An area where goods may be received and stored without entering a country's customs jurisdiction and without paying duty. Sometimes called a "free trade zone."

Forward book. The aggregate of all forward contracts for a given currency or all currencies.

Forward contract. A contract that obligates one party to sell and another to buy a specific asset for a specified price at a designated time.

Forward discount ("at a forward discount"). A phrase used to describe a currency whose forward price is cheaper than its spot price.

Forward exchange. Foreign currency traded for settlement beyond two working or business days from today.

Forward exchange position. The long or short position that a dealer may have in the forward market, as compared to spot dealing.

Forward exchange risk. The possibility of a loss on a covered position as a result of a change in the swap margin.

Forward-forward dealing. The simultaneous purchase and sale of a currency for different forward dates.

Forward premium ("at a forward premium"). A phrase used to describe a currency whose forward price is more expensive than its spot price.

Forward purchase. An outright purchase of a forward contract.

Forward rates. The actual rates at which foreign exchange for future delivery are quoted, bought, and sold.

Forward swap. A transaction in which the initial fixed- and floating-rate payments are deferred until a future period of time.

Forward transaction date. Value dates that are more than two business days following the trade date. Regular forward dates are 30, 60, and 90 days from the trade date.

Free alongside ship (F.A.S.). A term for a price quotation under which the seller delivers merchandise free of charge to the steamer's side and pays lighterage expenses up to that destination, if necessary.

Free on board (F.O.B.) (destination). A term for a price quotation under which the seller undertakes at his or her risk and expense to load the goods on a carrier at a specified location. Expenses subsequent thereto are for account of the buyer.

Free on board (F.O.B.) (vessel). A term for a price quotation under which the seller delivers the goods at his or her expense on board the steamer at the location named. Subsequent risks and expenses are for account of the buyer.

Free port. A foreign trade zone, open to all traders on equal terms, where merchandise may be stored duty-free pending its reexport or sale within that country.

Free trade area. An arrangement between two or more countries for free trade among themselves, although each nation maintains its own independent tariffs toward nonmember nations. It should not be confused with "free trade zone," which is synonymous with "foreign trade zone."

Fungible securities. Securities that are not individually designated by serial number as belonging to a particular owner. Instead, a clearing system or depository institution credits owners with a given number of a particular bond issue (or other security issue). The owner may have title to 50 bonds, but not to 50 specific bonds with designated serial numbers.

Futures commission merchant (FCM). A firm that is registered with the CFTC and legally authorized to solicit or accept orders from the public for the purchase or sale of futures contracts. Acts as an intermediary between a public customer and a floor broker.

Futures contract. An exchange-traded contract in which one party agrees to buy a security and another agrees to sell a security in the future. If held until maturity, the futures contract may involve accepting (if long) or delivering (if short) the asset on which the futures price is based.

Futures market. A market in which contracts are traded for future delivery of commodities, currencies, and financial instruments. The purchase or sale of a futures contract requires that a deposit, called margin, be maintained with a broker. The market is designed in such a way that it is easy to get out of a contract or cancel. The vast majority of participants, the buyers and sellers of futures contracts, do not intend to take delivery or deliver what they bought or sold. Futures contracts are used as an investment vehicle and as a vehicle for hedging positions.

G-10 countries. The informal term for the Group of 10 countries, which consists of Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, the United Kingdom, and the United States. Switzerland joined in 1984, but the name remains as is.

Gap. The period, in foreign-exchange transactions, between the maturities for purchases and those for sales of each foreign currency (exchange gap). In money market transactions, the period between the maturities of placements (loans) and the maturities of borrowing (deposits) of each currency (money market gap). The former occurs when a currency is purchased against one currency and sold against another, each time for different maturities. The money market gap is created by lending an amount of a certain currency for a longer or shorter period than that for which the same currency is borrowed.

Global bond. A temporary debt certificate issued by a Eurobond borrower, representing the borrower's total indebtedness. The global bond will subsequently be replaced by individual bearer bonds.

Global line. A bank-established aggregate limit that sets the maximum exposure the bank is willing to have to any one customer on a worldwide basis. See also *Multicurrency line*.

Gray market. A forward market for newly issued bonds that takes the form of forward contracting between market participants during the period between the announcement day of a new issue and the day final terms of the bond issue are signed. Bonds are traded at prices stated at a discount of premium to the issue price.

Group of Seven (G-7). A group of industrialized countries comprising Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States.

Guidance line. An authorization, unknown to the customer, for a line of credit. If communicated to the customer, the guidance line becomes an advised line of credit commitment.

Hard currency. The term ‘‘hard currency’’ is a carryover from the days when sound currency was freely convertible into ‘‘hard’’ metal, that is, gold. It is used today to describe a currency that is sufficiently sound so that it is generally accepted internationally at face value.

Hedging. A transaction used by dealers in foreign exchange, commodities, or securities, as well as manufacturers and other producers, to protect against severe fluctuations in exchange rates and prices. A current sale or purchase is offset by contracting to purchase or sell at a specified future date. The object is to defer a profit or loss on the current purchase or sale by realizing a profit or loss on a future purchase or sale. The hedge contract may run for a period that coincides with the expected liquidation of the asset or it may merely last for one, three, six, or twelve months to offset the exchange risk for an asset that is expected to be held for a long term, in which case the choice of the term of the hedge is a matter of relative cost and judgment. Also referred to as ‘‘covering.’’

Host currency. See *Local currency*.

Hot money. Funds temporarily transferred to a financial center and subject to withdrawal at any moment.

ICERC. See *Interagency Country Exposure Review Committee*.

Impact loan. A loan specifically designated by a government as important for the development of the country. It usually involves production for export. The term is most often used in regard to Japanese loans.

Implied forward rate. The rate of interest at which a borrowing or a lending transaction of a shorter maturity may be rolled over to yield an equivalent interest rate with a borrowing or a lending transaction of longer maturity.

Indirect quote. Quotation of a fixed unit of the local currency in variable units of foreign currencies.

Ineligible acceptance. An acceptance that does not meet the Federal Reserve eligibility requirements for use at the discount window.

In the money. A term used to refer to a call option whose strike price is below or a put option whose strike price is above the current price of the asset on which the option is written.

Initial margin. The minimum deposit a futures exchange requires from customers for any futures contract in which a customer has a net long or short position.

Interagency Country Exposure Review Committee (ICERC). A nine-member joint committee of three federal regulatory agencies established to administer the country risk supervision program. ICERC centralizes decision making for determinations about the credit-worthiness of individual countries.

Interbank offered rate (IBOR). The rate at which banks will lend to other banks for a particular currency at a particular location.

Interest arbitrage. Involves the movement of short-term funds from one currency to another for the purpose of investing idle funds at a higher yield. However, the real yield advantage in this situation is not merely the difference in interest rates between the two investment choices, but rather the difference in subtracting the cost of transferring funds into the desired currency and back again from the interest differential. There are four types of interest arbitrage: (1) covered interest arbitrage (transfer of short-term funds into a foreign currency for the sake of a higher yield, with the exchange risk covered), (2) inward interest arbitrage (transfer of short-term funds into local currency for a higher yield), (3) outward interest arbitrage (transfer of short-term funds into a foreign currency for a higher yield), and (4) uncovered interest arbitrage (transfer of short-term funds into a foreign currency for a higher yield, without covering the exchange risk).

Interest negative. The commission charged on foreign deposits on which no interest is allowed.

Interest parities. Differences at a given time between interest rates charged in two financial centers on short-term credits, investments, or time deposits of identical maturities.

Interest rate. The amount (generally expressed as a per annum percentage) of money charged for allowing another party the use of one's money.

Interest-rate cap. A transaction whereby a bank pays a fee up-front and will later receive payments if a designated interest rate exceeds a minimum threshold established in the contract. If during the contract, interest rates do not exceed the threshold, the bank loses the initial fee paid. By contrast, if interest rates exceed the threshold, a bank will receive progressively higher payments to offset higher interest expense. The payment received represents the difference between the designated rate and the threshold.

Interest-rate collar. The collar combines an interest-rate cap and a floor. A bank buys a cap and pays a fee, which protects the institution should interest rates exceed a stated threshold. The bank simultaneously sells a floor and receives a fee to offset the cost of the cap. The collar establishes a band of interest rates for liabilities—rates cannot exceed the cap's ceiling or the floor's minimum.

Interest-rate differential. The difference between the interest rates on two different currencies. Also the swap rate between two currencies expressed as a per annum percentage premium or discount.

Interest-rate floor. The floor obligates a seller to pay funds to the buyer if a specified interest rate falls below a strike rate.

Interest-rate futures. Interest-rate futures contracts offer a vehicle through which banks can shift interest-rate risk to the market for financial futures. Interest-rate futures are analogous to futures contracts on commodities. See also *Futures market*.

Interest-rate swap. A contractual obligation entered into by two parties to deliver a fixed sum of money against a variable sum of money at periodic intervals. It typically involves an exchange of payments on fixed- and floating-rate debt. If the sums involved are in different currencies, the swap is simultaneously an interest-rate swap and a currency swap.

International Banking Act of 1978 (IBA). The principal legislation pertaining to the activities of foreign banks in the United States. It established a policy of national treatment of foreign banks with regard to their operations in the United States.

International banking facility (IBF). A set of asset and liability accounts segregated on the books and records of a depository institution, U.S. branch or agency of a foreign bank, or an Edge Act or agreement corporation. IBF activities are essentially limited to accepting deposits from and extending credit to foreign residents (including banks), other IBFs, and the institutions establishing the IBF. IBFs are not required to maintain reserves against their time deposits or loans. IBFs may receive certain tax advantages from individual states.

International Center for Settlement of Investment Disputes (ICSID). See *World Bank*.

International Lending Supervision Act (ILSA). Enacted in 1983, the act requires U.S. banking agencies to consult with bank supervisory authorities in other countries to achieve consistent policies and practices in international lending.

International Monetary Fund (IMF). A specialized agency of the United Nations, the IMF encourages monetary cooperation, promotes stable exchange policy, and makes short-term advances and standby credits to members experiencing temporary payments difficulties. Its resources come mainly from subscriptions of members.

International Money Market of the Chicago Mercantile Exchange (IMM). The IMM is one of the world's largest markets for foreign-currency and Eurodollar futures trading.

International Swap Derivatives Association (ISDA). A trade association for derivative contracts.

Intervention. The actions of a central bank designed to influence the foreign-exchange rate of its currency. The bank can use its exchange reserves to buy its currency if it is under too much downward pressure or to sell its currency if it is under too much upward pressure.

Intracountry foreign-currency exposure. The risk that exists whenever a subsidiary or a branch lends, invests, places, or extends credit to entities that are located within the same country as the booking unit, but in a currency different from that of the country where the borrower and the booking unit are located.

Intraday position. The size of spot and forward positions allowed for a dealer during the business day, which may be larger than that allowed for the end of the date. Sometimes also called ''daylight'' limits.

Intrinsic value. The amount, if any, by which the current market price of the underlying instrument is above the exercise price for calls and below the exercise price for puts.

Issue price. The price at which a new issue of securities is placed on sale.

Joint venture. The participation of two or more entities in a single business activity. Used to facilitate entry into a market in which other forms of operation may be proscribed.

Last trading date. The final day on a futures or options exchange when trading may occur in a given futures contract month or in a given option series.

Latin American Free Trade Association (LAFTA). An association consisting of Argentina, Brazil, Colombia, Ecuador, Mexico, Paraguay, Peru, and Uruguay.

Lead manager. The commercial or investment bank with the primary responsibility for organizing a syndicated bank credit or bond issue. This includes the recruitment of additional lending or underwriting banks, the negotiation of terms with the borrower, and the assessment of market conditions.

Lending margin. The fixed percentage above the reference rate paid by a borrower in a rollover credit or on a floating-rate note.

Letter of credit—advised. An export letter of credit issued by a bank that requests another bank to advise the beneficiary that the credit has been opened in its favor. This occurs when the issuing bank does not have an office in the country of the beneficiary and uses the facilities of the advising bank. The advising bank is potentially liable only for its own error in making the notification.

Letter of credit—back-to-back. A letter of credit issued on the strength (or ''backing'') of another letter of credit, involving a related transaction and nearly identical terms. For example, ABC company in the United States is designated as the beneficiary of an irrevocable letter of credit confirmed by a U.S. bank to supply XYZ company in Bolivia, whose bank issued the letter of credit, with goods to be purchased from a third company. The third company, however, will not fill ABC's order unless it receives prepayment for the goods, either through cash or some other type of financing. If ABC is unable to prepay in cash, it will request its bank to issue a letter of credit in favor of the third company. If ABC's bank agrees, the domestic credit is then ''backed'' by the foreign letter of credit and a back-to-back letter-of-credit transaction exists.

Letter of credit—cash. A letter addressed from one bank to one or more of its correspondents that makes available to a party named in the letter a fixed sum of money up to a future specific date. The sum indicated in the letter is equal to an amount deposited in the issuing bank by the party before the letter is issued.

Letter of credit—commercial. A letter addressed by a bank, on behalf of a buyer of merchandise, to a seller authorizing the seller to draw drafts up to a stipulated amount under specified terms and undertaking conditionally or unconditionally to provide payment for drafts drawn.

- *Confirmed irrevocable letter of credit*—A letter in which a bank in addition to the issuing bank is responsible for payment.
- *Irrevocable letter of credit*—A letter in which the issuing bank waives all right to cancel or in any way amend without consent of the beneficiary or seller.
- *Revocable letter of credit*—A letter in which the issuing bank reserves the right to cancel or amend that portion of the amount that has not been demanded before the actual payment or negotiation of drafts drawn.
- *Revolving credit*—A letter in which the issuing bank notifies a seller of merchandise that the amount of credit when used will again become available, usually under the same terms and without the issuance of another letter.
- *Special clauses*—
  - *Green clause*—Similar to the red clause letter of credit below, except that advance payment is made, generally upon presentation of warehouse receipts evidencing storage of the goods.
  - *Red clause*—A clause permitting the beneficiary to obtain payment in advance of shipment so that the seller may procure the goods to be shipped.
  - *Telegraphic transfer clause*—A clause in which the issuing bank agrees to pay the invoice amount to the order of the negotiating bank upon receipt of an authenticated cablegram from the latter that the required documents have been received and are being forwarded.

Letter of credit—confirmed. A letter of credit issued by the local bank of the importer and to which a bank, usually in the country of the exporter, has added its commitment to honor drafts and documents presented in accordance with the terms of the credit. Thus, the beneficiary has the unconditional assurance that, if the issuing bank refuses to honor the draft against the credit, the confirming bank will pay (or accept) it. In many instances, the seller (exporter) may ask that the letter of credit be confirmed by another bank when the seller is not familiar with the foreign issuing bank or as a precaution against unfavorable exchange regulations, foreign-currency shortages, political upheavals, or other situations.

Letter of credit—deferred payment. A letter of credit under which the seller's draft specifies that the draft is payable at a later date, for example, 90 days after the bill-of-lading date or 90 days after presentation of the documents.

Letter of credit—export. A letter of credit opened by a bank, arising from the financing of exports from a country. The issuing bank may request another bank to confirm or advise the credit to the beneficiary. If confirmed, the credit becomes a confirmed letter of credit, and, if advised, it becomes an advised (unconfirmed) letter of credit.

Letter of credit—guaranteed. A letter of credit guaranteed by the customer (applicant) and often backed by collateral security. In domestic banks, the payment of drafts drawn under this credit is recorded in the general-ledger asset account "Customer Liability—Drafts Paid Under Guaranteed L/C."

Letter of credit—import. A letter of credit issued by a bank on behalf of a customer who is importing merchandise into a country. Issuance of an import credit carries a definite commitment by the bank to honor the beneficiary's drawings under the credit.

Letter of credit—irrevocable. A letter of credit that cannot be modified or revoked without the customer's consent or that cannot be modified or revoked without the beneficiary's consent.

Letter of credit—negotiation. A letter of credit requiring negotiation (usually in the locality of the beneficiary) on or before the expiration date. The engagement clause to honor drafts is in favor of the drawers, endorsers, or bona fide holders.

Letter of credit—nontransferable. A letter of credit that the beneficiary is not allowed to transfer in whole or in part to any party.

Letter of credit—reimbursement. A letter of credit issued by one bank and payable at a second bank that, in turn, draws on a third bank for reimbursement of the second bank's payment to the beneficiary. Those credits are generally expressed in a currency other than that of the buyer (issuing bank) or the seller, and, because of wide acceptability, many are settled in the United States through yet another bank as the reimbursing agent. Upon issuance, the correspondent sends the reimbursing bank an authorization to honor drawings presented by the negotiating bank.

Letter of credit—revocable. A letter of credit that can be modified or revoked by the issuing bank up until the time payment is made.

Letter of credit—revolving. A letter of credit issued for a specific amount that renews itself for the same amount over a given period. Usually, the unused renewable portion of the credit is cumulative as long as drafts are drawn before the expiration of the credit.

Letter of credit—standby. A letter of credit or similar arrangement, however named or described, that represents an obligation to the beneficiary on the part of the issuer—

- to repay money borrowed by or advanced to or for the account party,
- to make payment on account of any indebtedness undertaken by the account party, or
- to make payment on account of any default by the account party in the performance of an obligation.

Letter of credit—straight. A credit requiring presentation on or before the expiration date at the office of the paying bank. The engagement clause to honor drafts is in favor of the beneficiary only.

Letter of credit—transferable. A credit under which the beneficiary has the right to give instructions to the bank called upon to effect payment or acceptance to make the credit available in whole or in part to one or more third parties (second beneficiaries). The credit may be transferred only upon the express authority of the issuing bank and provided that it is expressly designated as transferable. It may be transferred in whole or in part, but may only be transferred once.

Letter of credit—traveler's. A letter of credit addressed to the issuing bank's correspondents, authorizing them to negotiate drafts drawn by the beneficiary named in the credit upon proper identification. The customer is furnished with a list of the bank's correspondents. Payments are endorsed on the reverse side of the letter of credit by the correspondent banks when they negotiate the drafts. This type of letter of credit is usually prepaid by the customer.

Letter of credit—usance. A letter of credit that calls for payment against time drafts, drafts calling for payment at some specified date in the future. Usance letters of credit allow buyers a grace period of a specified number of days, usually not longer than six months.

London Interbank Offered Rate (LIBOR). The rate at which, theoretically, banks in London place Eurocurrencies/Eurodollars with each other.

London International Financial Futures Exchange (LIFFE). A London exchange where foreign-currency and Eurodollar futures, as well as foreign-currency options, are traded on spot exchange.

Limits (bank customer—foreign-exchange and interbank). Maximum line amounts allowed with other banks for forward exchange transactions, Eurocurrency and Eurodollar transactions, and payments arising from foreign-exchange transactions on the same day.

Listing. The formal process required to have a security regularly quoted on an exchange. Eurobonds are usually listed so that they can be purchased by those institutional investors who are constrained to invest in listed securities.

Local-currency exposure. The amount of assets and nonbalance-sheet items that are denominated in the local currency of that country.

Lock-up. The term used to refer to procedures followed in a Eurobond issue to prevent the sale of securities to U.S. investors during the period of initial distribution.

Long position. An excess of assets (and/or forward purchase contracts) over liabilities (and/or forward sale contracts) in the same currency. A dealer's position when the net purchases and net sales leave him or her in a net-purchased position.

Loro accounts. Current accounts banks hold with foreign banks in a foreign currency on behalf of their customers.

Maintenance margin. The minimum equity a futures exchange requires in a customer's account for each futures contract subsequent to deposit of the initial margin.

Managed float. See *Dirty float*.

Management fee. The fee received by lead banks as compensation for managing a large-syndicate financing.

Manager of participation. The original lender of any loan in which participations are later sold and who generally has a fiduciary relationship with the other lenders. See also *Agent bank*.

Manager of syndicate. The bank that solicits the loan from the borrower and solicits other lenders to join the syndicate making the loan.

Margin. The amount of money and/or securities that must be posted as a security bond to ensure performance on a contract.

Marine insurance. Insurance for losses arising from specified marine casualties. Marine insurance is more extensive than other types as it may provide not merely for losses arising from fire, but also from piracy, wrecks, and most injuries sustained at sea.

- *Average*—A term in marine insurance signifying loss or damage to merchandise.
- *General average*—A loss arising from a voluntary sacrifice of any portion of a shipment or cargo to prevent loss of the whole and for the benefit of all persons at interest. The value of this loss is apportioned not only among all the shippers, including those whose property is lost, but also to the vessel itself. Until the assessment is paid, a lien lies against the whole cargo.
- *Particular average*—A partial loss or damage of merchandise caused by a peril insured against and that does not constitute a general average loss.
- *Free of particular average (F.P.A.)*—Insurance against partial loss regardless of the percentage of the loss.
- *Casco insurance*—Marine insurance on the ship itself (hull) that is usually purchased by the owners.
- *Cover note*—English equivalent of American binder.
- *Open policy*—A contract between an insurance company and a shipper by which all shipments made by the insured are automatically protected from the time the merchandise leaves the initial shipping point until delivery at destination.

Mark-to-market. The revaluation of a traded asset or commodity to reflect the most recently available market price.

Market-maker. A bank or other financial institution that gives two-sided (bid and offer) quotations. A market-maker stands prepared to do business on either side of the market without knowing if the inquiring institution intends to buy or sell.

Market order. An order that is to be executed immediately at the best available price in the market.

Matched. A forward purchase is matched when it is offset by a forward sale for the same date or vice versa. As a necessity, however, when setting limits for unmatched positions, a bank may consider a contract matched if the covering contract falls within the same week or semimonthly period.

Maturity date. The settlement date or delivery date for a forward contract.

Medium-term notes. Intermediate-term notes that carry a maturity between nine months and ten years.

Merchant bank. A European form of an investment bank.

Money market. A wholesale market for low-risk, highly liquid, short-term debt instruments.

Multicurrency line. A line of credit that gives the borrower the option of using any of the readily available major currencies.

Multilateral exchange contract. An exchange contract involving two foreign currencies against each other, for example, a contract for U.S. dollars against French francs made in London or a contract for British pounds against German marks made in New York. Also called an arbitrage exchange contract.

Multinational bank. A commercial bank engaged in selling services or conducting operations in more than one country.

Nationalization. The act whereby a central government assumes ownership and operation of private enterprises within its territory.

Negative interest. A fee charged by a bank for accepting a deposit from a customer. This can happen when a currency is under pressure to appreciate. A central bank in this situation can establish capital-import controls and limit the amount of deposits that a bank can receive from nonresidents. If market participants want to deposit more money in the country than the central bank will allow, interest rates will drop initially to zero and, if the pressure continues, produce negative interest. Any taxes that a central bank may impose on foreign deposits can also create negative interest.

Negative pledge. A contractual promise by a borrower in a syndicated loan or a bond issue not to undertake some future action. One typical negative pledge is that future new creditors will not be given rights greater than those of existing creditors.

Negotiable instruments. Written orders or promises to pay that may be transferred by endorsement or delivery, for example, by checks, bills of exchange, drafts, and promissory notes. Governed by article 3 of the Uniform Commercial Code.

Negotiate. (1) Letters of credit—To verify that the documents presented under a letter of credit conform to requirements and then, if the documents are in order, to pay the seller of the goods. (2) Negotiable instruments—To transfer possession of an instrument by a person other than the issuer to another person who thereby becomes its holder.

Net accessible interest differential. The difference between the interest rates that can actually be obtained on two currencies. This difference is usually the basis of the swap rate between the two currencies and, in most cases, is derived from external interest rates rather than domestic ones. These external rates, or Euro-rates, are free from reserve requirements (which would increase the interest rate) and from exchange controls (which would limit access to the money).

Net exchange position. An imbalance between all the assets and purchases of a currency, and all the liabilities and sales of that currency.

Net position. A bank has a net position in a foreign currency when its assets (including future contracts to purchase) and liabilities (including future contracts to sell) in that currency are not equal. An excess of assets over liabilities, including future contracts, is called a net "long" position, and liabilities in excess of assets result in a net "short" position. A net long position in a currency that is depreciating results in a loss because, with each day, the position is convertible into fewer units of local currency. A net short position in a currency that is appreciating represents a loss because, with each day, satisfaction of the position costs more units of local currency.

Netting arrangement. Agreement by two counterparties to examine all contracts settling in the same currency on the same day and to agree to exchange only the net currency amounts. Also applies to net market values of several contracts.

Nominal interest rate. The interest rate stated as a percentage of the face value of a loan. Depending on the frequency of interest collection over the life of the loan, the nominal rate may differ from the effective interest rate.

Nonrevolving. A line of credit that cannot be reused once it has been drawn down to a specified amount.

Nostro accounts. Demand accounts of banks with their correspondents in foreign countries in the currency of that country. These accounts are used to make and receive payments in foreign currencies for a bank's customers and to settle maturing foreign-exchange contracts. Also called due from foreign bank—demand accounts, our balances with them, or due from balances.

Novation. The substitution of a new party for one of the original parties to a contract. The result is a new contract with the same terms, but at least one new party.

Odd dates. Deals within the market are usually for spot, one month, two months, three months, or six months forward. Other dates are odd dates, and prices for them are frequently adjusted with more than a mathematical difference. Hence, most market deals are for regular dates, although commercial deals for odd dates are common.

Offer rate. The price at which a quoting party is prepared to sell or lend currency. This is the same price at which the party to whom the rate is quoted will buy or borrow if it desires to do business with the quoting party. The opposite transactions take place at the bid rate.

Offering circular. A document giving a description of a new securities issue, as well as a description of the entity making the issue.

Office of Foreign Asset Control (OFAC). An office within the U.S. Treasury Department that administers U.S. laws imposing economic sanctions against targeted hostile foreign countries. While OFAC is responsible for administration of these statutes, all of the bank regulatory agencies cooperate in ensuring compliance.

Official rate. The rate established by a country at which it permits conversion of its currency into that of other countries.

Offshore branch. Banking organization designed to take advantage of favorable regulatory or tax environments in another country. Many of these operations are shell branches with no physical presence.

Offshore dollars. The same as Eurodollars, but encompassing the deposits held in banks and branches anywhere outside of the United States, including Europe.

Open contracts (open positions). The difference between long positions and short positions in a foreign currency or between the total of long and short positions in all foreign currencies. Open spot or open forward positions that have not been covered with offsetting transactions. See also *Net position*.

Open interest. The total number of futures contracts for a particular asset that have not been liquidated by an offsetting trade or that have not been fulfilled by delivery.

Open market operations. Purchases or sales of securities or other assets by a central bank on the open market.

Open position limit. A limit placed on the size of the open position in each currency to manage off-balance-sheet items.

Opening bank. The bank that draws up and opens the letter of credit and that makes payment according to the conditions stipulated.

Option contract. A contract giving the purchaser the right, but not the obligation, to buy (call option) or sell (put option) an asset at a stated price (strike or exercise price) on a stated date (European option) or at any time before a stated date (American option).

Organization for Economic Cooperation and Development (OECD). Founded as a successor organization to the Organization for European Economic Cooperation (OEEC). The OEEC was originally established to administer aid under the Marshall Plan during the post-World War II period. The goals of the successor OECD are to stimulate world trade, economic growth, and economic development. Members include Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Japan, Luxembourg, Mexico, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States.

Organization of American States (OAS). An organization of 21 American republics (not including Canada) formed to promote intergovernmental cooperation in the Western Hemisphere.

Organization of the Petroleum Exporting Countries (OPEC). A federation of oil-exporting countries that sets petroleum prices for member countries. Members include Iran, Iraq, Kuwait, Saudi Arabia, and Venezuela.

Other transfer risk problems (OTRP). A category assigned by the Interagency Country Risk Exposure Review Committee (ICERC) for countries near default or in noncompliance with their debt requirements.

Out-of-the-money. A term used to refer to a call option whose strike price is above or to a put option whose strike price is below the current price of the asset on which the option is written.

Outright. Forward exchange bought and sold independently from a simultaneous sale or purchase of spot exchange.

Outright forward rate. A forward exchange rate that is expressed in terms of the actual price of one currency against another, rather than, as is customary, by the swap rate. The outright forward rate can be calculated by adding the swap premium to the spot rate or by subtracting the swap discount from the spot rate.

Overbought. The position of a trader who has bought a larger amount of a commodity or asset than he or she has sold.

Overnight. A swap transaction involving same-day settlement of the spot transaction against a value date of the next business day on the forward contract.

Overnight position. A foreign-exchange or money market position maintained overnight. There is more risk involved in this position than in one maintained during the day because political and economic events may take place at night when the operator cannot react immediately to them.

Override limit. The total amount of money (measured in terms of a bank's domestic currency) that the bank is willing to commit to all foreign-exchange net positions.

Oversold. The position of a trader who has sold a larger amount of a certain asset or commodity than he or she has bought.

Over-the-counter (OTC). Transactions not conducted in an organized exchange. OTC markets have no fixed location or listing of products.

Paris Club. An ad hoc group of western creditor governments that meets informally under the chairmanship of the French Treasury. Its function is to start the process of rescheduling a country's official debt.

Parity. A term derived from par, meaning the equivalent price for a certain currency or security relative to another currency or security, or relative to another market for the currency or security after making adjustments for exchange rates, loss of interest, and other factors.

Parity grid. The system of fixed bilateral par values in the European Monetary System. The central banks of the countries whose currencies are involved in an exchange rate are supposed to intervene in the foreign-exchange market to maintain market rates within a set range defined by an upper and a lower band around the par value.

Participation. The act of taking part in a syndicated credit or a bond issue.

Par value. The official parity value of a currency relative to the dollar, gold, Special Drawing Rights, or another currency.

Paying agent. A bank or syndicate of banks responsible for paying the interest and principal of a bond issue to bondholders on behalf of the bond issuer.

Performance bond. A bond supplied by one party to protect another against loss in the event of the default of an existing contract.

Placement memorandum. A document in a syndicated Eurocredit that sets out details of the proposed loan and gives information about the borrower.

Political risk. Political changes or trends, often accompanied by shifts in economic policy, that may affect the availability of foreign exchange to finance private or public external obligations. The banker must understand the subtleties of current exchange procedures and restrictions, as well as the possibilities of war, revolution, or expropriation in each country with which the bank transacts business, regardless of the actual currencies involved.

Portfolio investment. An investment in an organization, other than a subsidiary or joint venture, in which less than 20 percent of the voting shares are held.

Position. A situation created through foreign-exchange contracts or money market contracts in which changes in exchange rates or interest rates could create profits or losses for the operator.

Position book. A detailed, ongoing record of an institution's dealings in a particular foreign-currency or money market instrument.

Position risk. See *Net position*.

Position-trader. A speculator in the futures market who takes a position in the market for a period of time.

Premium. The adjustment to a spot price that is made in arriving at a quote for future delivery. If a dealer were to quote $2.00 and $2.05 (bid and asked) for sterling, and the premiums for six months forward are 0.0275 and 0.0300, the forward quotes would be adjusted to $2.0275 and $2.0800. The premium usually represents differences in interest rates for comparable instruments in two countries. However, in periods of crisis for a currency, the premium may represent the market anticipation of a higher price.

Price quotation system. A method of giving exchange rates in which a certain specified amount of a foreign currency (1 or 100, usually) is stated as the corresponding amount in local currency.

Primary dealers. Securities firms that are recognized by the Federal Reserve System to buy and sell securities with the Fed.

Private placement. The process of negotiating for the sale of securities, debt, equity, or a combination thereof to a relatively small group of investors.

Protest. The formal legal process of demanding payment of a negotiable item from the maker or drawee who has refused to pay.

Public Law (P.L.) 480. The most common reference to the Agricultural Trade Development and Assistance Act of 1954. Generally, P.L. 480 authorizes the President to provide various types of assistance to American agricultural exporters, such as making sales in the currency of the destination country.

Put. The ability of the bank to require repayment of the debt of a borrower by a third party because of nonperformance of the borrower through an agreement other than a formal guarantee.

Put option. A contract giving the purchaser the right, but not the obligation, to sell a particular asset at a stated strike price on or before a stated date.

Rate risk. In the money market, the chance that interest rates may rise when an operator has a negative money market gap (a short position) or that interest rates may go down when the operator has a positive money market gap (a long position). In the exchange market, the chance that the spot rate may rise when the trader has a net oversold position (a short position), or that the spot rate may go down when the operator has a net overbought position (a long position).

Rate swap. A transaction in which one participant pays a fixed rate of interest on a notional amount for a given period of time and the other pays a floating rate.

Reciprocal rate. The price of one currency in terms of a second currency, when the price of the second currency is given in terms of the first.

Recourse. The ability to pursue judgment for a default on a negotiable instrument against parties who signed the note.

Rembrandt bonds. Dutch guilder–denominated foreign bonds issued in Amsterdam.

Representations. Statements made by a borrower in a syndicated credit or bond issue describing the borrower's financial condition.

Representative office. A facility established in U.S. or foreign markets by a bank to sell its services and assist clients; in the United States, these offices cannot accept deposits or make loans.

Repurchase agreement (repo or RP). A holder of assets sells those assets to an investor with an agreement to repurchase them at a fixed price on a fixed date. The security ''buyer'' in effect lends the ''seller'' money for the period of the agreement, and the terms of the agreement are structured to compensate the buyer for this. Dealers use repo extensively to finance their positions.

Reserve account. Those items in the balance of payments that measure changes in the central bank's holdings of foreign assets (such as gold, convertible securities, or Special Drawing Rights).

Reserve currency. A foreign currency held by a central bank (or exchange authority) for the purposes of exchange intervention or the settlement of intergovernmental claims.

Reserve requirements. Obligations imposed on commercial banks to maintain a certain percentage of deposits with the central bank or in the form of central-bank liabilities.

Retiming. Restructuring of the timing of interest payable on bonds.

Revaluation. An official act wherein the parity of a currency is adjusted relative to the dollar, gold, Special Drawing Rights, or another currency, resulting in less revalued units relative to those currencies. (See also *Devaluation*.) Also, the periodic computations of the current values (revaluations) of ledger accounts and unmatured future purchase and sales contracts.

Revolving credit. A line of bank credit that may be used at the borrower's discretion. Interest is paid on the amount of credit actually in use, while a commitment fee is paid on the unused portion.

Revolving into term. A commitment that allows a revolving line of credit (usually one to three years) with term provision at the expiration of the revolver for an additional period of time. Most common is a two-year revolver with a five-year, fully amortizing term portion.

Revolving line of credit. A line of credit that permits successive drawings and payments at the borrower's discretion. The funds available to the borrower are replenished by any payments of principal.

Risk-management tools. Financial devices (such as futures or options) that permit a borrower or lender of funds to protect against the risks of changing currency prices and/or interest rates.

Risk participation. An agreement whereby a bank shares the risk in an outstanding credit or instrument. Credit-equivalent amounts of risk participations are assigned based on the risk category appropriate to the account party obligor or, if relevant, to the nature of the collateral or guarantees. Usually treated as a direct credit substitute.

Rollover. The process of selling new securities to pay off old ones coming due, refinancing an existing loan, or extending a maturing forward foreign-exchange contract.

Rollover credit. A bank loan with an interest rate periodically updated to reflect market interest rates. The interest rate in the loan for each subperiod is specified as the sum of a reference rate and a lending margin.

Rollover date. The end of an interest period in a revolving term loan.

Same-day funds. Federal funds, or the equivalent, used in the settlement of a transaction that will probably create an interest adjustment of the trading rate to compensate for the difference in the availability of the funds for use.

Samurai bonds. Yen-denominated bonds issued by a foreign borrower in Japan.

Scalpers. Floor or pit traders in the futures market with short-term horizons who sell slightly above the most recent trade and buy at a price slightly below.

Seasoned securities. Securities that have traded in the secondary market for more than 90 days.

Secondary market. A market in which securities are traded following the time of their original issue.

Selling concession. The share of total investment-banking fees accruing to the selling group.

Selling group. All banks involved in selling or marketing a new issue of bonds. Sometimes the term is used in reference to dealers acting only as sellers and is intended to exclude reference to underwriters or managers.

Seller's option contract. A contract in which the seller has the right to settle a forward contract at his or her option anytime within a specified period. See also *Option contract*.

Selling rates. Rates at which dealers are prepared to sell foreign exchange in the market.

Settlement day. The day on which the actual transfer of two currencies or the transfer of money for an asset takes place at a previously arranged price.

Settlement price. The official daily closing price for a futures or option contract. This price is established and used by a clearinghouse to determine each clearing firm's settlement variation.

Settlement risk. The possibility that a seller of foreign exchange or securities, having collected the payment in local currency, may fail to deliver the exchange or securities to the buyer.

Settlement variation. The sum of all changes in amount for each of a firm's futures or options positions as calculated from each day's settlement price. This amount is paid to or received from the clearinghouse each day based on the previous day's trading.

Shell branch. See *Offshore branch*.

Shogun bonds. Foreign bonds issued in Tokyo and denominated in currencies other than the Japanese yen. The usual denomination is the U.S. dollar.

Short position. An excess of liabilities (and/or forward sale contracts) over assets (and/or forward purchase contracts) in the same currency. A dealer's position when the net of purchases and sales leaves the trader in a net-sold or oversold position.

Sight draft. A draft payable upon presentation to the drawee or within a brief period thereafter known as "days of grace."

Society for Worldwide Interbank Financial Telecommunications (SWIFT). A telecommunications network established by major financial institutions to facilitate messages among SWIFT participants. These messages typically result in a monetary transaction between institutions. The network is based in Brussels.

Soft currency. A currency that is not freely convertible into other currencies.

Soft loans. Loans with exceptionally lenient repayment terms, such as low interest, extended amortization, or the right to repay in the currency of the borrower.

Sole of exchange. A phrase appearing on a draft to indicate that no duplicate is being presented.

Sovereign risk. The risk that the government of a country may interfere with the repayment of debt.

Space arbitrage. The buying of a foreign currency in one market and the selling of it for a profit in another market.

Special Drawing Rights (SDRs). International paper money created and distributed to governments by the IMF in quantities dictated by special agreements among its member countries. The value of SDRs is determined by the weighted value of a "basket" of major currencies.

Specially designated nationals. Persons or entities listed by OFAC. These persons or entities are typically front organizations and are subject to OFAC prohibitions. See also *Blocked account, Office of Foreign Asset Control*.

Speculation. The purchase or sale of a trading unit, usually on a forward basis, in hopes of making a profit at a later date. The term is used in the foreign-exchange, commodity, stock, and option markets.

Spot contract. A foreign-exchange contract traded in the interbank market in which the value date is two business days from the trade date.

Spot exchange (or spot currency). Foreign exchange purchased or sold for immediate delivery and paid for on the day of the delivery. Immediate delivery is usually considered delivery in one to two business days after the conclusion of the transaction. Many U.S. banks consider transactions maturing in as many as ten business days as spot exchange. Their reasons vary but are generally to facilitate revaluation accounting policies and to initiate final confirmation and settlement verification procedures on future contracts nearing maturity. See also *Futures (or forward) exchange contract*.

Spot month. The futures-contract month that is also the current calendar month.

Spot/next. In the foreign-exchange market, a term used to describe a swap transaction for value on the spot date with the reverse transaction taking place the next working day after the spot date. In the Eurocurrency market, a term used to describe a loan or deposit for value on the spot date with maturity on the next working day after the spot date.

Spot transaction. A transaction for spot exchange or currency.

Spread. The difference between the bid rate and the offer rate in an exchange-rate quotation or an interest quotation. This difference is not identical with the profit margin because traders seldom buy and sell at their bid and offer rates at the same time. In another sense (for example, Eurodollar loans priced at a mark-up over LIBOR), spread means a mark-up over cost, and, in this context, the spread is identical with the profit margin.

Square exchange position (or square-off). To make the inflows of a given currency equal to the outflows of that currency for all maturity dates. This produces a square exchange position in that currency.

Stabilization. The efforts by a lead manager in a securities issue to regulate the price at which securities trade in the secondary market, during the period that the securities syndicate is still in existence.

Sterilization. Intervention in the foreign-exchange market by a central bank in which the change in the monetary base caused by the foreign-exchange intervention is offset by open market operations involving domestic assets.

Straight bill of lading. A bill of lading drawn directly to the consignee and therefore not negotiable. See also *Bill of lading*.

Strike price. The price at which an option buyer may purchase (if a call option) or sell (if a put option) the asset upon which the option is written.

Subscription agreement. An agreement between a securities issuer and the managing banks that describes the terms and conditions of the issue and the obligation of the parties to the agreement.

Subscription period. The time period between the day on which a new securities issue is announced and the day on which the terms of the issue are signed and the securities are formally offered for sale.

Subsidiary. Entity in which a bank has a modicum of control. Used to facilitate entry into foreign markets in which other operations are proscribed.

Sushi bonds. Dollar-denominated Eurobonds issued by Japanese companies and purchased primarily by Japanese investors. These bond issues are typically managed by Japanese banks.

Swap. The combination of a spot purchase or sale against a forward sale or purchase of one currency in exchange for another. The trading of one currency (lending) for another currency (borrowing) for that period of time between which the spot exchange is made and the forward contract matures. See also *Swap cost (or profit)*.

Swap arrangement—reciprocal. A bilateral agreement between central banks enabling each party to initiate swap transactions up to an agreed limit to gain temporary possession of the other party's currency.

Swap cost (or profit). In a swap transaction, the cost or profit related to the temporary movement of funds into another currency and back again. That exchange cost or profit must then be applied to the rate of interest earned on the loan or investment for which the exchange was used. Furthermore, the true trading profits or losses generated by the foreign-exchange trader cannot be determined if swap profits or costs are charged to the exchange function rather than allocated to the department whose loans or investments the swap actually funded.

Swap and deposit. A combination of swap transactions that enables the borrower to have use of both currencies for the duration of the transaction.

Swap position. A situation in which the scheduled inflows of a given currency are equal to the scheduled outflows, but the maturities of those flows are purposely mismatched. The expectation in a swap position is that the swap rate will change and that the gap can be closed at a profit.

Swap rate. The difference between the spot exchange rate of a given currency and its forward exchange rate.

Swap-swap. A swap transaction involving one forward maturity date against another forward maturity date.

Swaption. An option on a swap. It gives the buyer the right, but not the obligation, to enter into an interest-rate swap at a future period of time.

Syndicate. A group of banks that acts jointly, on a temporary basis, to loan money in a bank credit (syndicated credit) or to underwrite a new issue of bonds (bond underwriting syndicate).

Syndicate leader. See *Manager of syndicate*.

Syndicate participation. Usually, a large credit arranged by a group of lenders, each of whom advances a portion of the required funds. It differs from a participation loan because the banks participate at the outset and are known to the borrower.

Take-down. The receipt of the principal of a loan by the borrower.

Tariff. A duty or tax on imports that can be either a percentage of cost or a specific amount per unit of import.

Telegraphic transfer (TT) rate. The basic rate at which banks buy and sell foreign exchange. Buying rates for mail transfers, foreign-currency drafts, traveler's checks, and similar instruments are all based on the TT rate. The TT rate may be slightly less favorable than other rates because of the time required for collection. Foreign-currency time (usance) drafts also are bought at the TT rate, but interest to maturity is deducted for the time which must elapse until maturity.

Telex. Direct communication between two banks or companies and organizations via satellite or underwater cable.

Tenor. A term designating payment of a draft as being due at sight, a given number of days after sight, or a given number of days after the date of the draft.

Term structure. The level of interest rates on debt instruments of a particular type, viewed as a function of term to maturity. The interest-rate level may rise or fall with increasing maturity.

Terms of trade. Relative price levels of goods exported and imported by a country.

Test key. A code used in transferring funds by cable or telephone so that the recipient may authenticate the message. A test key generally consists of a series of numbers, including a fixed number for each correspondent bank; a number for the type of currency; a number for the total amount; and, possibly, numbers for the day of the month and day of the week. A single number code indicates whether the total amount is in thousands, hundreds, tens, or digits. To arrive at a test number, the indicated numbers are totaled, and the total amount usually precedes the text of the message.

Third-country bills. Banker's acceptances issued by banks in one country that finance the transport or storage of goods traded between two other countries.

Tied loan. A loan made by a governmental agency that requires the borrower to spend the proceeds in the lender's country.

Time draft. A draft drawn to mature at a fixed time after presentation or acceptance.

Time value. The amount by which an option's market value exceeds its intrinsic value.

Tombstone. In a syndicated credit, an advertisement placed in a newspaper or magazine by banks to record their participation in the loan or, in a bond issue, to record their role in managing, underwriting, or placing the bonds.

Tomorrow next (tom/next). The simultaneous purchase and sale of a currency for receipt and payment on the next and second business day, respectively, or vice versa.

Tradable amount. The minimum amount accepted by a foreign-exchange broker for the interbank market, for example, 100,000 Canadian dollars or 50,000 pounds sterling.

Trade acceptance. A draft drawn by the seller (drawer) on the buyer (drawee) and accepted by the buyer. Also called a trade bill, customer acceptance, and two-name trade paper. See also *Acceptance*.

Trade accounts. Those parts of the balance of payments that reflect money spent abroad by the citizens of a country on goods and services and the money spent by foreigners in the given country for goods and services.

Trader's (or dealer's) ticket (slip). The handwritten record of a foreign-exchange trade and/or placing and taking of deposits that is written by the dealer who executed the transaction.

Trading position worksheet. A record of incomplete transactions in a particular currency.

Tranche. One of a number of drawings of funds made by a borrower under a term loan.

Transaction date. The date on which a contract's terms are negotiated and agreed on.

Transfer risk. The risk arising when a borrower incurs a liability in a currency that is not the currency in which revenues are generated. The borrower may not be able to convert its local currency to service an international loan if foreign exchange is not generated.

Trending of rates. Quoting a slightly higher or lower two-way rate in order to reflect a preference for either purchasing or selling.

Trust receipt. Used extensively in letter-of-credit financing, this is a document or receipt in which the buyer promises to hold the property received in the name of the releasing bank, although the bank retains title to the goods. The merchant is called the trustee, the bank the entruster. Trust receipts are used primarily to allow an importer to take possession of the goods for resale before payment to the issuing bank.

Two-way quotation. A simultaneous quotation of foreign-exchange buying and selling rates implying the willingness of the bank to deal either way.

Two-way rate. An exchange-rate or an interest-rate quotation that contains both a bid rate and an offer rate. The size of the spread between the two rates indicates the relative quality of the quotation.

Unconfirmed letter of credit. See *Letter of credit—advised*.

Undervalued. Decline of the spot rate below purchasing power parities, so that the goods of one county are cheaper than in another country. In relation to forward exchange, ''undervalued'' means that forward premiums are narrower or forward discounts are wider than the interest parities between the two financial centers.

Underwriting allowance. The share of total investment-banking fees accruing to the underwriting group.

Underwriting syndicate. The banks, in a new securities issue, that agree to pay a minimum price to the borrower even if the securities cannot be sold on the market at a higher price.

Uniform customs and practices for documentary credits. Sets of rules governing documentary letters of credit formulated by the International Chamber of Commerce. Includes general provisions, definitions, forms, responsibilities, documents, and the transfer of documentary letters of credit.

Unmatched. A forward purchase is unmatched when a forward sale for the same date has not been executed or vice versa.

Unmatured transactions. Trading transactions that have not reached their settlement dates.

Usance. The period of time between presentation of a draft and its maturity. See also *Tenor*.

Value-compensated. The payment or collection of a settlement cost on an open forward contract to cancel the contract rather than to execute an offsetting contract for the same maturity date.

Value date. The date on which foreign exchange bought and sold must be delivered and on which the price for the exchange must be paid.

Value-impaired. A category assigned by the Interagency Country Exposure Review Committee that indicates a country has protracted debt problems.

Value today. An arrangement by which spot exchange must be delivered and paid for on the day of the transaction instead of two business days later.

Value tomorrow. An arrangement by which spot exchange must be delivered and paid for on the business day following the transaction instead of two business days after the transaction.

Variation margins. Positive or negative changes in the value of a security bought on margin or a futures contract. These variations must be paid daily in cash. All securities bought or sold on margin and futures contracts are marked to market.

Volatility. The standard deviation of changes in the logarithm of an asset price, expressed at a yearly rate. The volatility is a variable that appears in option formulas.

Volume quotation system. A method of giving exchange rates in which a certain specified amount of local currency (usually 1 or 100) is stated as the corresponding amount in foreign currency.

Vostro account. A demand account maintained for a bank by a correspondent bank in a foreign country. The nostro account of one bank is the vostro account of the other bank. See also *Nostro account*.

Warehouse receipt. An instrument that lists and is a receipt for goods or commodities deposited in the warehouse that issues the receipt. These receipts may be negotiable or nonnegotiable. A negotiable warehouse receipt is made to the ‘‘bearer,’’ while a nonnegotiable warehouse receipt specifies precisely to whom the goods shall be delivered. There are several alternatives for releasing goods held under warehouse receipts: (1) the delivery of goods may be allowed only against cash payment or substitution of similar collateral; (2) some or all of the goods may be released against the trust receipt without payment, or (3) a warehouseman may release a stipulated quantity of goods without a specific delivery order. Banks will accept a warehouse receipt as collateral for a loan only if the issuer of a receipt is a bonded warehouseman. The bank must have protected assurances for the authenticity of the receipt and the fact that the commodities pledged are fully available as listed on the warehouse receipt.

Wash. A transaction that produces neither profit nor loss.

Wire. Often the words ‘‘wire’’ and ‘‘cable’’ are used interchangeably. In some cases, ‘‘wire’’ denotes messages sent within the confines of the United States, and ‘‘cable’’ refers to messages transmitted overseas. Others use ‘‘wire’’ to mean a transfer of funds by telephone rather than by cable, telex, or telegram.

Withholding tax. A tax imposed by a country on the gross amount of payments to a foreign lender from an in-country borrower.

Within-line facility (or facilities). Subfacilities of the line of credit that establish parameters, terms, and conditions of various other facilities available for specific additional purposes or transactions. The aggregate sum of all outstandings under within-line facilities must not exceed the total of the overall line of credit.

World Bank (The International Bank for Reconstruction and Development). An international financial organization whose purpose is to aid the development of productive facilities in member countries, particularly in developing countries. The chief source of funds is capital contributions made by member countries, which vary with the financial strength of the country.

Another funding source is the sale of long-term bonds.

Writer. An individual who issues an option and, consequently, has the obligation to sell the asset (if the option is a call) or to buy the asset (if the option is a put) on which the option is written if the option buyer exercises the option.

Yankee bond. A dollar-denominated foreign bond issued in the U.S. market.

Yield curve. The interest rates for each different tenor or maturity of a financial instrument. A graph of the yield curve has interest rates on the vertical axis and time-to-maturity on the horizontal axis. When longer maturities have higher interest rates than shorter maturities, the curve is called a positive or upward-sloping yield curve. The opposite type of curve is called a negative, downward-sloping, or inverted yield curve. When interest rates are the same for all maturities, the curve is called a flat yield curve. See also *Term structure*.

Yield to maturity. The rate of interest on a bond when calculated as that rate of interest which, if applied uniformly to future time periods, sets the discounted value of future bond coupon and principal payments equal to the current market price of the bond.

Zero coupon bond. A bond that pays no interest but that is redeemed at its face value at maturity.

Although the methods of international loan portfolio management are similar to those established for domestic lending, the additional risks in international lending require specialized expertise and careful management by the bank. Banks conducting international lending activities should establish strong policies that include not only the basic components found in domestic policies but also the following segments.

Geographic limits. The bank should delineate those countries or geographic areas where it can lend profitably and soundly in accordance with its objectives and in consideration of country risks. International lending officers must know the specific country limits established by the board of directors, and the bank should have a monitoring system to ensure adherence to those limits. The limits established will depend on each bank's available financial resources, the qualifications and skills of its staff, the extent of its lending activities, and its further growth potential.

Distribution by category. Limitations based on aggregate percentages of total international loans in real estate, consumer credit, ship financing, or other categories are common. Although loan distribution policy may differ among banks, international loans are generally granted in the following categories:

- import and export financing
- loans to corporations or their overseas branches, subsidiaries, or affiliates with a parent guarantee or other form of support
- loans granted to foreign local borrowers including foreign entities of U.S. concerns that borrow without any form of support from the parent corporation
- loans and placements to foreign banks or to overseas branches of U.S. banks
- loans to foreign governments or foreign governmental entities

The categories of credit extensions that the bank's international division should engage in and the nature of any limitations will depend on the particular bank and its customers. Deviations from policy limitations that have been approved by the board of directors or its designated committee(s) should be allowed to meet the changing requirements of the bank's customers. During times of heavy loan demand in one category, an inflexible loan distribution policy could cause that category to be slighted in favor of another.

Types of credits. The lending policy should state the types of international credits that the bank can make and set guidelines to follow in granting specific credits. The decision about the types of credits to be granted should be based on consideration of the expertise of the lending officers, deposit structure of the bank, and anticipated credit needs of its customers. Complex credits requiring more than normal policing should be avoided unless or until the bank obtains the necessary personnel to administer those credits properly. Types of credit that have resulted in an abnormal loss to the bank's international division should be controlled or avoided within the framework of stated policy. Syndications and other types of term loans should be limited to a given percentage of the bank's stable funds.

Maximum maturities. International credits should be granted with realistic repayment plans. Maturity scheduling should be related to the anticipated source of repayment, the purpose of the credit, the useful life of the collateral, and the degree of country risk. For term loans, a lending policy should state the maximum number of months during which loans may be amortized. Specific procedures should be developed for situations requiring balloon payments and modifications to the original terms of a loan. If the bank requires a cleanup (out-of-debt) period for lines of credit, that period should be explicitly stated.

Loan pricing. Interest rates, fees, commissions, and discounts on various loan types established by the loan policy must be sufficient to cover the costs of funds loaned, servicing of the loan (including general overhead), and probable losses, while providing for a reasonable rate of return. Periodic review allows the rates to be adjusted to account for changes in costs and competitive factors. Additionally, the bank must establish practices to ensure a continuous examination of the relationships between loan pricing and the cost of funds.

Foreign-exchange risks. Lending policy should include controls that minimize risks for loan portfolios in one currency funded by borrowings in another. These activities must be identified and should be limited by the bank if—

- a particular foreign government is expected to impose stringent exchange controls;
- the currencies involved are or will be subject to wide exchange-rate fluctuations; or
- political, social, or economic developments are likely to intensify exchange risks.

Multicurrency credit commitments permit borrowers to select from a specific list of currencies the one they prefer to use in each rollover period. The listed currencies, however, may be unavailable or available only at a high cost. The bank should protect itself by stating in the loan agreement that its requirement to provide any of the currencies listed is subject to availability at the time requested by the borrower. For detailed information on foreign-exchange risks, see section 7100, ‘‘International—Foreign Exchange.’’

Documentation and collateral. Trade financing often represents a significant amount of an international division's lending activity. In this type of financing, the bank deals only in documents, while its customer is responsible for the merchandise under the terms of the sales contract. The bank's control of documents, especially title documents, is crucial. Lending officers and applicable personnel, therefore, must be knowledgeable in handling documentation, which may be the bank's ultimate support for certain transactions.

The bank must establish policies for taking overseas collateral as security for a loan to ensure that local required procedures are met. For example, in many countries, liens on fixed assets must be registered with the local government, depending on the type of asset. Lending against current assets also requires special care and monitoring. The bank must know which countries do not recognize the legality of trust receipts as recognized in the United States. In other countries, borrowers sign powers of attorney or similar documents permitting lenders to take specifically defined collateral at any time. For these and other reasons, the bank must retain local lawyers who are thoroughly familiar with that country's laws, regulations, and practices and who will check loan agreements, guarantees, debt instruments, drafts, corporate resolutions, and other loan documentation. There are significant differences between loan agreements drawn in the United States and those drawn abroad. Nevertheless, the bank must ensure that its loan agreements with borrowers protect it adequately. Generally, few restrictive covenants are required for international loans because of competition in offshore markets and differing local practices. Nevertheless, the bank should insist on protective covenants when appropriate, especially if the borrowers are small or medium-sized obligors. The bank also should ensure that loan agreements provide for the borrower to reimburse the lender for certain unanticipated costs, including the imposition of taxes on interest withheld at the source without corresponding credits gained on the levy of U.S. taxes and the need to establish or increase bad debt reserves.

Financial information. Current and complete financial information is necessary at the inception and throughout the term of an international loan. The lending policy should specifically define financial-statement requirements for businesses, foreign banks, foreign governments, other foreign public-sector entities, and individuals, and it should include criteria for the requirement of audited, nonaudited, fiscal, interim, operating, cash-flow, and other statements. The requirements should be defined clearly enough so that any credit data exception in the examination report is a clear exception to the bank's lending policy.

The reliability of financial statements and accompanying information differs greatly among countries. In some countries, accounting standards and traditions are lax and audited statements are virtually unknown. Financial information provided for tax-collection purposes in foreign countries may differ from that given in confidence to the bank to obtain credit.

In analyzing financial statements of foreign entities, factors are present that do not exist when analyzing those of U.S. enterprises, such as markedly different accounting concepts, the wide use of ‘‘hidden reserves,’’ translation problems, different methods of valuing assets, or unfamiliar and sharply different legal principles. A general rule in analyzing local currency statements is not to translate figures to U.S. dollar equivalents. Fluctuating exchange rates can have a significant impact on the analysis of U.S. dollar equivalents over a period of time. If a loan is to be repaid in currency other than the borrower's domestic currency, an analysis of probable future foreign-exchange-rate movements is necessary to assess the borrower's ability to generate sufficient local currency to buy the necessary exchange. An analysis of the availability of exchange is also required to ensure full repayment at maturity. Financial Accounting Standards Board Statement No. 52, "Foreign-Currency Translation," takes certain translation adjustments out of earnings and places them in a separate component of equity capital ("foreign-currency translation adjustments"), thereby reducing the fluctuations in earnings produced by changing exchange rates. Since the financial information provided is not always reliable, the bank's policies should enable it to determine by other means the capacity, integrity, experience, and reputation of the foreign borrower.

Extensions of credit to foreign banks constitute an important segment of an international division's foreign loans. It is important to obtain information on the nature of the bank's business; its assets, liabilities, and contingent accounts; and its record of past earnings. A review of these data should lead to a determination of the strength of the bank and its ability to meet its obligations in the foreseeable future. At minimum, this review should include—

- the size and liquidity of primary and secondary reserves;
- the nature of lending activities, including types and terms of loans, extent of collateral held, and loss experience;
- lending policies and controls in effect to ensure compliance with applicable lending laws and regulations;
- the size and character of investments;
- the size of fixed assets;
- the size and nature of investments in subsidiaries and other affiliates and the extent to which the bank will support those entities in times of difficulty;
- the source and nature of deposits and their volatility;
- the nature and extent of other liabilities and contingent liabilities, including standby facilities;
- the earnings and dividend record and the adequacy of capital;
- the activities of the bank in the foreign-exchange and interbank markets;
- the size and character of the bank's international business; and
- the competency of management.

The quality of management is the key to the analysis of foreign banks and is best determined by frequent visits by officers of the lending bank. Credit checks from other lenders should be required with periodic updates. Credit reports are not available in all countries and, when provided, are often incomplete or vague. Consequently, there is no substitute for firsthand information obtained from visits to overseas banks.

Country risk. Balance of payments; exchange control; and economic, political, and social information on each borrower's home country should be on file to enable the bank to assess the elements of country risk. The lack of this information is as serious a weakness as the lack of financial information on the borrowers. For additional information, see section 7040, "International—Transfer Risk."

Limits and guidelines for purchasing loans. Purchasing loans from dealers or correspondent banks is a common practice in banks with limited opportunities to generate international credit extensions on their own. However, these purchases may restrict a bank to low-profit loans at narrow spreads over a medium-to long-term period. Buying loans seldom builds relationships with borrowers since the relationship generally stays with the bank originating the loan. Therefore, the lending policy should limit the amount of paper purchased from any one outside source and should state an aggregate limit on all these loans.

Limitation on aggregate outstanding loans. Limitations on the total amount of loans outstanding relative to other balance-sheet accounts should be established for the bank, with limits (or sublimits) applicable to international loans clearly defined. Controls over the international loan portfolio are usually expressed relative to deposits, capital structure, or total assets.

Concentration of credits. The same types of concentrations of credits found in a domestic loan portfolio may exist in the international portfolio. In international banking, however, an additional concentration involves loans to a foreign government, its agencies, and its majority-owned or -controlled entities. Loans to specific private businesses may be included in those concentrations if an interrelationship exists in the form of guarantees, moral commitments, significant subsidies, or other factors indicating dependence on the government. The bank's directorate should evaluate the risks involved in various concentrations and determine those concentrations that should be avoided or limited. The lending policy should also require that all concentrations in the international division be reviewed and reported frequently. For a full discussion of this component, see section 2050, ''Concentrations of Credits.''

Loan authority. The lending policy should establish written limits for all international lending officers. Lending limits also may be established for group authority, allowing a combination of officers or a committee to approve loans larger than those the members would be permitted to approve individually. The reporting procedures and the frequency of committee meetings should be defined. If the bank operates foreign branches, head office–delegated lending authority should be clearly defined and understood by overseas lending officers.

Nonperforming credits and charge-offs. The lending policy should define nonperforming credit extensions of all types (delinquencies, nonaccruals, or reduced rates) and should specify their accounting and reporting requirements. Reports should be submitted regularly to the board of directors and senior management. The management of banks with overseas branches must take extra care to define and communicate their banks' policies and procedures on nonperforming credits to ensure that all bank offices are properly identifying, accounting for, and reporting credits. The reports should include sufficient detail to allow for the determination of risk factors, loss potentials, and alternative courses of action to effect repayment of nonperforming credits. The policy governing delinquent credits should require a follow-up notice procedure that is systematic and progressively stronger. Guidelines should be established to ensure that all accounts are presented to and reviewed by senior management or the directorate for potential charge-off at a stated period of delinquency.

Other. The lending policy should be supplemented with other written guidelines for specific departments concerned with credit extensions, such as letters of credit, banker's acceptances, and discounted trade bills. Written policies and procedures approved and enforced in those departments should be referenced in the general lending policy of the bank.

Before a bank grants international credit, its objectives, policies, and practices must be clearly established. The bank must consider its overall size, financial resources, the nature of its customers, its geographic location, and the qualifications and skills of its staff. An examiner should review policies and practices to determine if they are clearly defined and adequate to monitor the condition of the portfolio. If written guidelines do not exist, there is a major deficiency in the lending area, and the board of directors is not properly discharging its duties and responsibilities. If no exception is taken to the objectives, policies, and practices, the international loan portfolio can then be reviewed to ensure compliance.

The failure of the directors to establish a sound international lending policy, of the management to establish adequate written procedures, or of both to monitor and administer the international lending function within established guidelines has resulted in serious problems for banks. Major sources and causes of loan trouble, as discussed in domestic ''Loan Portfolio Management,'' section 2040, also apply to international lending.

1. To determine if policies, practices, procedures, and internal controls for international loan portfolio management are adequate.
2. To determine if bank officers are operating in conformance with the established bank guidelines.
3. To determine the scope and adequacy of the audit function as it relates to international lending procedures.
4. To determine the overall quality of the international loan portfolio and how that quality affects the soundness of the bank.
5. To prepare information on the bank's lending function in a concise, reportable format.
6. To determine compliance with applicable laws and regulations.
7. To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws and regulations are cited.

1. If selected for implementation, complete or update the International Loan Portfolio Management section of the Internal Control Questionnaire.
2. Test for compliance with policies, practices, procedures, and internal controls in conjuction with performing the remaining examining procedures. Also obtain a listing of any deficiencies noted in the latest review done by internal and external auditors from the examiner assigned to the audit review and determine if appropriate corrections have been made.
3. Request reports on the following from the bank's international division, by department, as of the examination date unless otherwise specified:
   a. Past-due loans. This report should cover:
      - Single payment and demand notes past due.
      - Single payment and demand notes on which interest is due and unpaid for 30 days or more.
      - Consumer, mortgage and term loans payable in regular installments on which one installment is due and unpaid for 30 days or more.
      - Outstandings under cancelled advance (overdraft) facilities that are unpaid.
      - Discounted (purchased) outgoing foreign bills matured and unpaid and advances secured by pledged delinquent foreign bills.
      - Unauthorized overdrafts including any resulting from customers not paying the bank for banker's acceptances or drafts it paid.

      And should include the following information:
      - Name of the obligor.
      - Original amount of the loan.
      - Outstanding balance of the loan.
      - Date the loan was made.
      - Due date.
      - Terms of the loan.
      - Number of payments the loan is delinquent.
      - Date of the borrower's last payment.
      - Date to which interest is paid.

      For larger international loans, the report should also include:
      - Purpose of the loan.
      - Any action being taken to bring the loan current.
   b. International loans on which interest is not being collected in accordance with the terms of the loan.
   c. International loans the terms of which have been modified by a reduction of interest rate or principal payment or by a deferral of interest or principal.
   d. International loans for which repayment terms have been restructured.
   e. International loan participations purchased and sold and participations in consortium credits since the previous examination.
   f. International loans sold in full since the previous examination.
   g. International credits considered ''problem credits'' by management (this report may be either as of the examination date or as of the date the report was last submitted to the officer's loan review committee(s), the loan and discount committee(s), or the board of directors).
   h. International credit commitments and other contingent liabilities.
   i. Loans secured by stock of other banks and rights, interest, or powers of a savings and loan association.
   j. Extensions of credit to employees, officers, directors, or their interests.
   k. Extensions of credit to executive officers, directors, principal shareholders and their interests of correspondent banks.
   l. Miscellaneous loan debit and credit suspense accounts.
   m. Current interest rate structure.
   n. Current lending authorities of officers and credit committee(s).
4. Obtain the following information:
   a. A copy of written policies covering all international lending functions.
   b. A statement of whether a standing committee administers the lending function.
   c. Copies of reports furnished to the board of directors for its meetings.
   d. Lists of directors, executive officers, principal shareholders and their interests.
   e. A summary of the officer borrowing report (debts to own and other banks).

   f. A list of previously charged-off loans approved by the directors.
5. Obtain a copy of the latest reports furnished to the international loan and discount committee(s). (The domestic loan and discount committee(s) sometimes handle(s) international loans and discounts.)
6. Review international lending policies and updates and abstract appropriate excerpts on:
   a. Distribution of loans by category.
   b. Geographic area and country exposure limitations.
   c. Type of borrowing and industrial concentration limitations.
   d. Lending authorities of committees and officers.
   e. Any prohibited types of international loans.
   f. Maximum maturities for various types of international loans.
   g. Interest rate structure.
   h. Minimum downpayment for various types of loans.
   i. Collateral appraisal policies including:
      - Persons authorized to perform appraisals.
      - Lending values of various types of assets.
   j. Financial information requirements by types of loans.
   k. Guidelines for purchasing other banker's acceptances and commercial paper.
   l. Guidelines for loans to major shareholders, directors, officers, or their interests.
7. When more than one international lending policy exists, determine if they are internally consistent by reviewing the guidelines previously obtained.
8. Review minutes of the bank's international loan and discount committee(s) meetings to obtain:
   a. Present members and their attendance record.
   b. Scope of work performed.
   c. Any information considered useful in the examination of specific loan categories or other areas of the bank.
9. Compare reports furnished to the board of directors and the loan and discount committee(s), and those received from the bank in step 3 to determine any material differences and that the differences are transmitted to the board in a timely manner.
10. Compare the lists of directors, officers and their related interests to determine:
    a. Preliminary compliance with Regulation O (12 CFR 215) (loans to insiders).
    b. Preliminary compliance with established policies.
11. Perform the following steps for past-due loans:
    a. Compare the following to determine any material inconsistencies:
       - The past-due schedule received in step 3. Delinquency reports submitted to the board.
       - List of loans considered ''problem'' loans by management.
    b. Scan the delinquency lists submitted to the board of directors and senior management to determine that reports are sufficiently detailed to evaluate risk factors.
    c. Compile current aggregate totals of past-due paper.
12. Perform the following using the loan commitments and contingent schedules obtained in step 3:
    a. Reconcile appropriate contingency totals to memoranda ledger controls.
    b. Review reconciling items for reasonableness.
13. Obtain the listing of Uniform Review of Shared National Credits and update the listing based on information obtained in step 3.
14. Obtain the classifications and categories of strong, moderately strong, and weak countries from Interagency Country Exposure Review Committee meeting for which write-ups have been made available and update that data based on information obtained in step 3.
15. Distribute the applicable schedules and other information obtained in the preceding steps to the examiners performing the loan examination programs. Request that the examiners test the accuracy of the information. Also, request that they perform appropriate steps in the separate program ''Concentration of Credits.''
16. Determine the general distribution and characteristics of the international loan portfolio by:
    a. Determining the percentage of total loans in specific classes and geographic areas.
    b. Comparing international loan category distributions to policy guidelines.

17. Obtain the results of the reviews performed of the various segments of the international division during the course of the examination, and perform the following:
    a. Determine any nonadherence to internally established policies, practices, procedures, and controls.
    b. Compare the various international division results to determine the extent of nonadherence and if it is systemwide.
    c. Organize internal guideline exceptions in order of relative importance.
    d. Determine the aggregate amount of statutory bad debts.
    e. Organize violations by law and regulation.
    f. Review international credit classifications and assets listed for special mention to determine:
        - Inclusion of all necessary information.
        - Substantiation of classification or criticism.
    g. Determine the aggregate amount of credit extensions listed in each of the four levels of criticism.
    h. Compile a listing of all credit extensions not supported by current and satisfactory credit information.
    i. Compile a listing of all credit extensions not supported by complete collateral documentation.
    j. Review the separate procedures for "Concentration of Credits" and determine:
        - If all necessary data is included.
        - If there is substantiation for including specific items in the report of examination as a concentration.
        - If the concentration is undue or unwarranted.
    k. Compute the following ratios and compare to computations from prior examinations:
        - Aggregate international division past due paper to international division loans and overdrafts outstanding.
        - Aggregate international division "A" paper to international division past due.
        - Total international division past due, nonaccural and renegotiated rate credits to total international division credits.
        - Aggregate classified international credits to primary capital funds.
        - Aggregate classified international credit to total bank classified credits.
        - Weighted classified international credits to primary capital funds.
18. Forward the totals of international division loss and doubtful classifications to the examiner assigned to analyze the adequacy of the bank's capital.
19. Compare management's list of "problem" credits from step 3 to the examiner's listing of international classified and criticized credits to determine the extent of management's knowledge of its own international credit problems.
20. Determine, through an in-depth analysis of information previously generated, the causes of existing problems or weaknesses within the international division's systems which present potential for future problems.
21. Forward the following information to the examiner assigned to analyze the bank's loan loss reserves.
    a. A listing of international division credits considered "problem" credits by management.
    b. A listing of classified and criticized credits relating to the international division.
    c. A listing of previously charged-off loans.
22. Organize the results of the examination of the international lending function to facilitate discussion with the examiner-in-charge and, upon approval, with senior management of the bank.
23. During discussion with senior management, structure inquiries in such a manner as to:
    a. Gain insight into management's international lending philosophy.
    b. Elicit management responses for correction of deficiencies.
24. Write, in appropriate report format, general remarks which may include:
    a. The scope of the examination of the international lending function.
    b. The quality of internal policies, practices, procedures, and controls over the international lending function.
    c. The general level of adherence to internal policies, practices, procedures, and controls that govern the bank's international lending function.
    d. The scope and adequacy of the internal loan review system regarding international credit extensions.
    e. The quality of the entire international credit portfolio.

f. The competency of management with respect to the international lending function.
g. Causes of existing credit problems.
h. Expectations for continued sound international lending and correction of existing credit control and quality deficiencies.
i. Promises made by management for correction of credit control and quality deficiencies.
j. Credit extensions to insiders and their interests.

25. Compile or prepare all information which provides substantiation for your general remarks.
26. Update the workpapers with any information that will facilitate future examinations.

Review the bank's internal controls, policies, practices, and procedures for managing the bank's loan portfolio. The bank's system should be documented in a complete and concise manner and include, where appropriate, narrative descriptions, flowcharts, copies of forms used, and other pertinent information.

1. Has the board of directors, consistent with its duties and responsibilities, adopted written international loan portfolio management objectives and policies that:
   a. Establish suggested guidelines for distribution of international loans by different categories?
   b. Establish geographic area limits for credits?
   c. Establish suggested guidelines for aggregate outstanding international loans in relation to other balance sheet categories?
   d. Establish international loan authority of committees and individual lending officers?
   e. Define acceptable types of international loans?
   f. Establish maximum maturities for various types of international loans?
   g. Establish international loan pricing?
   h. Establish appraisal policy?
   i. Establish minimum financial information required at inception of the credits?
   j. Establish limits and guidelines for purchasing paper?
   k. Establish guidelines for loans to bank directors, officers, and their related interests?
   l. Establish collection procedures?
   m. Define the duties and responsibilities of international loan officers and loan committees?
   n. Outline international loan portfolio management objectives that acknowledge:
      - Concentrations of credit within specific industries and relating to country credits?
      - The need to employ personnel with specialized knowledge and experience?
      - Possible conflicts of interest?
2. Are international loan portfolio management objectives and policies reviewed at least annually to determine if they are compatible with changing market conditions?
3. Are the following reported to the board of directors or its designated committees (indicate which) at their regular meetings (at least monthly):
   a. Past-due single payment loans (if so, indicate the minimum days past due for them to be included ___________)?
   b. Loans on which interest only is past due (if so, indicate the minimum days past due for them to be included ________)?
   c. Term loans on which one installment is past due (if so, indicate the minimum days past due for them to be included ___________)?
   d. Outstandings under overdraft facilities that are unpaid (if so, indicate the minimum days past due for them to be included ___________)?
   e. Discounted (purchased) outgoing foreign bills matured and unpaid (or advances collateralized by pledged delinquent foreign bills) (if so, indicate the minimum days past due for them to be included ___________)?
   f. Overdrafts resulting from a customer not paying the bank for banker's acceptances or drafts the bank paid (if so, indicate minimum days past due for them to be included ___________)?
   g. Total outstanding international loan commitments?
   h. Loans requiring special attention?
   i. New loans and loan renewals or restructured loans?
4. Are reports submitted to the board or its committees rechecked by a designated person for possible omissions prior to their submission?
5. Are written applications required for all international loans?
6. Does the bank maintain credit files for all international borrowers?
7. Does the credit file contain information on:
   a. The purpose of the loan?
   b. The planned repayment schedule?
   c. The disposition of loan proceeds?

d. The points to be raised regarding the borrower from which to base questions during officer calling programs?
e. Lending officer calls on customers and foreign countries?

8. Does the bank require periodic submission of financial statements by all international division borrowers whose loans are not fully secured by readily marketable collateral?
9. Is a tickler file maintained to assure that current financial information is requested and received?
10. Does the bank require submission of certified financial statements based on dollar amount of commitment (if so, state the dollar or equivalent minimum $________)?
11. Are financial statements of foreign borrowers spread in the credit file by local currency and U.S. dollar equivalents, if appropriate, on a yearly comparative basis?
12. Are borrower financial statements spread with those of comparable borrowers in the same country?
13. Does the bank perform a credit investigation on proposed and existing borrowers for new loan applications?
14. Does the bank have a periodic lending officer call program for:
    a. Customers?
    b. Countries?
15. Is it required that all international loan commitments be in writing?
16. Are international lines of credit reviewed and updated at least annually?
17. Are borrower's outstanding liabilities checked to appropriate lines of credit prior to granting additional advances?
18. Is there an internal review system (it may be a function of the internal audit department) which covers each department and:
    a. Rechecks interest, discounts, fees, commissions, and maturity date computations?
    b. Re-examines debt instruments for proper execution, receipt of all required supporting papers, and proper disclosure forms?
    c. Determines that international loan approvals are within the limits of the bank's lending authorities?
    d. Determines that international loans outstanding and committed are within the bank's foreign country or foreign currency limits?
    e. Determines that notes and debt instruments are being approved initially by the loan officer?
    f. Ascertains that new international loans are within the limitations set for the borrower by corporate resolution?
    g. Rechecks liability ledgers to determine that new loans have been accurately posted?
    h. Rechecks the preparation of maturity and interest notices?
    i. Examines entries to various general ledger loan controls?
    j. Confirms collateral, loans, and discounts with customers on a test basis?
19. Does the bank have an international loan review section or the equivalent?
20. Is the loan review section independent of the international lending function?
21. Are the initial results of the international loan review process submitted to a person or committee which is also independent of the international lending function?
22. Are all international loans exceeding a certain dollar amount selected for review?
23. Do international lending officers recommend loans for review?
24. Is a method, other than those detailed in steps 23 or 24, used to select international loans for review (if so, provide details)?
25. Are internal reviews conducted at least annually for all international lending areas?
26. In an officer identification system, are guidelines in effect which define the consequences of an officer withholding a loan from the review process?
27. Is the bank's international problem loan list periodically updated by the lending officers?
28. Does the bank maintain a list of international loans reviewed, indicating the date of the review and the credit rating?
29. Does the loan review section prepare summaries to substantiate credit ratings, including pass loans?
30. Are loan review summaries maintained in a central location or in appropriate credit files?
31. Are followup procedures in effect for internally classified international loans, including an update memorandum to the appropriate credit file?
32. Are officers and employees prohibited from holding blank signed notes and other debt

instruments in anticipation of future borrowings?

33. Are paid and renewed notes cancelled and promptly returned to customers?
34. Do loan proceeds disbursed in cash require a customer receipt?
35. Are international loan records retained in accordance with record retention policy and legal requirements?
36. Are new notes microfilmed daily?
37. Is a systematic and progressively stronger follow-up notice procedure utilized for delinquent loans?
38. Does the bank maintain loan interest, discount, fee, and commission rate schedules for various types of international loans?
39. Does the bank periodically update the above rate schedules (if so, state normal frequency ___________)?
40. Does the bank maintain records in sufficient detail to generate the following information by type of advance:
    a. The cost of funds loaned?
    b. The cost of servicing loans, including overhead?
    c. The cost factor of probable losses?
    d. The programmed profit margin?
41. Does the international division maintain adequate and current country analysis information?
42. Has the international division conducted studies for those industries in which it is a substantial lender?

CONCLUSION

43. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
44. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

A bank's international division lends, either directly or through state entities, to U.S. importers and exporters, foreign companies, multinational corporations, foreign banks, and foreign governments. The terms of these lending activities are consistent with the purpose of the financing.

Short-term working-capital loans to commercial business enterprises commonly finance inventories or receivables arising from trade. Receivable pledges, warehouse receipts, and liens on inventory or commodities may be held as collateral. However, in certain countries, these forms of collateral are not legally recognized and, therefore, the banks must be thoroughly familiar with applicable local laws, regulations, and practices. Loans to foreign banks are usually short-term and unsecured.

Medium-term lending (one to five years) generally represents capital goods financing, shipping loans, and various specialized credits. Long-term loans (those exceeding five years) are normally used to finance extensive projects of multinational corporations, foreign governments, or foreign state entities. Government guarantees of private long-term loans are common when the project has significant importance to a national economy.

The methods of loan financing in an international division are the same as those for domestic lending. Loans in the international division may be direct or discounted. In both of these instances, the bank holds a promissory note or similar instrument evidencing indebtedness. Current account advances, however, are a category of loans unique to international banking. This method of financing is an American substitute, used by banks in the United States, for the European method of financing by overdrafts, which is also a common lending method of overseas offices of U.S. banks. Current account advances, like overdrafts, are extensions of credit in which no instrument of specific indebtedness is used; however, a signed agreement is on file stating the conditions applicable to advances made by the bank to the obligor. Other types of international financing treated as loans include own acceptances purchased (discounted), other banker's acceptances purchased, and discounted trade acceptances.

The same credit risks apply to international division loans as to those made in domestic loan departments, with the addition of country risk, which is the primary additional component that distinguishes an international loan from a domestic loan. Country risk encompasses the entire spectrum of risks arising from the economic, social, and political environments of a foreign country and from the governmental policies structured to respond to those conditions that may have adverse consequences for the repayment of a foreign borrower's debt. More specifically, there is a risk associated with a borrower's capacity to obtain the foreign exchange required to service its cross-border debt (that is, transfer risk). An obligor may have the financial means in its domestic currency to repay its indebtedness, but nationalization, expropriation, governmental repudiation of external indebtedness, the imposition of exchange controls, or currency devaluation may preclude the lender from obtaining timely repayment. Apart from a nation's outright repudiation of external debt, these developments might not result in an uncollectible extension of credit; however, the delay in collection could adversely affect the condition of the lending bank.

This section is designed to apply to most types of loans and current account advances found in an international division. However, lending areas in many international divisions and overseas branches are often segregated into separate departments and differ substantially from international loans and current account advances. Those are discussed in separate sections of this manual: ''International—Financing Foreign Receivables,'' ''International—Banker's Acceptances,'' ''International—Letters of Credit,'' and ''International—Guarantees Issued,'' sections 7050, 7060, 7080, and 7090, respectively.

1. To determine the adequacy of policies, practices, procedures, and internal controls for international loans and advances.
2. To determine if bank officers are operating in conformance with established bank guidelines.
3. To evaluate the portfolio for credit quality, collectibility, and collateral sufficiency.
4. To determine the scope and adequacy of the audit function as it relates to international lending procedures.
5. To determine compliance with applicable laws and regulations.
6. To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws and regulations are cited.

1. If selected for implementation, complete or update the international lending section of the internal control questionnaire.
2. Determine the scope of the examination on the basis of the evaluation of internal controls and the work performed by internal and external auditors.
3. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examination procedures. Also, obtain a listing of any deficiencies noted in the latest reviews done by internal and external auditors from the examiner assigned to the audit review and determine if appropriate corrections have been made.
4. Obtain a trial balance of the customer liability records.
   a. Reconcile balances to department controls and the general ledger.
   b. Review reconciling items for reasonableness.
5. Using an appropriate technique, select borrowers for examination, and prepare credit line cards.
6. Obtain the following information:
   a. past-due, nonaccrual, and reduced-rate loans and advances
   b. loans whose terms have been modified by a reduction in interest rate or principal payment or by a deferral of interest or principal
   c. loans transferred, either in whole or in part, to another lending institution as a result of a sale, participation, or asset swap since the previous examination.
   d. loans acquired from another lending institution as a result of a purchase, participation, or asset swap since the previous examination
   e. loan commitments and other contingent liabilities
   f. reports of the indebtedness of executive officers, principal shareholders, and their related interests to correspondent banks
   g. a list of correspondent banks
   h. extensions of credit to major stockholders of the bank and to bank employees, officers, and directors, and to their related interests (specify which officers are considered executive officers)
   i. miscellaneous loan-debit and credit-suspense accounts
   j. Interagency Country Exposure Review Committee determinations
   k. criticized Shared National Credits (applicable international division credits)
   l. loans considered "problem loans" by management
   m. specific guidelines in the lending policy
   n. current lending authorities of bank officers and credit committees
   o. the current interest-rate lending structure of the bank
   p. any useful information on international division credit extensions resulting from the review of the minutes of the loan and discount committee(s) and any other credit committee(s)
   q. reports on international division credit extensions furnished to the loan and discount committee(s) and any other credit committee(s)
   r. relevant reports furnished to the board of directors
   s. loans criticized during the previous examination
7. Review the information received and perform the following procedures.
   a. *Loans transferred, either in whole or in part, to or from another lending institution as a result of a participation, sale or purchase, or asset swap.*
      - Participations only:
        — Test participation certificates and records, and determine that the parties share in the risks and contractual payments on a pro rata basis.
        — Determine that the bank exercises similar controls and procedures over loans serviced for others as for loans in its own portfolio.
        — Determine that the bank, as lead or agent in a credit, exercises similar controls and procedures over syndications and participations sold as for loans in its own portfolio.
      - All transfers:
        — Investigate any situations in which loans were transferred immediately before the date of examination to determine if any were transferred

to avoid possible criticism during the examination.

— Determine whether any of the loans transferred were either nonperforming at the time of transfer or classified at the previous examination.

— Determine that the consideration received for low-quality loans transferred from the bank to an affiliate is properly reflected on the bank's books and is equal to the fair market value of the transferred loans (while fair market value may be difficult to determine, it should at a minimum reflect both the rate of return being earned on such loans as well as an appropriate risk premium). Section 23A of the Federal Reserve Act generally prohibits a state member bank from purchasing a low-quality asset.

— Determine that low-quality assets transferred to the parent holding company or a nonbank affiliate are properly reflected at fair market value on the books of both the bank and its affiliate.

— If low-quality loans were transferred to or from another lending institution for which the Federal Reserve is not the primary regulator, prepare a memorandum to be submitted to the Reserve Bank supervisory personnel. The Reserve Bank will then inform the local office of the primary federal regulator of the other institution involved in the transfer. The memorandum should include the following information, as applicable:

(1) name of originating institution
(2) name of receiving institution
(3) type of transfer (i.e., participation, purchase or sale, swap)
(4) date of transfer
(5) total number of loans transferred
(6) total dollar amount of loans transferred
(7) status of the loans when transferred (e.g., nonperforming, classified, etc.)
(8) any other information that would be helpful to the other regulator

b. *Miscellaneous loan-debit and credit-suspense accounts.*
   - Discuss with management any large or old items.
   - Perform additional procedures as considered appropriate.

c. *Loan commitments and other contingent liabilities.* Analyze the commitment or contingent liability together with the combined amounts of the current loan balance, if any.

d. *Loans criticized during the previous examination.* Determine disposition of loans so criticized by transcribing the current balance and payment status or the date the loan was repaid and the source of repayment.
   - Investigate any situations in which all or part of the funds for the repayment came from the proceeds of another loan at the bank or as a result of a participation, sale, or swap with another lending institution.
   - If repayment was a result of a participation, sale, or swap, refer to step 7a of this section for the appropriate examination procedures.

e. *Shared National Credits.*
   - Compare the schedule of international loans and current account advances included in the Uniform Review of National Credits program with the bank's reports of international loans outstanding.
   - For each loan or advance so identified, transcribe appropriate information to line cards. No further examination procedures are necessary for these credits.

f. *Interagency Country Exposure Review Committee credits.*
   - Identify any loans that were selected for review that are criticized for transfer-risk reasons by the Interagency Country Exposure Review Committee.
   - For each loan or advance so identified, transcribe appropriate information to line cards. No further examination procedures are necessary for these credits.

8. Transcribe or compare information from the above schedules to credit line cards, where appropriate, and indicate any past-due status.
9. Prepare credit line cards for any international loan not previously selected for review

that, on the basis of information derived from the above schedules, requires an in-depth review.

10. Obtain customer liability and other information on common borrowers from examiners assigned to cash items, overdrafts, and other lending areas, and together decide who will review the borrowing relationship. Pass or retain complete credit line cards.
11. Prepare collateral line cards for all borrowers selected in the preceding steps.
12. Obtain credit files for all borrowers for whom examiner credit line cards were prepared, and complete the credit line cards, where appropriate. To analyze the international loans, perform the following procedures:
    a. Analyze balance sheets and profit-and-loss figures as shown in current and preceding financial statements, and determine the existence of any favorable or adverse trends or ratios.
    b. Review components of the balance sheet as shown in the current financial statements, and determine the reasonableness of each item as it relates to the total financial structure of the borrower.
    c. Review supporting information for the major balance-sheet items and the techniques used in consolidation, and determine the primary sources of repayment and evaluate the adequacy of those sources.
    d. Ascertain compliance with provisions of credit agreements.
    e. Review digests of officers' memoranda, mercantile reports, credit checks, and correspondence to determine the existence of any problems that might deter the contractual repayment programs of the borrower's indebtedness.
    f. Relate collateral values to outstanding debt, and determine when the collateral was last appraised.
    g. Compare interest rates charged with the current interest-rate schedule of the bank, and determine that the terms are within established guidelines.
    h. Compare the original amounts of the customer's obligations to the bank with the lending officer's authority.
    i. Analyze secondary support afforded by guarantors and endorsers.
    j. Ascertain compliance with the bank's established international loan policy.
13. For loans selected for review, check the central liability file for borrowers indebted above the cutoff line or for borrowers displaying credit weakness or suspected of having additional liability in other lending areas.
14. Transcribe significant liability and other information on officers, principals, and affiliations of borrowers selected for review. Cross-reference line cards to borrowers, where appropriate.
15. Determine the bank's compliance with laws and regulations pertaining to international lending by performing the following steps:
    a. *Lending limits.*
       - Determine the bank's lending limit as prescribed by state law.
       - Determine advances or combinations of advances with aggregate balances above the limit, if any.
    b. *Section 23A, Relations with Affiliates (12 USC 371c), and section 23B, Restrictions on Transactions with Affiliates (12 USC 371c-1), of the Federal Reserve Act, and the Board's Regulation W.*
       - Obtain a listing of loans to affiliates.
       - Test-check the listing against the bank's customer liability records to determine its accuracy and completeness.
       - Ensure that loans to affiliates do not exceed limits of section 23A and Regulation W.
       - Ensure that loans to affiliates meet the collateral requirements of section 23A and Regulation W.
       - Determine that low-quality assets have not been purchased from an affiliate.
       - Determine that all covered transactions with affiliates are on terms and conditions that are consistent with safe and sound banking practices.
       - Determine that all transactions with affiliates comply with the market-terms requirement of section 23B and Regulation W.
    c. *18 USC 215, Receipt of Commission or Gift for Procuring Loans.*
       - While examining the international lending function, determine the existence of any possible cases in which a bank officer, director, employee, agent, or attorney may have received anything of value for procuring or endeavoring to procure any extension of credit.

- Investigate any such suspected instances.

d. *Federal Election Campaign Act (2 USC 441b), Political Contributions and Loans.*
- While examining the international lending area, determine the existence of any loans in connection with any political campaigns.
- Review each such credit to determine whether it is made in accordance with applicable banking laws and in the ordinary course of business.

e. *Regulation Y (12 CFR 225.7), Tie-In Provisions.* While reviewing international credit and collateral files, especially loan agreements, determine whether any extension of credit is conditioned upon—
- obtaining or providing any additional credit, property, or service from or to the bank or its holding company (or a subsidiary of its holding company), other than a loan, discount, deposit, or trust service, or
- the customer not obtaining a credit, property, or service from a competitor of the bank or its holding company (or a subsidiary of its holding company), other than a reasonable condition to ensure the soundness of the credit.

f. *Insider lending activities.* The examination procedures for checking compliance with the relevant law and regulation covering insider lending activities and reporting requirements are as follows. (The examiner should refer to the appropriate sections of the statutes for specific definitions, lending limitations, reporting requirements, and conditions indicating preferential treatment.)
- *Regulation O (12 CFR 215), Loans to Executive Officers, Directors, and Principal Shareholders and Their Related Interests.* While reviewing information relating to insiders received from the bank or appropriate examiner (including loan participations, loans purchased and sold, and loan swaps)—
  - — test the accuracy and completeness of information about international loans by comparing it with the trial balance or loans sampled;
  - — review credit files on insider loans to determine that required information is available;
  - — determine that loans to insiders do not contain terms more favorable than those afforded other borrowers;
  - — determine that loans to insiders do not involve more than normal risk of repayment or present other unfavorable features;
  - — determine that loans to insiders do not exceed the lending limits imposed by Regulation O;
  - — if prior approval by the bank's board was required for a loan to an insider, determine that such approval was obtained;
  - — determine compliance with the various reporting requirements for insider loans;
  - — determine that the bank has made provisions to comply with the disclosure requirements for insider loans; and
  - — determine that the bank maintains records of public disclosure requests and the disposition of the requests for a period of two years after the dates of the requests.
- *Title VIII of the Financial Institutions Regulatory and Interest Rate Control Act of 1978 (FIRA) (P.L. 95–630), as amended by the Garn–St Germain Depository Insititutions Act of 1982, Loans to Executive Officers, Directors, and Principal Shareholders of Correspondent Banks.*
  - — Obtain from or request that the examiners reviewing due from banks and deposit accounts verify a list of correspondent banks provided by bank management, and ascertain the profitability of those relationships.
  - — Determine that loans to insiders of correspondent banks are not made on preferential terms and that no conflict of interest appears to exist.

g. *12 USC 1828(v), Loans Secured by Bank Stock.*
- While examining international loans, determine the existence of any loans or discounts that are secured by the insured financial institution's own stock.
- In each such case, determine that the chief executive officer has promptly

reported such fact to the proper regulatory authority.

h. *12 USC 83 (Rev. Stat. 5201), made applicable to state member banks by section 9, paragraph 6, of the Federal Reserve Act (12 USC 324), Loans Secured by Own Stock (see also* Federal Reserve Regulatory Service *3–1505):*
   - While examining international loans, determine the existence of any loans secured by the bank's own shares or capital notes and debentures.
   - Confer with the examiner assigned investment securities to determine whether the bank owns any of its own shares or its own notes and debentures.
   - In each case in which such collateral or ownership exists, determine whether the collateral or ownership was taken to prevent a loss on a debt previously contracted (DPC) transaction.
   - In each case of ownership, determine whether the shares or subordinated notes and debentures have been held for a period of not more than six months.

i. *Regulation U (12 CFR 221).* While reviewing credit files, check the following for all loans that are secured directly or indirectly by margin stock and that were extended for the purpose of buying or carrying margin stock:
   - Except for credits specifically exempted under Regulation U, determine that the required Form FR U-1 has been executed for each credit by the customer and that it has been signed and accepted by a duly authorized officer of the bank acting in good faith.
   - Determine that the bank has not extended more than the maximum loan value of the collateral securing such credits, as set by section 221.7 of Regulation U, and that the margin requirements are being maintained.
   - Determine compliance with other specific exceptions and restrictions of the regulation as they relate to the credits reviewed.

j. *Regulation K (12 CFR 211) and Regulation Y (12 CFR 225), International Banking Operations.*
   - Review all applicable sections, especially those concerned with—
     — loans or extensions of credit to foreign banks,
     — loans to executive officers of foreign branches of state member banks,
     — a statement of policy or the availability of information to facilitate supervision of foreign operations, and
     — reporting and disclosure of international assets and accounting for fees on international loans.

k. *Financial Recordkeeping and Reporting of Currency and Foreign Transactions (31 CFR 103), Retention of Credit Files.* Review the operating procedures and credit file documentation, and determine if the bank retains records of each extension of credit over $10,000, specifying the name and address of the borrower, the amount of the credit, the nature and purpose of the loan, and the date thereof. (See 31 CFR 103.33.) (Loans secured by an interest in real property are exempt.)

l. *12 CFR 400–402, Export-Import Bank of the United States.* Review extensions of credit to determine compliance with Eximbank regulations as they relate to direct lending programs, cooperative financing facilities, private export funding, exporter credit programs, medium-term export debt obligations, leasing, and direct discount programs.

m. *7 CFR 1400–1499, Commodity Credit Corporation.* Determine the compliance of international loans relating to Commodity Credit Corporation programs.

n. *22 CFR 200–299, Agency for International Development.* Review to determine the compliance of international loans related to Agency for International Development programs.

o. *Section 909, International Lending Supervision Act (12 USC 3908).* Section 909 of the International Lending Supervision Act of 1983 (the act) requires that FDIC-insured banks and Edge and agreement corporations prepare a written economic feasibility evaluation signed by a senior official of the banking institution for any proposed extension of credit by the lead U.S. banking institution or institutions, which individually or when aggregated with credits of other U.S. banking institutions exceeds $20 million per project, to finance the construction or operation of any mining operation, any metal or mineral primary processing operation, any metal fabricating facility or operation, or any metal-making (semi- and finished) operation located outside the United States or its territories or possessions. The act stipulates that the evaluation shall consider the profit potential, the competitive and economic impact of the project, and the reasonable expectation of repayment. The act also mandates that any new evaluations be reviewed by federal examiners in the context of every examination. The following checklist should be used to test compliance with the requirements of the act:

- Does the banking institution have a written economic feasibility evaluation for all credit extensions by that banking institution alone or in conjunction with other U.S. banking institutions, which individually or when aggregated with credits of other U.S. banking institutions exceed $20 million per project, to finance any of the designated projects?
- Is the evaluation signed by a senior officer of the examined or the lead U.S. banking institution?
- Does the evaluation consider the following:
  - — profit potential of the project
  - — impact of the project on world markets
  - — inherent competitive advantages and disadvantages of the project over the entire life of the project
  - — the likely effect of the project on the overall long-term economic development of the country in which it is located
  - — the reasonable expectation of repayment from revenues generated by the project, without regard to any subsidy provided by the government involved or any instrumentality of any country

Although the bank's evaluation should be done in a professional manner, examiners need not verify its accuracy. However, any negative responses to the foregoing questions would be indicative of noncompliance with the statute and should be discussed with the appropriate level of bank management. Any apparent violations should be cited in the examination report, along with a discussion of any remedial actions taken by bank management during the examination.

16. Perform the appropriate steps in ''Concentrations of Credit,'' section 2050.3.
17. Discuss with appropriate officers, and prepare summaries in appropriate report form of—
    a. delinquent loans;
    b. violations of laws and regulations;
    c. loans not supported by current and complete financial information;
    d. loans on which collateral documentation is deficient;
    e. concentrations of credit;
    f. criticized loans;
    g. inadequately collateralized loans;
    h. extensions of credit to major shareholders, employees, officers, directors, and their related interests;
    i. loans whose ultimate collection is questionable for any other reason; and
    j. other matters regarding the condition of the department.
18. Provide details of classified international participation loans that are not covered by the Shared National Credit Program. Include the names and addresses of all participating state member banks and copies of the criticized loan comments.
19. Provide the examiner-in-charge with your findings on—
    a. the adequacy of written policies relating to international loans;
    b. the manner in which bank officers are operating in conformance with established policy;
    c. adverse trends within the international lending function;
    d. the accuracy and completeness of the schedules obtained from ''International—Loan Portfolio Management,'' section 7020.3.
    e. internal control deficiencies or exceptions;
    f. recommended corrective action when policies, practices, or procedures are deficient;
    g. the competency of management of the international lending function; and
    h. other matters of significance.
20. Update the workpapers with any information that will facilitate future examinations.

Review the bank's internal controls, policies, practices, and procedures for granting and servicing international loans. The bank's system should be documented in a complete and concise manner and include, where appropriate, narrative descriptions, flowcharts, copies of forms used, and other pertinent information. Items marked with an asterisk require substantiation by observation or testing.

POLICIES

1. Has the board of directors, consistent with its duties and responsibilities, adopted written international loan policies that:
   a. Establish procedures for reviewing international loan applications?
   b. Define qualified borrowers?
   c. Establish minimum standards for documentation in accordance with the Uniform Commercial Code?
2. Are international loan policies reviewed at least annually to determine if they are compatible with changing market conditions?

RECORDS

*3. Is the preparation and posting of subsidiary international loan records performed or reviewed by persons who do not also:
   a. Issue official checks or drafts?
   b. Handle cash?

*4. Are the subsidiary international loan records (control totals) balanced daily with the appropriate general ledger accounts and reconciling items adequately investigated by persons who do not normally handle loans and post records?

5. Are the following properly recorded as "loans" for accounting and call report purposes:
   a. Acceptances of other banks purchased?
   b. Own acceptances purchased (discounted)?
   c. Customer's liability to the bank on drafts paid under letters of credit for which the bank has not been reimbursed?

*6. Is a loan delinquency report prepared for and reviewed by management frequently (if so, how often ___________)?

*7. Are inquiries about loan balances received and investigated by persons who do not process loans, handle settlements, or post records?

*8. Are bookkeeping adjustments checked and approved by an appropriate officer?

9. Is a daily record maintained summarizing loan transaction details, i.e., loans granted, payments received, and interest collected, to support applicable general ledger account entries?

10. Are frequent note (or record copy) and liability trial balances prepared and reconciled monthly with control accounts by employees who do not process or record loan transactions?

INTEREST

*11. Is the preparation and posting of interest records performed or reviewed by persons who do not also:
   a. Issue official checks or drafts?
   b. Handle cash?

12. Are any independent interest computations made and compared or adequately tested to initial interest records by persons who do not also:
   a. Issue official checks or drafts?
   b. Handle cash?

COLLATERAL

13. Are multicopy, pre-numbered records maintained that detail the complete description of collateral pledged?
14. Are the functions of receiving and releasing collateral to borrowers and of making entries in the collateral register performed by different employees?
15. Is negotiable collateral held under joint custody?
16. Are receipts obtained and filed for released collateral?
17. Are securities valued and margin requirements reviewed at least monthly?

18. When collateral support is the cash surrender value of insurance policies, is a periodic accounting received from the insurance company and maintained with the policy?
19. Is a record maintained of entry to the collateral vault?
20. Are stock powers filed separately to bar negotiability and to deter abstraction of both the security and the negotiating instrument?
21. Are securities out for transfer, exchange, etc., controlled by pre-numbered temporary vault-out tickets?
22. Are pledged deposit accounts properly coded to negate unauthorized withdrawal of funds?
23. Are acknowledgements received for pledged deposits held at other banks?
24. Is an officer's approval necessary before collateral can be released or substituted?

OTHER

25. Are notes and advance slips safeguarded during bank hours and locked in the vault overnight?
26. Are all loan rebates approved by an officer and made only by official check?
27. Does the bank have an internal review system that:
    a. Re-examines collateral items and supporting documentation for negotiability and proper assignment?
    b. Test checks values assigned to collateral when the loan is made and at frequent intervals thereafter?
    c. Determines that items released on temporary vault-out tickets are authorized and have not been outstanding for an unreasonable length of time?
    d. Determines that loan payments are promptly posted?
28. Are all notes and advances recorded on a register or similar record and assigned consecutive numbers?
29. Are payment notices prepared and sent by someone not connected with loan processing?
30. Are any notes signed by a customer in blank and held in anticipation of future borrowings properly safeguarded?
31. Are lending officers frequently informed of maturing loans and credit lines?

CONCLUSION

32. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
33. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

When banks engage in international lending, they undertake customary credit risk as denoted by the possibility of nonpayment because of an obligor's weak financial condition or a lack of adequate collateral protection. International lending also bears risks associated with conditions within a foreign borrower's home country; these risks are commonly referred to as country risk. Conditions that may give rise to country risk include a country's underlying economic, political, and social trends and movements that may have potential consequences for foreigners' debt and equity investments in that country. In addition to the adverse effect that deteriorating economic conditions and political and social unrest may have on the rate of default by obligors in a country, country risk includes the possibility of nationalization or expropriation of assets, government repudiation of external indebtedness, exchange controls, and currency depreciation or devaluation. An assessment about the level of country risk should reflect an evaluation of the effect of prevailing (and possible future) economic, political, and social conditions on a country's ability to sustain external debt service, as well as reflect the impact of these conditions on the credit risk of individual counterparties located in the country.

Transfer risk is a facet of country risk. It is the possibility that an asset cannot be serviced in the currency of the payment because the obligor's country lacks the necessary foreign exchange or has put restraints on its availability.[1]

The traditional examination approach to commercial credit risk is treated separately in other sections of this manual. The purpose of this section is to delineate the current examination policies, objectives, and procedures for evaluating a bank's country- and transfer-risk exposures and its management system for monitoring and controlling them.

COUNTRY RISK

Country or sovereign risk encompasses the entire spectrum of risks and factors that arise from the economic, social, and political environments of a foreign country that may have potential consequences for foreigners' debt and equity investments in that country. A detailed description of these factors is described below.

Macroeconomic Factors

The first factor affecting country risk is the size and structure of a country's external debt in relation to its economy, more specifically—

- the current level of short-term debt and the potential effect that a liquidity crisis would have on the ability of otherwise creditworthy borrowers in the country to continue servicing their obligations, and
- to the extent the external debt is owed by the public sector, the ability of the government to generate sufficient revenues, from taxes and other sources, to service its obligations.

The condition and vulnerability of the country's current account is also an important consideration, including—

- the level of international reserves, including forward market positions of the country's monetary authority (especially when the exchange rate is fixed);
- the level of import coverage provided by the country's international reserves;
- the importance of commodity exports as a source of revenue, the existence of any price-stabilization mechanisms, and the country's vulnerability to a downturn in either its export markets or the price of an exported commodity; and
- the potential for sharp movements in exchange rates and their effect on the relative price of the country's imports and exports.

The role of foreign sources of capital in meeting the country's financing needs is another important consideration in the analysis of country risk, including—

- the country's access to international financial markets and the potential effects of a loss of market liquidity;

1. Exchange controls are an example of transfer risk. The Interagency Country Exposure Review Committee (ICERC) assigns ratings to foreign exposures based on its evaluation of the level of transfer risk associated with a country. See the *Guide to the Interagency Country Exposure Review Committee Process*, which was issued in November 1999, for a comprehensive discussion of the operations of the ICERC. See also section 7040.3.

- the country's relationships with private-sector creditors, including the existence of loan commitments and the attitude among bankers toward further lending to borrowers in the country;
- the country's current standing with multilateral and official creditors, including the ability of the country to qualify for and sustain an International Monetary Fund or other suitable economic adjustment program;
- the trend in foreign investments and the country's ability to attract foreign investment in the future; and
- the opportunities for privatization of government-owned entities.

Past experience has highlighted the importance of a number of other important macroeconomic considerations, including—

- the degree to which the country's economy may be adversely affected through the contagion of problems in other countries;
- the size and condition of the country's banking system, including the adequacy of the country's system for bank supervision and any potential burden of contingent liabilities that a weak banking system might place on the government;
- the extent to which state-directed lending or other government intervention may have adversely affected the soundness of the country's banking system, or the structure and competitiveness of the favored industries or companies; and
- for both in-country and cross-border exposures, the degree to which macroeconomic conditions and trends may have adversely affected the credit risk associated with counterparties in the country.

Social, Political, and Legal Climate

The analysis of country risk should also consider the country's social, political, and legal climate, including—

- the country's natural- and human-resource potential;
- the willingness and ability of the government to recognize economic or budgetary problems and implement appropriate remedial action;
- the degree to which political or regional factionalism or armed conflicts are adversely affecting the government of the country;
- any trends toward government-imposed price, interest-rate, or exchange controls;
- the degree to which the country's legal system can be relied on to fairly protect the interests of foreign creditors and investors;
- the accounting standards in the country and the reliability and transparency of financial information;
- the extent to which the country's laws and government policies protect parties in electronic transactions and promote the development of technology in a safe and sound manner;
- the extent to which government policies promote the effective management of the institution's exposures; and
- the level of adherence to international legal and business-practice standards.

Institution-Specific Factors

Finally, an institution's analysis of country risk should consider factors relating to the nature of its actual (or approved) exposures in the country, including, for example—

- the institution's business strategy and its exposure-management plans for the country;
- the mix of exposures and commitments, including the types of investments and borrowers, the distribution of maturities, the types and quality of collateral, the existence of guarantees, whether exposures are held for trading or investment, and any other distinguishing characteristics of the portfolio;
- the economic outlook for any specifically targeted industries within the country;
- the degree to which political or economic developments in a country are likely to affect the institution's chosen lines of business in the country (For instance, the unemployment rate or changes in local bankruptcy laws may affect certain activities more than others.);
- for an institution involved in capital markets, its susceptibility to changes in value based on market movements (As the market value of claims against a foreign counterparty rises, the counterparty may become less financially sound, thus increasing the risk of nonpayment. This is especially true for over-the-counter derivative instruments.);

- the degree to which political or economic developments are likely to affect the credit risk of individual counterparties in the country (For example, foreign counterparties with healthy export markets or whose business is tied closely to supplying manufacturing entities in developed countries may have significantly less exposure to the local country's economic disruptions than do other counterparties in the country.); and
- the institution's ability to effectively manage its exposures in a country through in-country or regional representation, or by some other arrangement that ensures the timely reporting of, and response to, any problems.

Risk-Management Process for Country Risk

Country risk has an overarching effect on an institution's international activities and should explicitly be taken into account in the risk assessment of all exposures (including off-balance-sheet) to all public- and private-sector foreign-domiciled counterparties. The risk associated with even the strongest counterparties in a country will increase if, for example, political or macroeconomic conditions cause the exchange rate to depreciate and the cost of servicing external debt to rise. Country risk can occur in many different forms, and the nature of specific risks can change over time. A U.S. banking organization with significant direct or indirect international exposure should have in place an effective country-risk management process that is commensurate with the volume and complexity of its international activities. Examiners should be continually evaluating the adequacy of the country-risk management process at internationally active institutions, and they should regularly update their assessments. An institution's country-risk management process should give particular attention to any concentrations of country risk.

Country risk is not necessarily limited to institutions with direct international exposures. Domestic counterparties with significant economic dependence on a foreign country or region (for example, through export dependence) can pose an indirect country risk to institutions that do not have direct international activity. While institutions are not required to incorporate indirect country risk into a formal country-risk management process, they should nevertheless take these country-risk factors into account, where appropriate, when assessing the creditworthiness of domestic counterparties. Examiners should ensure that the overall credit-risk management process takes into account indirect country risk where applicable in all supervised institutions.

To effectively control the risk associated with international activities, institutions must have a risk-management process that focuses on the broadly defined concept of country risk. A sound country-risk management process includes effective oversight by the board of directors, adequate risk-management policies and procedures, an accurate country-exposure reporting system, an effective country-risk analysis process, a country-risk rating system, country-exposure limits, ongoing monitoring of country conditions, periodic stress testing of foreign exposures, and adequate internal controls and an audit function.

Oversight by the Board of Directors

If country risk is to be managed properly, the board of directors must oversee the process effectively. The board is responsible for periodically reviewing and approving policies governing the institution's international activities to ensure that they are consistent with the institution's strategic plans and goals. The board is also responsible for reviewing and approving limits on country exposure and ensuring that management is effectively controlling the risk. When evaluating the adequacy of the institution's capital and allowance for loan and lease losses (ALLL), the board should take into account the volume of foreign exposures and the ratings of the countries to which the institution is exposed.

Policies and Procedures for Managing Country Risk

Bank management is responsible for implementing sound, well-defined policies and procedures for managing country risk that—

- establish risk-tolerance limits;
- delineate clear lines of responsibility and accountability for country-risk management decisions;

- specify authorized activities, investments, and instruments; and
- identify both desirable and undesirable types of business.

Management should also ensure that country-risk management policies, standards, and practices are clearly communicated to the affected offices and staff.

Country-Exposure Reporting System

To effectively manage country risk, the institution must have a reliable system for capturing and categorizing the volume and nature of foreign exposures. The reporting system should cover all aspects of the institution's operations, whether conducted through paper transactions or electronically. An accurate country-exposure reporting system is also necessary to support the regulatory reporting of foreign exposures on the quarterly Country Exposure Report, FFIEC 009.

The board of directors should regularly receive reports on the level of foreign exposures. If the level of foreign exposures in an institution is significant,[2] or if a country to which the institution is exposed is considered to be high risk, exposures should be reported to the board at least quarterly. More frequent reporting is appropriate when a deterioration in foreign exposures would threaten the soundness of the institution.

Country-Risk Analysis Process

Although the nature of the country-risk analysis process and the level of resources devoted to it will vary from institution to institution, depending on the size and sophistication of its international operations, a number of considerations are relevant to evaluating the process in all institutions:

- Is there a quantitative and qualitative assessment of the risk associated with each country in which the institution is conducting or planning to conduct business?
- Is a formal analysis of country risk conducted at least annually, and does the institution have an effective system for monitoring developments in the interim?
- Does the analysis take into account all aspects of the broadly defined concept of country risk, as well as any unique risks associated with specific groups of counterparties the institution may have targeted in its business strategy?
- Is the analysis adequately documented, and are conclusions concerning the level of risk communicated in a way that provides decision makers with a reasonable basis for determining the nature and level of the institution's exposures in a country?
- Given the size and sophistication of the institution's international activities, are the resources devoted to the analysis of country risk adequate?
- As a final check of the process, are the institution's conclusions concerning a country reasonable in light of information available from other sources, including external research and rating services and the Interagency Country Exposure Review Committee (ICERC)?

Country-Risk Ratings

Country-risk ratings summarize the conclusions of the country-risk analysis process. The ratings are an important component of country-risk management because they provide a framework for establishing country-exposure limits that reflect the institution's tolerance for risk.

Because some counterparties may be more exposed to local country conditions than others, it is a common and acceptable practice for institutions to distinguish between different types of exposures when assigning their country-risk ratings. For example, trade-related and banking-sector exposures typically receive better risk ratings than other categories of exposure because the importance of these types of transactions to a country's economy has usually moved governments to give them preferential treatment for repayment.

The risk-rating systems of some institutions differentiate between public-sector and private-sector exposures. In some institutions, a country's private-sector credits cannot be rated less severely than its public-sector credits (that is, the institution imposes a ''sovereign ceiling'' on

2. For purposes of this guidance, concentrations of exposures to individual countries that exceed 25 percent of the institution's tier 1 capital plus the ALLL are considered significant. However, in the case of particularly troubled countries, lesser degrees of exposure may also be considered to be significant.

the rating for all exposures in a country). Both are acceptable practices.

An institution's country-risk ratings may differ from the ICERC-assigned transfer-risk ratings because the two ratings differ in purpose and scope. An institution's internally assigned ratings help it to decide whether to extend additional credit, as well as how it should manage existing exposures. Such ratings should, therefore, have a forward-looking and broad country-risk focus. The ICERC's more narrowly focused transfer-risk ratings are primarily a supervisory tool to identify countries where concentrations of transfer risk might warrant greater scrutiny and to determine whether some minimum level of reserves against transfer risk should be established.

Country-Exposure Limits

As part of their country-risk management process, internationally active institutions should adopt a system of country-exposure limits. Because the limit-setting process often involves divergent interests within the institution (such as the country managers, the institution's overall country-risk manager, and the country-risk committee), country-risk limits will usually reflect a balancing of several considerations, including—

- the overall strategy guiding the institution's international activities,
- the country's risk rating and the institution's appetite for risk,
- perceived business opportunities in the country, and
- the desire to support the international business needs of domestic customers.

Country-exposure limits should be approved by the board of directors, or a committee thereof, and communicated to all affected departments and staff. Exposure limits should be reviewed and approved at least annually—and more frequently when concerns about a particular country arise.

An institution should consider whether its international operations are such that it should supplement its aggregate exposure limits with more discrete controls. Such controls might take the form of limits on the different lines of business in the country, limits by type of counterparty, or limits by type or tenor of exposure. An institution might also limit its exposure to local currencies. Institutions that have both substantial capital-market exposures and credit-related exposures typically set separate aggregate exposure limits for each because exposures to the two lines of business are usually measured differently.

Although country-by-country exposure limits are customary, institutions should also consider limiting (or at least monitoring) exposures on a broader (for example, regional) basis. A troubled country's problems often affect its neighbors, and the adverse effects may also extend to geographically distant countries with close ties through trade or investment. By monitoring and controlling exposures on a regional basis, institutions are in a better position to respond if the adverse effects of a country's problems begin to spread.

For institutions that are engaged primarily in direct lending activities, monthly monitoring of compliance with country-exposure limits is adequate. However, institutions with more volatile portfolios, including those with significant trading accounts, should monitor compliance with approved limits more frequently. Exceptions to approved country-exposure limits should be reported to an appropriate level of management or the board so that it can consider corrective measures.

Monitoring Country Conditions

The institution should have a system in place to monitor current conditions in each of the countries where it is significantly exposed. The level of resources devoted to monitoring conditions within a country should be proportionate to the institution's level of exposure and the perceived level of risk. If the institution maintains an in-country office, reports from the local staff are an obviously valuable resource for monitoring country conditions. In addition, periodic country visits by the regional or country manager are important to properly monitor individual exposures and conditions in a country. The institution may also draw on information from rating agencies and other external sources.

Communication between senior management and the responsible country managers should be regular and ongoing. The institution should not rely solely on informal lines of communication and ad hoc decision making in times of crisis. Established procedures should be in place for dealing with exposures in troubled countries, including contingency plans for reducing risk and, if necessary, exiting the country.

Stress Testing

Institutions should periodically stress-test their foreign exposures and report the results to the board of directors and senior management. As used here, stress testing does not necessarily refer to the use of sophisticated financial modeling tools, but rather to the need for all institutions to evaluate in some way the potential impact different scenarios may have on their country-risk profiles. The level of resources devoted to this effort should be commensurate with the significance of foreign exposures in the institution's overall operations.

Internal Controls and Audit

Institutions should ensure that their country-risk management process includes adequate internal controls and that an audit mechanism ensures the integrity of the information used by senior management and the board to monitor compliance with country-risk policies and exposure limits. The system of internal controls should, for example, ensure that the responsibilities of marketing and lending personnel are properly segregated from the responsibilities of personnel who analyze country risk, rate country risk, and set country limits.

TRANSFER RISK

Transfer risk focuses on a borrower's capacity to obtain the foreign exchange required to service its cross-border debt. The examination of transfer risk entails (1) the identification of selected country exposures of a bank that are considered significant relative to the bank's capital and the economic performance of the country; (2) the classifications of substandard, value-impaired, and loss; (3) a determination as to the adequacy of mandated special reserves against certain international assets classified value-impaired; (4) the segregation and analysis of those nonclassified credits into ''other transfer-risk problems'' that warrant bank management's close attention and into concentrations that warrant special comment; and (5) an in-depth assessment of the adequacy of the systems the bank employs to monitor and control this facet of international lending. Five report pages have been designed to reflect an examiner's analysis of the transfer-risk element in international lending for a particular bank, as follows.

The first page, ''Selected Country Exposures,'' merely lists, without comments, exposures that are deemed significant in relation to a bank's capital and the economic performance of the country. Exposures, depending on the country grouping, are taken from the bank's last quarterly Country Exposure Report, FFIEC 009, and compared with the bank's capital as of the same date.

The second page, ''Classifications Due to Transfer Risk,'' reflects credits ICERC has classified because of their transfer risk. Totals in each classification should be carried forward to the ''Summary of Classified Items'' page, with adjustments to eliminate those credits classified because of commercial risk, in accordance with the instructions in section 7040.3.

In December 1983, the federal banking agencies adopted examination categories for identifying credits that have been adversely affected by transfer-risk problems. In addition, the International Lending Supervision Act of 1983 requires banks to establish and maintain a special reserve when the value of international assets has been impaired by a protracted inability of the borrowers in a country to make payments on external indebtedness or when no definite prospects exist for orderly restoration of debt service. Both issues are outlined in section 7040.3.

The third page, ''Nonclassified Credits Warranting Attention I; Other Transfer Risk Problems (OTRP),'' is used to highlight all or a portion of those credits to a country that is not complying with its external debt-service obligations, but is taking positive steps to restore debt service through economic adjustment measures, generally as part of an IMF program. While not subject to classification, exposures in this category should be considered by examiners as a judgmental factor in their general assessment of a bank's asset quality and the adequacy of its reserves and capital.

The fourth page, ''Nonclassified Credits Warranting Attention II; Concentrations of Transfer Risk Warranting Special Comment,'' identifies exposures, as of the examination date, in which a combination of the amount outstanding in relation to the bank's capital funds, the composition of the portfolio, and the economic performance of the country would warrant the bank to focus special attention on its exposure.

The fifth page, ‘‘Analysis of the Country Exposure Management System,’’ presents in narrative form an assessment of a bank's system for monitoring and controlling its transfer-risk exposures. Included are comments relative to the bank's procedures for measuring exposure, the system for establishing country lending limits, and the bank's capability to analyze countries. Comments on page 1 of the report of examination may range from criticisms of weaknesses in the country-exposure-management system to high concentrations of risk in potentially weak or problematic countries.

COUNTRY-RISK MANAGEMENT

1. If the bank is internationally active, to determine the nature and extent of the bank's direct and indirect country-risk exposure.
2. If the bank has significant direct or indirect international exposure, to evaluate and determine whether it has in place an effective country-risk management process that is commensurate with the volume and complexity of its international activities.
3. To review and determine if the bank's system of policies, procedures, and internal controls and if its rating system and stress testing for county-risk management are adequate and reliable.
4. To determine if the bank's board of directors oversees and regularly reviews its country-risk management process, approves limits on country exposure, provides for adequate capital that is commensurate with its direct and indirect country-risk exposures, and ensures that management is effectively controlling the risk.
5. To determine if management clearly communicates the bank's country-risk management policies, standards, and practices to the affected offices and staff.
6. To determine if the scope of the bank's audit function is adequate and if the function is sufficiently comprehensive to ensure the integrity of the information senior management and the board use to monitor the bank's country-risk management process. To ensure that the board of directors or its audit committee has provided for adequate audit coverage of country-risk management functions.
7. To recommend corrective action if a bank's country risk-management process and controls are deficient in relation to the level of country-risk exposure.
8. To determine if the bank is properly preparing the Country Exposure Report, FFIEC 009, which is required to be filed quarterly with the respective Reserve Banks.
9. To identify and report individual country exposures considered significant in relation to the bank's capital and the economic performance of the country.

CLASSIFICATIONS DUE TO TRANSFER RISK

1. To evaluate the portfolio to identify those credits in countries considered subject to classification by the Interagency Country Exposure Review Committee (ICERC).
2. To determine if the bank has adequately provided the required special reserves for those international assets included in the country exposures classified value-impaired.
3. To develop information on the composition of those exposures subject to classification.
4. To prepare report pages on all transfer risks subject to classification.
5. To determine the effect of total transfer-risk classifications on the overall quality of the international loan portfolio, as well as on the total bank.

NONCLASSIFIED CREDITS WARRANTING ATTENTION—OTHER TRANSFER-RISK PROBLEMS

1. To identify and report any exposures to countries identified as ‘‘other transfer-risk problems.’’
2. To develop information on the composition of those exposures so identified, for the report page.

NONCLASSIFIED CREDITS WARRANTING ATTENTION—CONCENTRATIONS OF TRANSFER RISK WARRANTING SPECIAL COMMENT

1. To identify and report any concentrations of transfer risk warranting special comment.
2. To develop information on the composition of those concentrations for the report page.

ANALYSIS OF THE COUNTRY-RISK MANAGEMENT SYSTEM

1. To determine if the bank's policies, practices, procedures, and internal controls for the management of transfer risk are adequate.
2. To determine if bank officers are operating in conformance with established guidelines.
3. To prepare narrative commentary on the bank's country-exposure management system and on any noted deficiencies, in a concise reportable format.

COUNTRY RISK

Country risk, which has an overarching effect on the realization of an institution's foreign assets, encompasses all of the uncertainties arising from the economic, social, and political conditions in a country. It includes the possibility of deteriorating economic conditions, political and social upheaval, nationalization and expropriation of assets, government repudiation of external indebtedness, exchange controls, and currency depreciation or devaluation.

Analysis of the Country-Risk Management System

Generally, all banks have systems for appraising, monitoring, and controlling their foreign-lending activities. These systems differ from bank to bank in terms of the measure of the outstanding exposure, the independence of transfer-risk assessments and control from marketing considerations, the capability to make country judgments on the basis of analytical factors and firsthand knowledge of the country, the centralization and formality of procedures, and the level of in-depth review. When performing and updating the bank's risk assessment, the central point of contact for the institution should include an analysis of the institution's direct and indirect country-risk exposures (including any significant country-risk concentrations) and the adequacy and reliability of its country-risk management. Given the variations, banks' country-risk management systems should consist of three important components.

One component is the provision for evaluation of economic trends, political developments, and the social fabric within countries where bank funds are at risk. These so-called country studies are derived from economic data supplied by the borrower or published by institutional lenders; sociopolitical commentaries; on-site reports from bank branches, subsidiaries, or affiliates; or bank-officer visits to the country.

The second component involves the undertaking by the board of directors and senior management to define the level of country exposure the bank is willing to assume. This undertaking normally includes the establishment of limits on aggregate outstandings, maturities, and categories of risk exposures by country, which serve as a guide to operating management in the development and servicing of the bank's international credit portfolio.

The third component is the bank's internal-reporting system designed to monitor and control country exposure. A comprehensive reporting system is required to accurately assign risk exposures to the country of risk, ensure adherence to the directives of the board, provide for at least an annual review of portfolio composition in individual countries, and establish a clear-cut methodology for reporting exceptions to established limits.

A summary of the country-risk management system should be prepared. Set forth below are guidelines and procedures for examiners to use in evaluating the systems banks use to monitor and control country-risk elements in their international loan portfolios. In assessing the quality of the country-risk management system, examiners should, as a matter of course, spot-check the accuracy of the data submitted on the Country Exposure Report, FFIEC 009. The review should include the exposures for at least several countries. Material exceptions should be commented on. To prepare this summary, the examiner should perform the following procedures:

1. Obtain any written policies, procedures, or summaries of the bank's country-risk management system. Determine whether the bank's country-risk management system includes—
   a. effective oversight by the board of directors,
   b. adequate risk-management policies and procedures,
   c. an accurate country-exposure reporting system,
   d. an effective country-risk analysis process,
   e. a country-risk rating system,
   f. country-exposure limits,
   g. ongoing monitoring of country conditions,
   h. periodic stress testing of foreign exposures, and
   i. adequate internal controls and an audit function. (See SR-02-5.)

2. Obtain the following from a review of the minutes and reports of the board of directors:
   a. a copy of written policies covering transfer risk
   b. the name and composition of the committee responsible for administration of transfer risk
3. Review international-lending policies and determine—
   a. if the board of directors regularly reviews and gives final approval to the limits on country exposure at least annually (or quarterly, if the foreign exposures are high risk or the concentrations are significant);
   b. who initiates the country ratings and country limits;
   c. how frequently and by whom country ratings and limits are reviewed and changed;
   d. how the bank defines the ratings assigned to the various countries;
   e. how country limits are determined;
   f. who is responsible for monitoring compliance with country limits;
   g. if country-risk limits consider—
      - the overall strategy guiding the institution's international activities,
      - the country's risk rating and the institution's appetite for risk,
      - perceived business opportunities in the country, and
      - the desire to support the international business needs of domestic customers;
   h. to what extent country limits are viewed as guidelines that may be exceeded;
   i. if the bank has different sublimits for private- and public-sector credits;
   j. if separate limits are established for private- and public-sector credits;
   k. if the board of directors or a committee thereof periodically reviews country ratings and limits, and evaluates the bank's performance against those standards;
   l. to what extent comments or classifications of bank supervisors are considered in establishing, increasing, or decreasing country limits;
   m. how the system has been changed since the last examination;
   n. if the bank has a reliable system for capturing and categorizing the volume and nature of foreign exposures;
   o. whether the bank has a system to monitor current conditions in each of the countries where it is significantly exposed;
   p. if there is regular, ongoing communication between senior management and the responsible country managers;
   q. if established procedures are in place for dealing with exposures in troubled countries, including contingency plans for reducing risk and, if necessary, exiting the country; and
   r. whether the bank periodically conducts stress tests (financial modeling or measuring the impact of various scenarios on its country-risk profiles) of its foreign exposures and if the results are reported to senior management and the board of directors.
4. Review reports furnished to the board or the appropriate committee to ensure that comprehensive and accurate information is being submitted on a timely basis.
5. Obtain the bank's report on the general distribution and characteristics of the international loan portfolio and compare loan-category distributions for adherence to guidelines.
6. During discussion with senior management, direct inquiries to—
   a. gain insight into general management's international lending philosophy, and
   b. elicit management responses for correction of deficiencies.

When reporting on the bank's country-risk management system, the examiner should consider factors such as—

1. the quality of internal policies, practices, procedures, and controls over the international-lending functions;
2. the scope and adequacy of the internal loan-review system as it pertains to country risk;
3. causes of existing problems;
4. commitments from management for correction of deficiencies;
5. expectations for continued sound international lending or correction of existing deficiencies;
6. the ability of management to monitor and control transfer risk;
7. the general level of adherence to internal policies, practices, procedures, and controls; and
8. the scope and adequacy of the bank's analysis of country conditions.

TRANSFER RISK

Transfer risk is one facet of the more broadly defined concept of country risk. Transfer risk focuses more on the availability of foreign exchange to service a country's external debt.

The transfer-risk examination procedures emphasize diversification of exposure in relation to a bank's capital as the primary method of moderating transfer risk. Where concentrations are noted, the degree of risk inherent therein is assessed in light of the composition of the portfolio and the general economic and political factors that may affect the debt-service capacity of the individual countries.

INTERAGENCY COUNTRY EXPOSURE REVIEW COMMITTEE

Information concerning the relative grouping and classification of countries and appropriate comments are prepared by the Interagency Country Exposure Review Committee (ICERC) and will be furnished to examiners as required in the examination process. Since this information is sensitive, adequate safeguards should be established to ensure that it is not accessible to unauthorized personnel. The chief executive officers of those banks filing the quarterly FFIEC 009 receive copies of the write-ups on classified countries for *only* those classifications applicable to their own bank. In no event should the complete listing of country groupings be divulged. This approach parallels that of the Shared National Credit Program.

To promote uniform and consistent application of these procedures, examiners should avoid ad hoc interpretations of the instructions and should address all questions to their respective offices. The federal banking agencies have developed a publication, *Guide to the Interagency Country Exposure Review Committee Process*, to clarify and make more transparent the role of the ICERC in the supervisory process. (See SR-99-35.)

Application of ICERC Ratings

ICERC transfer-risk ratings are applicable in—

- every U.S.-chartered insured commercial bank in the 50 states of the United States, the District of Columbia, Puerto Rico, and U.S. territories and possessions;
- every U.S. bank holding company, including its Edge and agreement corporations and other domestic and foreign nonbank subsidiaries; and
- the U.S. branches and agencies of foreign banks (however, the allocated transfer-risk reserve (ATRR) requirement does not apply to these entities).

ICERC ratings are generally applicable to all types of foreign assets held by an institution, with the exception of premises, other real estate owned, and goodwill. For purposes of the ICERC rating, the determination of where the transfer risk for a particular exposure lies takes into consideration the existence of any guarantees and is based on the country of residence of the ultimate obligor. (See the instructions for the FFIEC 009.)

The ICERC transfer-risk rating is the only rating applicable to sovereign exposures in a reviewed country (that is, direct or guaranteed obligations of the country's central government or government-owned entities). However, if they are carried on the institution's books as an investment, securities issued by a sovereign entity are also subject to the FFIEC's Uniform Agreement on the Classification of Assets and Appraisal of Securities Held by Banks. The FFIEC agreement provides for specific, and possibly more severe, classification treatment of sub-investment-quality securities. Furthermore, except as noted in the next paragraph, the ICERC transfer-risk rating is also the minimum risk rating applicable to all other cross-border and cross-currency exposures of U.S. banks in a reviewed country.

Regardless of the currencies involved, to the extent that an institution's claims on local country residents are funded by liabilities to local country residents, the ICERC's transfer-risk ratings do not apply. For example, to the extent that it has liabilities to local residents (such as sterling deposits), claims of the London branch of a U.S. bank on a public- or private-sector obligor in the United Kingdom (whether the claims are denominated in sterling, dollars, or marks) are not subject to the ICERC transfer-risk rating.

The ICERC is not able to evaluate the credit risk associated with individual, private-sector exposures in a country. Therefore, based on an evaluation of credit-risk factors (including the effects of country risk), examiners may assign credit-risk ratings to individual, private-sector exposures that are more severe than the ICERC-assigned transfer-risk rating for the country. For any given private-sector exposure, the applicable rating is *the more severe* of either the ICERC-assigned transfer-risk rating for the country or the examiner-assigned credit-risk rating (including ratings assigned as a result of the Shared National Credit Program).

Questions sometimes arise concerning the consideration that examiners should give to informal expressions of support by the central government of a country for a particular borrower or sector of the economy (most often, banking). Unless they constitute a guarantee or other legally binding commitment, examiners should view such expressions of support as no more than a mitigating factor in their evaluation of the counterparty's credit risk. Informal expressions of support by the central government would not cause the counterparty's credit-risk rating to revert to the ICERC-assigned transfer-risk rating for the country.

Although the ICERC may have rated ordinary short- and/or long-term exposures in a country as OTRP, substandard, value-impaired, or loss, several special categories of exposure in a country may receive a less severe transfer-risk rating if certain conditions are met, as described below.

- *Performing short-term bank and performing short-term trade exposures.*[1] Short-term bank and trade exposures are generally considered to have a lower level of transfer risk because, historically, they have received priority in the allocation of a country's foreign-exchange resources. In recognition of their historical performance, the ICERC usually assigns a more favorable rating to these types of exposures.
- *Securities held in trading accounts.* Presuming that there is an active and liquid market for the securities and that the bank has procedures in place to appropriately value them, the ICERC may, on a case-by-case basis, assign a less severe transfer-risk rating to specific securities held in the bank's trading account. In any case, because FASB Financial Accounting Standard No. 115 requires that they be marked to market, trading-account securities are not subject to an ATRR requirement.
- *Direct-equity investments.* The ICERC may, on a case-by-case basis, assign a less severe transfer-risk rating to specific direct-equity investments when *all* of the following conditions are met:
  - — The investment has been marked to market or is valued using the equity-accounting method.
  - — The institution has provided the ICERC with evidence that the foreign business is financially viable.
  - — The institution has provided the ICERC with evidence of its ability to repatriate dividends, interest payments, and proceeds from the sale of assets on a timely basis.

1. A *performing credit* is current and has not been restructured to avoid delinquency or because of a deterioration in the financial condition of the borrower. A credit is considered "current" if it has not been reported as past due or nonaccrual for the bank call report. *Trade credit* consists of credit extensions that are directly related to imports or exports and that will be liquidated through the proceeds of international trade. These credit extensions will include pre-export financing only when there is a firm export sales order and the proceeds of the order will pay off the indebtedness.

EXAMINATION REPORTING OF TRANSFER RISK

The entire examination section dealing with transfer risk should be placed in an international operations section of the commercial report of examination. In addition, the discussion of transfer-risk assets should be separated from the discussion of all other loans and assets classified or specially mentioned elsewhere in the report.

Selected Country Exposures

A list should be presented of those transfer-risk exposures considered large relative to the bank's own capital funds, after taking into account the economic, social, and political circumstances within a country. These exposures, which comprise total claims and contingencies, should be taken from the last quarterly FFIEC 009 filed by the bank under examination and compared with consolidated bank capital as of the same date. For this purpose, capital is defined as tier 1 and tier 2, and it should be footnoted as such on this page. The examiner should also note that this report of country exposure and its comparison with bank capital may differ from actual exposure as of the date of examination. The level at which exposure is listed is based on a review of the performance of each country by the ICERC.

Examiners are encouraged to review the instructions for preparing the country-exposure report for further information concerning the preparation of this page. While it is not expected that examiners review the country-exposure reports filed between examinations for accuracy, a spot-check to verify that such reports are being prepared properly should be made. Material reporting errors uncovered during the examination should be included in comments on reporting exceptions elsewhere in the report of examination. When bank management relies on the data generated for the country-exposure report, and when reporting exceptions are noted, comments should be incorporated in the analysis of the country-risk management system.

Ratings and Classifications Due to Transfer Risk

A list of exposures subject to classification as a result of transfer-risk considerations should be prepared. The decision to classify a bank's exposure to a particular country is made by the ICERC based on criteria incorporated into the provisions of the International Lending Supervision Act of 1983.

The ICERC's assessment of transfer risk reflects the committee's application of the following category definitions.

- *Strong.* The country does not experience social, economic, or political problems that could interrupt repayment of external debt.
- *Moderately strong.* The country experiences a limited number of identifiable economic, social, or political problems that do not presently threaten orderly repayment of external debt.
- *Weak.* The country experiences many economic, social, or political problems. If not reversed, these problems could threaten orderly repayment of external debt.

The ratings and classification categories, and when they are applied, are as follows.

Other Transfer-Risk Problems (OTRP)

- A country is not complying with its external debt-service obligations, as evidenced by arrearages, forced restructuring, or rollovers; however, the country is taking positive actions to restore debt service through economic adjustment measures, generally as part of an International Monetary Fund (IMF) program.
- A country is meeting its debt obligations, but noncompliance appears imminent.
- Exposures to a country have been classified previously, but recent debt-service performance indicates classification is no longer warranted (for example, the country is complying with the terms of IMF and rescheduling programs). However, sustained resumption of orderly debt service needs to be demonstrated.

Substandard

- A country is not complying with its external service obligations, as evidenced by arrearages, forced restructuring, or rollovers.
- The country is not in the process of adopting an IMF or other suitable economic adjustment program, or is not adequately adhering to such a program.
- The country and its bank creditors have not negotiated a viable rescheduling and are unlikely to do so in the near future.

Value-Impaired

A country has protracted arrearages, as indicated by more than one of the following:

- The country has not fully paid its interest for six months.
- The country has not complied with IMF programs (and there is no immediate prospect for compliance).
- The country has not met rescheduling terms for over one year.
- The country shows no definite prospects for an orderly restoration of debt service in the near future.

Loss

A loan is considered uncollectible and of such little value that its continuance as a bankable asset is not warranted. An example would be an outright statement by a country that it is repudiating obligations to banks, the IMF, or other lenders.

The ICERC also prepares the write-ups supporting each classification. Examiners are to provide commentary on the disaggregation of each country exposure subject to classification. Include comments relative to the bank's country lending limit and any references to any proposed increases or decreases to such limit. The examiner's commentary is to be followed by a standardized write-up on each country for which the bank has exposures, prepared by the ICERC.

Credits Warranting Attention

Other Transfer-Risk Problems (OTRP)

A listing and narrative on the bank's total exposure, or portion thereof, to a country for which the exposures were designated as OTRP should be prepared. Comments for each country will consist of a paragraph detailing the composition of the exposure, as prepared by the examiner. Following the comments will be a standardized write-up prepared by the ICERC, discussing developments in the country. When exposures to a country are split between classifications and OTRP, the standardized country write-up need be shown *only* on the classification page with a reference to such on the OTRP page.

Examiners should consider the total of OTRP exposures as a judgmental factor in their general assessment of a bank's asset quality and the adequacy of its reserves and capital. This view is similar to the consideration given to factors such as concentrations in the portfolio, the level and composition of nonaccruing or reduced-rate assets, and management's demonstrated ability to administer and collect problem credits.

Nonclassified Credits Warranting Attention

Concentrations of Transfer Risk Warranting Special Comment

A listing and narrative on exposures to weak and moderately strong countries as of the examination date and compared with the bank's capital as of that date should be prepared. When the country-exposure report is filed on a consolidated bank holding company basis, the data may be used to prepare a selected country exposures page and a summary that is compared with the holding company's capital. However, examiners should attempt to segregate the bank's exposures for all other transfer-risk pages. When exposures to particular countries at the holding company are deemed to be significant relative to the bank, examiners are to note such in their commentary on those countries.

Each country exposure should be listed alphabetically, accompanied by a paragraph detailing the composition of the bank's exposure. Include comments relative to the country lending limit and proposals to increase or decrease it. The examiner's commentary is to be followed by a standardized write-up, prepared by the ICERC. The criteria for determining exposures warranting comments are listed below.

Strong countries. The "strong countries" designation applies when the country does not experience social, economic, or political problems that could interrupt repayment of external debt. No exposures to strong countries will be commented on in this page. Extremely large exposures to these countries may be commented on in the discussion of the exposure-management system and in the examiner's summary comments.

Moderately strong countries. The moderately strong countries designation applies when the country experiences a limited number of identifiable economic, social, or political problems that do not presently threaten orderly repayment of external debt. The following criteria apply; item 2 is optional.

1. Exposures exceeding 15 percent of capital must be commented on.
2. For exposures between 10 and 15 percent of capital, there is a presumption in favor of commenting if outstandings with a maturity in excess of one year exceed 7.5 percent of capital. If maturities in excess of one year are less than that amount, there will be a presumption against commenting.
3. Exposures below 10 percent will not be commented on.

Weaker countries. The weaker countries designation applies when the country experiences many economic, social, or political problems. If not reversed, these problems could threaten orderly repayment of external debt. The following criteria apply; item 2 is optional:

1. Exposures exceeding 10 percent of capital must receive comment.
2. For exposures between 5 and 10 percent of capital, there is a presumption in favor of commenting only if amounts due in excess of one year exceed 5 percent of capital. If amounts maturing in excess of one year are less than 5 percent, the presumption is against commenting.

When comment is optional (points 2 above), the examiner will be allowed some flexibility and may determine not to follow the presumptions if other pertinent banking factors weigh more heavily either for or against comment. These factors might be management ability, the nature of ICERC's comment about the country, or the results of a more detailed breakdown of the composition of the portfolio. It is possible that exposures will be listed on this page with other exposures to the same country either subject to classification or listed as an other transfer-risk problem. In such instances, the standardized write-up should appear on either of those pages with a cross-reference noted on this page.

RESERVING REQUIREMENTS

The agencies believe responsibility for recognizing and accounting for deterioration in the value of a bank's assets, including a deterioration due to transfer-risk problems, rests, in the first instance, with the management of a bank and its auditors. The banking agencies also have a responsibility to ensure that banks are following reasonable and prudent policies in this regard, and that necessary adjustments are being made consistently. To ensure this, the federal banking agencies, pursuant to the International Lending Supervision Act, require U.S. banks to establish an ATRR against the risks presented in certain international assets whose value has been found by the ICERC to have been significantly impaired by protracted transfer-risk problems. The ATRR should be applied to certain international assets that have been classified for transfer-risk reasons as value-impaired. The act also requires that the ATRR be established by a charge against current income, be segregated from the bank's general allowance for possible loan losses, be deducted from gross loans and leases, and not be included as part of bank capital.

The alternative to establishing an ATRR is the direct charge-off of that portion of the international asset deemed to be of diminished value. However, if this alternative accounting treatment is used, the institution may not write up the value of the assets if the ATRR requirement is later reduced or eliminated. No ATRR provisions are required if the bank has previously written down or charged off the requisite amounts. Furthermore, no ATRR will be required on contingent liabilities. Instead, contingent liabilities to value-impaired countries will be reviewed on a case-by-case basis, but generally will be treated as OTRP.

The ATRR amounts mandated will be reviewed regularly by the ICERC to determine if additional reserves are required or whether downward adjustments need to be made. Initially, special reserves would not apply to net new lending when additional loans are made in the context of an IMF or other appropriate economic adjustment program, and when the lending generally enhances the debt-service capability of the country concerned. Whether an ATRR is subsequently required for these new loans would be determined by the ICERC on the basis of performance and the continued inapplicability of the established criteria.

To calculate the reserves, examiners must multiply the reserve percentage times the amount of the adjusted exposure subject to transfer risk and the ATRR. This calculation should be done on the face amount of each loan outstanding before deducting any previous write-downs. For purposes of this computation, interest payments that have been applied to existing loan balances are tantamount to write-downs and are an acceptable alternative to the establishment of an ATRR. The number derived after the calculation should be netted against previous write-downs to arrive at the mandated ATRR. In accordance with SR-92-2 (FIS), February 10, 1992, the resulting net exposure, after adjusting for the ATRR, is included in the total classified value-impaired, but is weighted like a substandard credit *only* in determining the asset quality of the bank and other measures of financial soundness. The resulting net exposure, after adjustment for the ATRR, is included in the total classified value-impaired and is looked on as a doubtful classification *only* in determining the asset quality of the bank and other measures of financial soundness. When a shortfall exists, management should be apprised and be expected to comply with the statute in establishing the required reserve. Comments relative to any shortfall and management's actions should be made on page 1. Although the general rule is that all exposures rated value-impaired are subject to the ATRR requirement, over the years there have been a number of clarifications and refinements. (See 12 CFR 20, 211, and 351.)

OTHER MATTERS

Discussion of Transfer Risk on Examiner's Comments Page

As a general rule, classifications due to transfer risk are included in the total assets classified and discussed under a major heading, such as "Asset Quality." Transfer-risk classifications of any significance should be highlighted. When the bank has other exposures of concern that warrant not only senior management's special attention, but the attention of the bank's board of directors, comments may be generated under a separate caption entitled "Transfer Risks." The examiner should include comments relative to the classifications; the shortfall, if any, in the mandatory reserves against exposures considered value-impaired; other transfer-risk problems (OTRP); concentrations warranting special comment; and any other noted deficiency, such as an ineffective country-risk management system.

Sharing Information with State Banking Examiners

When an examination of a state member bank is being conducted concurrently or on a joint basis with state authorities, Federal Reserve examiners may share with state banking examiners information on those countries to which the bank under examination has exposures subject to classification or comment.

Country Categories

The complete listing of countries as prepared by the ICERC is highly confidential and for internal use only. In discussions with bank management, examiners should refer only to countries that will be commented on in that bank's examination report. In this context, any reference to a "categorization" of countries should be couched in neutral terms.

Examiners are to provide the examiner-in-charge with essential information that will help facilitate future examinations. In addition, all workpapers should be maintained in an orderly manner, properly labeled, and available for inspection when and if necessary.

1. Has the board of directors, consistent with its duties and responsibilities, adopted written objectives and policies for international loan portfolio management? Do these policies and objectives—
   a. establish country-exposure limits for credits, including sublimits for transfer risk?
   b. establish limits for distribution of credits by type and maturity?
   c. acknowledge concentrations of credit within countries, and acknowledge the need to employ personnel with appropriate specialized knowledge and experience to supervise those concentrations?
2. Are objectives and policies for international loan portfolio management reviewed at least annually to determine if they are compatible with changing market conditions?
3. Are significant changes in country conditions or levels of exposure promptly brought to the attention of the board of directors or its designated committee?
4. Are country limits revised in response to substantive changes in economic, political, and social conditions within particular countries?
5. Is a formal analysis of country risk prepared, and are country limits reviewed, updated, and approved by the board of directors at least annually?
   a. Does the analysis take into account all aspects of the broadly defined concept of country risk, as well as any unique risks associated with specific groups of counterparties the institution may have targeted in its business strategy?
   b. Is the analysis adequately documented, and are conclusions concerning the level of risk communicated in a way that provides decision makers with a reasonable basis for determining the nature and level of the institution's exposures in a country?
   c. Are the bank's conclusions concerning a country reasonable in light of information available from other sources, including external research and rating services and the Interagency Country Exposure Review Committee (ICERC)?
6. Before granting additional advances or commitments, are outstandings checked to appropriate country limits?
7. Are lending officers cognizant of specific country limitations?
8. Are procedures for exceeding country limits clearly defined?
9. Does the bank have a periodic foreign call program for countries?
10. Is there an internal-review system to determine that international risk assets outstanding and committed are within the bank's foreign-exposure limits?
11. Are country-risk factors (economic, political, and social) and other factors in a particular country considered in the bank's internal periodic review of its risk assets?
12. Does the bank have an adequate, current system for country-risk analysis? Does the system consist of a regular, periodic quantitative and qualitative assessment and review of risk for each country in which the bank conducts or plans to conduct business, and does this system include—
    a. a review of country conditions on a regular basis (state the frequency and indicate who performs analyses)?
    b. a continuing review of current country data obtained from internal and external sources?
    c. an analysis of economic, political, social, and other factors affecting country risk?
13. Does the bank have a formal reporting system on country risk?
14. Does the reporting system provide complete exposure data quickly and in sufficient detail to assess particular risks?
15. Does the bank's country-risk evaluation system accurately recognize exposure from country to country, on the basis of legally binding guarantees, collateral, or reallocation by the office of responsibility?
16. Given the size and sophistication of the institution's international activities, are the resources devoted to the analysis of country risk adequate?
17. Is a regular determination made about each country's transfer risk, including whether transfer risk is increased due to the bank's heavy debt servicing or other financial restraints, and whether the country has

exchange controls and hard-currency restrictions?

18. Has the bank adequately provided the required special reserves for those international assets that are included in the country exposures classified value-impaired?

INTRODUCTION

Financing foreign receivables, a specialized area of commercial lending in an international banking division, includes open-account financing, sales on consignment, advances against collections, discounting trade acceptances, banker's acceptances, factoring, and forfaiting. Certain foreign receivables are guaranteed or insured against cross-border risk by the Export-Import Bank of the United States, the Foreign Credit Insurance Association, and other U.S. and foreign organizations. Factoring is discussed in section 2180 of this manual, and accounts receivable financing is discussed in section 2160 (Asset-Based Lending) of this manual.

OPEN-ACCOUNT FINANCING

The simplest method of financing foreign receivables is on open account. In this type of sale, the buyer and seller agree on payment at a specified date without a negotiable instrument, such as a draft or acceptance, evidencing the obligation. In most instances, the shipping documents are sent directly to the buyer rather than through a bank. The exporter may request that the buyer make payment to the bank at which the exporter maintains an account. The advantages of an open-account sale are its simplicity, lack of bank charges, and the avoidance of stamp duties that certain countries apply to drafts.

The financing of open-account sales does have certain risks. Neither the lending bank nor the exporter have control over the shipping documents, and the buyer (importer) may take possession of the goods without the consent of the bank or exporter. In addition, if the importer does not register the goods with the proper authorities, the importer may not have access to the amount of foreign exchange necessary to pay for the imports at the time of payment. Perhaps the greatest risk in open-account financing is the lack of standard trade-financing documentation on which to base legal action against the importer in the event of default. Therefore, open-account sales are most appropriate when the buyer is a subsidiary of a related company or is well known to the seller and when the importing country has no significant economic, political, or social problems and, consequently, is not encountering foreign-exchange difficulties.

SALES ON CONSIGNMENT

Under a consignment arrangement, goods are consigned to the importer (consignee) abroad, and the exporter (consignor) retains title to them until they are sold to a third party. However, unless the shipment is made to an exporter's overseas branch or subsidiary, the exporter's credit risk may be considerable. As with open-account sales, there is a lack of standard trade-financing documentation on which to base legal action if the consignee defaults. The exporter should thoroughly understand the inherent credit risks, especially when goods are consigned to an agent, representative, or import house abroad.

In countries with free ports or free trade zones, consigned goods may be placed under bonded warehouse control in the name of a foreign bank or branch of the bank. Arrangements may then be made to release the consigned merchandise at the time it is sold. Merchandise is cleared through customs after the sale has been completed. However, that type of consignment should not be made and will not usually be accepted by foreign banks until all pertinent conditions and regulations are verified and storage facilities are arranged. The exporter's bank also should verify that goods not sold may be returned to the country of origin. Consignment shipments financed by the bank should be limited to countries that do not have burdensome foreign-exchange restrictions and that have sufficient foreign exchange available to pay for imports.

To overcome the disadvantages of financing shipments on an open-account or consignment basis, exporters frequently ship goods against documentary collections. Consequently, the exporter, in the case of a time or arrival draft, or the exporter and the importer jointly, in the case of a sight draft, finance the shipment. The exporter and the importer may have unused credit lines with their banks and be in a position to borrow the needed money without tying the financing to the trade transaction. However, often the exporter's or the importer's regular bank lines are fully drawn down, so they may seek bank financing in the form of advances against outward collections, discounting trade acceptances, banker's acceptances, factoring, or forfaiting.

ADVANCES AGAINST FOREIGN COLLECTIONS

A manufacturer or merchant conducting a strictly domestic business often obtains a loan from a bank, finance company, factor, or forfaiter using accounts receivable as security. The same general type of financing vehicle is available to exporters to finance their foreign receivables.

A common method of financing foreign receivables is through the exporter pledging all outward collections to its bank. The exporter may then borrow from the bank up to a stated maximum percentage of the total amount of receivables pledged at any one time. When notes rather than drafts are used to finance foreign receivables, they are usually paid on demand, enabling the exporter to increase or decrease the loan depending on its needs and the current amount of collections outstanding. Preferably, all of the collections lodged with the exporter's bank should be pledged to the bank. When a particular collection is paid, it is remitted by a foreign collecting bank to the exporter's bank, which has already advanced the funds to the exporter. The exporter's bank then uses the proceeds of the collection to reduce the exporter's loan.

Some exporters have no need for a continuous financing arrangement but occasionally may wish to obtain financing on only one large foreign receivable. In these instances, the exporter's bank may be willing to advance funds to the exporter with only that one receivable as security. Again, the bank establishes a maximum percentage of the amount of the receivable that it is willing to advance. When payment for the receivable is obtained, the bank uses the proceeds to liquidate the loan, crediting any excess to the exporter. Bank financing in the form of advances against export receivables is an accepted practice in international trade and is not considered factoring.

Besides having a lien on the exporter's outward collections, the bank usually retains recourse to the exporter, whose credit strength and reputation are of prime importance. Other factors, however, are also significant. If the foreign importers are companies with strong reputations and financial strength, the bank will likely advance a larger percentage on collections directed to them. The bank will also likely advance a larger percentage of funds to importers in those countries in which importers promptly pay drafts drawn on them. In other countries where payment is generally slow, perhaps because importers are financially weak or because U.S. dollar or other foreign-currency exchange is hard to obtain, the bank will advance a lower percentage on collections. The exporter's bank may be completely unwilling to finance collections directed to importers or countries with reputations for habitually slow payments.

When a bank advances against foreign receivables, it must carefully scrutinize the supporting documents. Since the bank wishes to maintain control of the merchandise, the bill of lading should be either ‘‘to the order of’’ the shipper and blank-endorsed or ‘‘to the order of’’ the bank. The bill of lading must not be consigned to the buyer (importer) since this gives the buyer control over the goods. Also, financed shipments should be covered by adequate insurance.

DISCOUNTING TRADE ACCEPTANCES

A draft accepted by the foreign importer becomes a trade acceptance carrying the full credit obligation of the importer. These trade acceptances are also frequently called ‘‘trade bills’’ or ‘‘trade paper.’’ The acceptance is returned to and becomes the property of the exporter, who will ask the collecting bank to present it to the importer or acceptor for payment at maturity. The exporter is, therefore, providing the financing or ‘‘carrying’’ its own foreign receivables. However, if the exporter needs the funds before maturity of the trade acceptance, the exporter may ask the bank to ‘‘discount’’ the draft. If the primary obligor (the acceptor) is a well-known company of good credit standing, the bank may be willing to discount the draft without recourse to the exporter. More commonly, however, the lending bank looks to the exporter for recourse should the primary obligor fail to pay the amount when due.

When discounting a trade acceptance, the bank applies a discount to the face amount of the draft and advances the remainder to the exporter until the draft's maturity. The bank is ‘‘buying’’ the trade acceptance for value and is entitled to any benefits from the primary obligor to which it is due as a holder in due course of a negotiable instrument. This is also the case whenever the bank advances against a single collection or a pool of collections. Any intermediary "collecting" bank also has a financial interest in the collection and has all the rights of a holder in due course under the Uniform Commercial Code.

BANKER'S ACCEPTANCES CREATED AGAINST FOREIGN COLLECTIONS

During periods of tight money, banks may choose to finance foreign collections by using banker's acceptances. Banker's acceptances are discussed in section 7060, "International—Banker's Acceptances," so the following comments relate only to the financing of foreign collections.

As with all acceptance financing, the exporter first submits a signed acceptance agreement to its bank. To obtain acceptance financing for foreign receivables, the exporter draws two drafts. The first is a time draft drawn on the foreign buyer (the importer) that, along with the necessary documents, is sent for collection in the usual manner. The second draft, for the same or a smaller amount as agreed to by the bank and the exporter, is drawn by the exporter on its bank and has the same tenor as the draft drawn on the importer. The bank accepts the second draft and discounts it, crediting the net amount to the exporter's account. The bank has now created a banker's acceptance that can be sold in the highly liquid acceptance market, provided the bank's reputation is solid. When payment is received from the importer, the bank applies the proceeds towards its own acceptance, which will be presented for payment if sold in the market. Should the drawee default, the bank has recourse to the drawer and can demand payment from that source.

FORFAITING

Forfaiting is basically nonrecourse financing of receivables, similar to factoring. However, although a factor normally purchases a company's short-term receivables, a forfait bank purchases notes that are long-term receivables with maximum maturities of eight years. The forfaiting bank has no recourse to the seller of the goods, but gets the notes at a substantial discount in exchange for cash. Zurich and Vienna are the centers of forfaiting. Many large banks, including U.S. institutions, provide forfaiting through either their branches or specialized subsidiaries in these cities.

Forfaiting is used when government export credits or credit guarantees are not available or when a seller does not extend long-term credits to areas such as Eastern Europe. Forfaiting is also an important method of financing for small and medium-sized companies because it enables them to engage in transactions that would normally exceed their financial capabilities. By using forfaiting, small and medium-sized concerns can immediately sell their long-term receivables without recourse.

Forfaiting presents all of the risks associated with factoring, along with the risks associated with the long-term nature of purchased receivables. The examiner should review the bank's forfaiting activities carefully to determine whether long-term receivables have been purchased from countries prone to periodic political or economic turmoil and the resulting fluctuations in exchange rates.

U.S. AND FOREIGN RECEIVABLES GUARANTEE AND INSURANCE PLANS

To reduce credit, political, and other risks associated with foreign receivables financing, banks may avail themselves of a variety of guarantee and insurance plans, both public and private, that are available in many countries. Because of the complexity of the numerous plans available, an examiner must frequently rely on the technical knowledge of the staff in a bank's international division who handle these transactions. Nevertheless, the examiner should know the risk coverage and claim adjustment provisions of the major plans. Often a bank's experience with its receivables insurance and guarantee plans is indicative of its effectiveness and of whether the bank has properly met its responsibilities under the programs.

Export-Import Bank of the United States

The Export-Import Bank of the United States (Eximbank) issues to commercial banks, for a fee, guarantees of payment for foreign receivables that the bank purchases from exporters, generally without recourse to the exporter. The maturities of the receivables range from 181 days to over five years. Generally, the foreign buyer must make a cash payment, either before or upon delivery, of at least 10 percent of the invoice value, and the amount of receivables purchased by the bank without recourse to the exporter normally cannot exceed 90 percent of the financed portion of the sale (invoice amount less cash payment). This guarantee covers political risks, such as inconvertibility of foreign currencies into U.S. dollars, governmental actions preventing importation of goods, war, civil strife, expropriation, and confiscation by government action. Commercial risks, basically the credit risk of the foreign purchaser, usually are covered from six months to five years.

Foreign Credit Insurance Association

The Foreign Credit Insurance Association (FCIA) is an association of leading marine, property, and casualty insurance companies. In cooperation with Eximbank, FCIA offers a comprehensive selection of credit insurance policies that protect policyholders against loss from failure to receive payment from foreign buyers.

FCIA coverage protects the exporter against the failure of the buyer to pay dollar obligations for commercial or political reasons; enables the exporter to offer foreign buyers competitive terms of payment; supports the exporter's prudent penetration of higher risk foreign markets; and gives the exporter greater liquidity and flexibility in administering a foreign receivables portfolio. The FCIA does not itself finance export sales. However, the exporter who insures account receivables against commercial and political risks is usually able to obtain financing from commercial banks and other lending institutions at lower rates and on more liberal terms than would otherwise be possible by assigning the proceeds of the FCIA insurance to the lenders.

Comprehensive FCIA policies protect exporters against nonpayment of receivables due to unforeseeable commercial and political occurrences. Commercial risks covered include insolvency or protracted default, which may be caused by economic deterioration in the buyer's market area, shifts in demand, unanticipated competition, tariffs, or technical changes. Political risk coverage applies to defaults due to government action, such as currency inconvertibility, expropriation, and cancellation of import license, and to political disturbances, such as war, revolution, and insurrection.

FCIA generally offers four basic types of policies covering political and commercial risks:

- Short-term policies covering shipments normally sold on terms up to 180 days. The usual policy covers 100 percent of political risks and 90 percent of any losses from commercial risk.
- Medium-term policies insuring transactions from six months to five years. FCIA covers up to 100 percent of political risks and 90 percent of commercial risks, with the remainder retained by the exporter.
- Combined short-term/medium-term policies for sales that pass through distributors before reaching final buyers.
- Master policies that include the basic insurance features of the previous policies plus discretionary and deductible provisions. Under a master policy, usually only for short-term transactions, exporters may obtain FCIA authority to grant insured credit up to a certain amount without seeking prior approval. The deductible provision, used only for commercial risks and not political risks, requires the exporter to assume a fixed amount of the first loss on total debts.

(Source: *Washington Agencies That Help to Finance Foreign Trade*, seventh edition, Bankers Trust Company, New York.)

Other Insurers

Numerous other private and governmental institutions, both in the United States and overseas, guarantee or insure risks assumed by commercial banks financing foreign receivables. Some examples of these institutions in other countries are the Export Credits Guarantee Department (ECGD) in the United Kingdom, COFACE in France, and HERMES in Germany.

In the United States, the Overseas Private Investment Corporation (OPIC), a corporation wholly owned by the U.S. government, offers insurance against the political risks of inconvertibility, expropriation, war, revolution, and insurrection and guarantees the repayment of private U.S. loans for U.S. citizens, U.S. concerns that are substantially and beneficially U.S.-owned, and foreign concerns that are at least 95 percent owned by U.S. individuals or entities.

1. To determine if the policies, practices, procedures, and internal controls for the financing of foreign receivables are adequate.
2. To determine if bank officers are operating in conformance with established bank guidelines.
3. To evaluate the portfolio for credit quality, collectibility, and collateral sufficiency.
4. To determine the scope and adequacy of the audit function as it relates to the financing of foreign receivables.
5. To determine compliance with laws and regulations.
6. To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws and regulations are cited.

1. If selected for implementation, complete or update the international—financing foreign receivables section of the internal control questionnaire.
2. Determine the scope of the examination on the basis of the evaluation of internal controls and the work performed by internal or external auditors.
3. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examination procedures. Also obtain a listing of any deficiencies noted in the latest reviews done by internal and external auditors from the examiner assigned to the audit review, and determine if appropriate corrections have been made.
4. Obtain trial balances of applicable customer liability records.
   a. Reconcile balances to department controls and the general ledger.
   b. Review reconciling items for reasonableness.
5. Using an appropriate technique, select borrowers for examination.
6. Prepare examiners' credit line cards to include—
   a. customers' aggregate foreign receivables–financing liability and
   b. debt instruments aggregating customers' total outstanding liability.
7. Obtain the following information:
   a. past-due, nonaccrual, and reduced-rate loans, advances, and acceptances
   b. loans whose terms have been modified by a reduction in the interest rate or the principal payment or by a deferral of interest or principal
   c. loans transferred, either in whole or in part, to another lending institution as a result of a sale, participation, or asset swap since the previous examination
   d. loans acquired from another lending institution as a result of a purchase, participation, or asset swap since the previous examination
   e. loan commitments and other contingent liabilities
   f. loans to principal shareholders, officers, and directors and to their related interests (indicate which officers are considered executive officers)
   g. reports on the indebtedness of executive officers and principal shareholders and their related interests to correspondent banks
   h. a list of correspondent banks
   i. miscellaneous loan-debit and credit-suspense accounts
   j. Interagency Country Exposure Review Committee determinations
   k. criticized Shared National Credits (applicable international credits)
   l. loans considered "problem loans" by management
   m. background information on directors, executive officers, principal shareholders, and their related interests
   n. specific guidelines in the lending policy governing the financing of foreign receivables
   o. current lending authorities of officers and lending committee (or committees)
   p. the current interest-rate structure
   q. any useful information obtained from the review of the minutes of the loan and discount committee or any similar committee
   r. reports furnished to the loan and discount committee or any similar committee
   s. relevant reports furnished to the board of directors
   t. loans classified during the previous examination
8. Review the information received and perform the following:
   a. *Loans transferred, either in whole or in part, to or from another lending institution as a result of a participation, sale or purchase, or asset swap.* Perform procedures in step 7a of section 7030.3, "International—Loans and Current Account Advances: Examination Procedures."
   b. *Miscellaneous loan-debit and credit-suspense accounts.*
      - Discuss with management any large or old items.
      - Perform additional procedures as considered appropriate.

c. *Loan commitments and other contingent liabilities.* Analyze the commitments and contingent liabilities of the obligors together with the combined amounts of their current loan balances.
d. *Loans criticized during the previous examination.* Determine disposition of loans so classified by transcribing the current balance and payment status, or the date the loan was repaid and the source of repayment.
   - Investigate any situations in which all or part of the funds for the repayment came from the proceeds of another loan at the bank or as a result of a participation, sale, or swap with another lending institution.
   - If repayment was a result of a participation, sale, or swap, refer to step 7a of "International—Loans and Current Account Advances: Examination Procedures," section 7030.3, for the appropriate examination procedures.
e. *Shared National Credits.*
   - Compare the schedule of foreign receivables financed included in the uniform review of Shared National Credits Program with the listing of credits selected for review to determine which loans in the sample are portions of Shared National Credits.
   - For each loan so identified, transcribe appropriate information from the schedule to line cards. No further examination procedures are necessary in this area.
f. *Interagency Country Exposure Review Committee credits.* Identify any credits that were selected for review that are criticized for transfer-risk reasons by the Interagency Country Exposure Review Committee.

9. Transcribe or compare information from the above schedules to credit line cards, where appropriate, and indicate any past-due status.
10. Prepare credit line cards for any loan not in the sample that, on the basis of information derived from the above schedules, requires an in-depth review.
11. Obtain liability and other information on common borrowers from examiners assigned to international cash accounts, overdrafts, and other loan areas, and together decide who will review the borrowing relationship. Pass or retain completed credit line cards.
12. Prepare collateral line cards for all borrowers selected in the preceding steps.
13. Obtain credit files for all borrowers for whom examiner credit line cards were prepared, and complete credit line cards, where appropriate. To analyze foreign receivables financed, perform the following procedures:
    a. Analyze the customers' balance sheets and profit-and-loss figures as shown in current and preceding financial statements, and determine the existence of any favorable or adverse trends.
    b. Review components of the balance sheet as shown in the current financial statements, and determine the reasonableness of each item as it relates to the total financial structure.
    c. Review supporting information for the major balance-sheet items and the techniques used in consolidation, determine the primary sources of repayment, and evaluate their adequacy.
    d. Determine compliance with provisions of loan agreements.
    e. Review digests of officers' memoranda, mercantile reports, credit checks, and correspondence to determine the existence of any problems that might deter the contractual repayment program.
    f. Obtain the following information:
       - *Open-account financing.*
         — whether the shipment is directed to third parties or branches and subsidiaries of the borrower
         — the financial strength and trustworthiness of the overseas buyer
         — the extent of foreign-exchange control and the availability of exchange for the importer to effect payment
         — the bank's past experience in dealing with the borrower who sells on open account
       - *Sales on consignment.*
         — whether the shipment is directed to third parties or branches and subsidiaries of the obligor
         — the financial strength and trustworthiness of the foreign consignee
         — the responsibilities of the foreign sales agent, overseas representa-

tive, or import house under contract
- — the extent of foreign-exchange control and the availability of exchange for that type of transaction in the country of destination
- — whether the borrower's goods, without a definite buyer, are consigned abroad in the name of the borrower's bank or a foreign bank
- — whether the goods being shipped are assigned to a responsible warehouseman
- — any arrangements that have been made whereby the selling agent negotiates for the sale of the goods
- — the regulations in the country of destination regarding the return of unsold consigned goods to the country of origin
- — the bank's past experience in dealing with the borrower who sells on consignment

• *Advances against collections.*
- — the relationship between the amount collected in a month on the collections pledged as collateral and the borrower's credit limit
- — the tenor of sight drafts—a stated number of days after sight or a stated number of days after the date of the draft
- — instructions regarding delivery of documents against payment (D/P) or documents against acceptance (D/A)
- — whether amounts advanced against collections are within the percentage of advance limitation established
- — aging of drafts (collections)
- — ineligible drawees, including house bills
- — concentrations of drawees
- — financial strength of drawees
- — unusual situations such as disputes, nonacceptance of goods, and possession of goods without payment
- — dishonor and protest instructions
- — any special instructions
- — the extent of foreign-exchange controls and the availability of exchange for that type of transaction in the country of destination
- — the bank's experience in dealing with the borrower who receives advances against collections

• *Discounted trade acceptances.*
- — the relationship between the amount collected in a month on the trade acceptances discounted and the borrower's credit limit
- — whether the bank discounted the trade acceptance with or without recourse
- — whether the borrower retains a percentage of the trade acceptance endorsed to the bank
- — aging of trade acceptances
- — ineligible drawees, including house bills
- — concentrations of drawees
- — financial strength of the drawees
- — unusual situations, such as disputes, nonacceptance of goods, and possession of goods without payment
- — dishonor and protest instructions
- — any special instructions
- — the extent of foreign-exchange controls and the availability of exchange for that type of transaction in the country of destination
- — the bank's experience in dealing with the borrower for whom its trade acceptances are discounted by the bank

• *Banker's-acceptance financing.*
- — the relationship between the amount collected from the foreign buyer in a month and the borrower's credit limit
- — whether the discounted draft drawn by the exporter (customer) on the exporter's bank has the same tenor as the draft addressed to the foreign buyer
- — the procedures for applying payment received from the foreign buyer to pay the bank's own acceptance
- — aging of time drafts drawn on the importer (drawee)
- — ineligible foreign buyers (drawees), including house bills
- — concentrations of foreign buyers (drawees)
- — financial strength of the foreign buyers (drawees)

   — disputes, nonacceptance of goods, and possession of goods without payment
   — dishonor and protest instructions
   — any special instructions
   — the extent of foreign-exchange control and the availability of exchange for that type of transaction in the country of destination
   — the bank's experience in dealing with the borrower
- *Factoring.*
   — the extent the factor "guarantees" letters of credit opened by the bank in favor of overseas suppliers
   — whether the title documents on import transactions are consigned to or endorsed over to the factor
   — whether the importer who receives goods under trust receipt agrees to hold them in trust for the factor
   — whether the imported goods held under warehouse receipt are stored in an independent warehouse for the account of the factor
   — whether usance letters of credit are paid to the bank by the factor at maturity, and whether the resulting acceptances are charged to the bank customer's account for payment to the factor when due
   — whether the factor borrows from the bank or creates a banker's acceptance pending payment of accounts receivable resulting from the sale of goods imported under letters of credit
   — the financial strength of the importer for whom the bank opened the letter of credit
   — any disputes, nonacceptance of goods, and possession of goods without payment
   — the bank's experience in dealing with the factor
- *Forfaiting.*
   — agings of debtor accounts purchased
   — ineligible debtor accounts purchased, including affiliate receivables, if any
   — concentration of debtor accounts purchased
   — the adequacy of the bank's credit investigation before approving the sale (or signing of a sales contract) creating a receivable
   — the financial strength of the debtor accounts purchased
   — the capability of the exporter from whom receivables were purchased to provide any required after-sales service and to honor warranties
   — disputes and returns
   — the extent of foreign exchange restrictions, availability of exchange, and country risk involved that could jeopardize collection of receivables purchased
   — the bank's experience in dealing with both the debtors and the exporter
- *U.S. and foreign receivables guarantee and insurance plans.* Determine whether foreign receivables coverage by FCIA, Eximbank, or other insurance or guarantee programs is sufficient, adequately identifies risks, and is consistent with established limits.

g. Analyze secondary support offered by guarantors and endorsers.
h. Determine compliance with the bank's established international loan policy.

14. For loans in the sample, check the central liability file on borrowers indebted above the cutoff line or borrowers displaying credit weaknesses or suspected of having additional liability in other loan areas.
15. Transcribe significant liability and other information of officers, principals, and affiliations of appropriate borrowers contained in the sample. Cross-reference line cards to borrowers, where appropriate.
16. Determine compliance with laws and regulations pertaining to financing foreign receivables by performing the following steps.
   a. *Lending limits.* Determine the bank's lending limit as prescribed by state law, and note any exceptions.
   b. *Section 23A, Relations with Affiliates (12 USC 371c), and section 23B, Restrictions on Transactions with Affiliates (12 USC 371c-1), of the Federal Reserve Act, and the Board's Regulation W.* Perform procedures in step 15b of "International—Loans and Current Account Advances: Examination Procedures," section 7030.3.
   c. *18 USC 215, Receipt of Commission or*

Gift for Procuring Loans.
- While examining foreign receivables financing, determine the existence of any possible cases in which a bank officer, director, employee, agent, or attorney may have received anything of value for procuring or endeavoring to procure any extension of credit.
- Investigate any such suspected irregularities.

d. *Federal Election Campaign Act (2 USC 441b), Political Contributions.*
- Determine the existence of any loans in connection with any political campaigns.
- Review each such credit to determine whether it is made in accordance with applicable banking laws and in the ordinary course of business.

e. *12 USC 1972 and Regulation Y (12 CFR 225.7), Tie-In Provisions and Exceptions.* Determine whether any credit extension is conditioned upon—
- obtaining or providing any additional credit, property, or service from or to the bank or its holding company (or a subsidiary of its holding company), other than a loan, discount, deposit, or trust service, or
- the customer not obtaining a credit, property, or service from a competitor of the bank or its holding company (or a subsidiary of its holding company), other than a reasonable condition to ensure the soundness of the credit

f. *Regulation O (12 CFR 215), Loans to Executive Officers, Directors, and Principal Shareholders and Their Related Interests, and Title VIII of the Financial Institutions Regulatory and Interest Rate Control Act of 1978 (FIRA) (12 USC 1972(2)), as amended by the Garn–St Germain Depository Institutions Act of 1982, Loans to Executive Officers, Directors, and Principal Shareholders of Correspondent Banks.* Perform the Regulation O procedures of ‘‘International—Loans and Current Account Advances: Examination Procedures,’’ section 7030.3.

g. *Financial Recordkeeping and Reporting of Currency and Foreign Transactions (31 CFR 103), Retention of Credit Files.* Review the operating procedures and credit file documentation, and determine if the bank retains records of each extension of credit over $10,000, specifying the name and address of the borrower, the amount of the credit, the nature and purpose of the loan, and the date thereof. (Loans secured by an interest in real property are exempt.)

17. Perform the appropriate procedural steps in ‘‘Concentrations of Credit: Examination Procedures,’’ section 2050.3.
18. Discuss with appropriate officers, and prepare summaries in appropriate report form of—
    a. delinquent loans;
    b. loans not supported by current and complete financial information;
    c. loans on which documentation is deficient;
    d. loans with credit weaknesses;
    e. inadequately collateralized loans;
    f. criticized loans, including supporting commentaries;
    g. concentrations of credit;
    h. extensions of credit to major shareholders, officers, and directors and to their related interests;
    i. violations of laws and regulations; and
    j. other matters regarding the condition of the department.
19. Evaluate the bank for—
    a. the adequacy of written policies relating to financing foreign receivables;
    b. the manner in which bank officers are operating in conformance with established policy;
    c. adverse trends in those sections of the international sector of the bank concerned with financing foreign receivables;
    d. the accuracy and completeness of the schedules obtained from ‘‘International—Loan Portfolio Management,’’ section 7020.3;
    e. recommended corrective action when policies, practices, or procedures are deficient;
    f. the competency of departmental management; and
    g. other matters of significance.
20. Update the workpapers with any information that will facilitate future examinations.

Review the bank's internal controls, policies, practices, and procedures regarding foreign receivables financing. The bank's system should be documented in a complete and concise manner and include, where appropriate, narrative descriptions, flowcharts, copies of forms used, and other pertinent information. Items marked with an asterisk require substantiation by observation or testing.

POLICIES

1. Has the board of directors, consistent with its duties and responsibilities, adopted written foreign receivables financing policies that:
   a. Establish procedures for reviewing financing applications?
   b. Establish standards for determining credit lines?
   c. Establish standards for determining the percentage of advances made against acceptable collections (receivables)?
   d. Define acceptable receivables (collections)?
   e. Establish minimum requirements for verification of borrower's receivables (collections)?
   f. Establish minimum standards for documentation in accordance with the Uniform Commercial Code?
2. Are foreign receivables financing policies reviewed at least annually to determine if they are compatible with changing market conditions?

ACCOUNTING RECORDS

*3. Is the preparation and posting of subsidiary records performed or adequately reviewed by persons who do not also:
   a. Issue official checks or drafts?
   b. Handle cash?

*4. Are subsidiary records reconciled, at least monthly, with the appropriate general ledger accounts and reconciling items adequately investigated by persons who do not normally handle foreign receivables financing?

5. Are inquiries regarding foreign receivables financing loan balances received and investigated by persons who do not normally process documents, handle settlements, or post records?

*6. Are bookkeeping adjustments checked and approved by an appropriate officer?

*7. Is a daily record maintained summarizing transaction details, i.e., loans made, payments received, and interest collected to support applicable general ledger entries?

*8. Are frequent debt instrument and liability ledger trial balances prepared and reconciled monthly with control accounts by employees who do not process or record loan transactions?

DOCUMENTATION

9. Are terms, dates, weights, description of the merchandise, etc., shown on invoices, shipping documents, trust receipts, and bills of lading scrutinized for differences?
10. Are procedures in effect to determine if the signatures shown on the above documents are authentic?
11. Are payments received from customers scrutinized for differences in invoice dates, numbers, terms, etc.?

LOAN INTEREST

*12. Is the preparation and posting of loan interest records performed or adequately reviewed by persons who do not also:
   a. Issue official checks or drafts?
   b. Handle cash?

13. Are independent interest computations made and compared or adequately tested to initial loan interest records by persons who do not also:
   a. Issue official checks or drafts?
   b. Handle cash?

COLLATERAL

*14. Does the bank record on a timely basis a first lien on assigned foreign receivables for each borrower?

15. Do loans granted on the security of the foreign receivables also have an assignment of the inventory?
16. Does the bank verify the borrower's receivables or require independent verification on a periodic basis?
17. Does the bank require the borrower to provide aged receivables schedules on a periodic basis?
18. Are underlying bills of lading covering shipments either to the order of the shipper or blank endorsed to the order of the bank rather than the foreign buyer?
19. Are the shipments being financed covered by adequate insurance?

ADVANCES AGAINST COLLECTIONS AND DISCOUNTED TRADE ACCEPTANCES

20. Are permanent registers kept for foreign collections against which advances were made or trade acceptances discounted?
21. Are all collections indexed in a collection register?
22. Do these registers furnish a complete history of the origin and final disposition of each collection against which advances were made or trade acceptances discounted?
23. Are receipts issued to loan customers for all collections received from them?
24. Are serial numbers or prenumbered forms assigned to each collection item and all related papers?

*25. Are all incoming tracers and inquiries handled by an officer or employee not connected with the processing of collections?

26. Is a daily record maintained showing the various collections which have been paid and credited to the borrower's advance?

*27. Are proceeds of paid collections credited to the correct customer's advance?

28. Is an itemized daily summary made of all interest charged and received from the exporter or importer (drawee) indicating underlying collection numbers and amounts?
29. Are payments collected from importers (drawees) by foreign banks or branches of U.S. banks forwarded directly to the bank and not through the exporter?
30. If the exporter accepts importer (drawee) payments directly, are controls established or audits of exporter's books conducted (if so, explain briefly)?
31. Are employees handling collections periodically rotated, without advance notification, to other banking duties?

*32. Is the employee handling collection proceeds required to apply them to the borrower's advance on the same business day that payment is received?

33. Is the disposition of each collection noted on the register so that verification of disposition can be made?

*34. Has a regular policy of following procedures been established for sending tracers and inquiries on unpaid collections in the hands of correspondents?

*35. Should the foreign drawee refuse to honor the draft, are instructions clear as to what actions should be taken by the collecting bank?

36. In the event of non-payment of the collection, is the borrower promptly notified by the bank?

*37. Are collections against which advances have been made or trade acceptances discounted distinctly segregated from ordinary collection items?

*38. Are collections above maintained under memorandum control and is the control balanced regularly?

*39. Are collections against which advances have been made or trade acceptances discounted booked by persons other than employees handling those items?

*40. Are collections carried over to the next business day adequately secured?

41. Does the customer for whom trade acceptances were discounted know whether they were purchased with or without recourse to that customer?

*42. Do all parties, i.e., the seller (exporter), importer (buyer), and banks, clearly understand whether interest, discount, and collection charges are to be absorbed by the seller or paid by the importer?

FACTORING

43. Has the bank properly surrendered the

shipping documents to the factor either through endorsement or consignment?

*44. Do bank advances or banker's acceptances to the factor in payment of sight or time draft coincide with the expected payment of the accounts receivable by the ultimate customer?

FOREIGN CREDIT INSURANCE ASSOCIATION INSURANCE

45. Is the bank aware of risks not covered under its FCIA insurance?
46. Does the bank monitor whether the borrower exceeded its FCIA established credit limits?
47. Does the bank monitor whether the borrower properly assigned the proceeds of its FCIA insurance to the bank?
48. Is the bank aware whether the FCIA insurance is on either ''simple notice'' or a ''special assignment'' basis?
49. Does the bank retain recourse to the exporter under its FCIA arrangement?
50. Has the bank reported delinquencies to FCIA in accordance with its agreement with the Association?
51. If default occurs, does the bank file a proper claim with FCIA?

EXPORT-IMPORT BANK OF THE UNITED STATES

52. Does the bank, financing under Eximbank arrangements, have properly executed Eximbank guarantees or commitments covering transactions?
53. If the bank has discretionary authority from Eximbank, does it nevertheless inform Eximbank of each transaction thereunder?
54. If the bank has been issued an ''equipment political risk guarantee'' by Eximbank, does it have a written statement from the government of the country in which the equipment will be used indicating that it will permit the importation, use, and any subsequent exportation of the equipment?
55. Does the bank monitor whether loan agreements between applicable borrowers and the bank are acceptable to Eximbank?
56. Does the bank report delinquencies to Eximbank in a timely manner as specified in its agreement with that agency?
57. If default occurs, does the bank file a proper claim with Eximbank?

CONCLUSION

58. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
59. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

One method of financing international trade is by the use of a banker's acceptance. This instrument may be used to finance all of the successive stages of the movement of goods through the channels of trade from the point of origin to the final destination.

A banker's acceptance is an order in the form of a time draft (also referred to as a bill of exchange or a usance draft) drawn by one party (the drawer) in favor of itself or another party (the payee), addressed to (drawn on) a bank (the drawee), and accepted by that bank to pay the holder a certain sum on or before a specified date. The bank's acceptance of this order from the drawer, by stamping "ACCEPTED" across the face of the draft and dating and signing the stamp, is a formal acknowledgment of the obligation and constitutes an unconditional promise by that bank to honor the time draft at maturity. The drawee bank creating the acceptance is primarily liable for the instrument while the payee, as first endorser, is secondarily liable for paying the holder in due course. If the drawee (acceptor) is other than a bank, the instrument is a trade acceptance, not a banker's acceptance.

Most banker's acceptances are used to finance trade transactions. Accordingly, acceptances are often created in connection with a letter of credit, although they may arise in connection with collection or open-account transactions. (See section 7080, "International—Letters of Credit.") In general, acceptance credit is considered self-liquidating in that it must provide the means for its own payment at maturity. To accomplish this, the acceptance must be based on a specific trade transaction in which goods are being shipped before entering the channels of trade. There should be satisfactory evidence to indicate that the draft, when created, is based on an actual shipment or storage and that, at maturity of the draft, the proceeds from the sale of the goods will be used to settle the draft. To a lesser extent, acceptances also finance the domestic shipment of goods and domestic or foreign storage of readily marketable staples.

The payee of the acceptance may hold an acceptance until maturity, discount it with his or her bank, or sell it in the acceptance market. When a bank discounts (purchases) its own acceptance for the payee, its "Customer's Liability on Acceptances" (asset) and "Bank's Liability on Acceptances" (liability) accounts are reduced, and the discounted acceptance is recorded with other loans and discounts. If the accepting bank subsequently rediscounts (sells) the acceptance in the market, that acceptance is rebooked as "Customer's Liability on Acceptances" and "Bank's Liability on Acceptances," and the loan and discount accounts are reduced. Rediscounted acceptances are not considered borrowings. The customer's liability on acceptances is reduced by a customer's prepayment or anticipation of an acceptance outstanding. The bank's liability is not similarly reduced by an anticipation.

The established market for banker's acceptances in the United States is regulated by the Federal Reserve System. Federal Reserve Banks are authorized to discount or purchase eligible banker's acceptances subject to qualitative and quantitative limits, thus providing a source of liquidity to the selling banks. The creation of banker's acceptances is governed by section 13 of the Federal Reserve Act, which establishes criteria that must be met for the instrument to be eligible for either discount or purchase by a Federal Reserve Bank. The rules governing whether an acceptance meets the eligibility requirements for discount or purchase are important for two major reasons. First, acceptances meeting the conditions of eligibility are more readily salable in the market than acceptances that do not satisfy these conditions and, as such, provide a greater degree of liquidity for the accepting bank. Second, ineligible acceptances, unlike those that are eligible, are subject to reserve maintenance requirements, thus raising the cost to the borrower over that of an eligible acceptance. The examiner must be familiar with the criteria used for determining eligibility for discount or purchase by a Federal Reserve Bank.

Section 207 of the Bank Export Services Act (title II of P.L. 97-290), which amended section 13 of the Federal Reserve Act (12 USC 372), limits the aggregate amount of eligible banker's acceptances that may be created by a member bank to 150 percent (or 200 percent with the permission of the Board) of its paid-up and unimpaired capital stock and surplus. In addition, a member bank is prohibited from creating eligible banker's acceptances for any one person in the aggregate in excess of 10 percent of the institution's capital. Eligible banker's acceptances growing out of domestic transactions are not to exceed 50 percent of the aggregate of all eligible acceptances authorized for a member bank. All of the foregoing limitations are also applicable to U.S. branches and agencies of foreign banks that are subject to reserve requirements under section 7 of the International Banking Act of 1978 (12 USC 3105).

Banker's acceptances as a source of financing and investment offer significant advantages to borrowers, accepting banks, and investors alike. Over the years, a banker's acceptance has often been a cheaper financing vehicle than a loan since it is readily marketable, considered an important secondary reserve for the accepting bank, and a relatively secure investment to the investor because of its two-name backing.

1. To determine if objectives, policies, practices, procedures, and internal controls for banker's acceptances are adequate.
2. To determine if bank officers are operating in conformance with the established guidelines.
3. To determine the scope and adequacy of the audit function as it applies to banker's acceptances.
4. To evaluate the portfolio for documentation and collateral sufficiency, credit quality, and collectibility.
5. To determine compliance with applicable laws and regulations.
6. To recommend corrective action when objectives, policies, practices, procedures, or internal controls are deficient or when violations of laws and regulations have been cited.

1. If selected for implementation, complete or update the banker's acceptance section of the Internal Control Questionnaire.
2. Determine the scope of the examination based on the evaluation of internal controls and the work performed by internal and external auditors.
3. Test for compliance with policies, practices, procedures and internal controls in conjunction with performing the remaining examination procedures. Also obtain a listing of any deficiencies noted in the latest review done by internal and external auditors from the examiner assigned to the audit review and determine if appropriate corrections have been made.
4. Obtain a trial balance of the customer liability records and:
   a. Reconcile balances to department controls and the general ledger.
   b. Review reconciling items for reasonableness.
5. Using an appropriate technique, select borrowers for examination.
6. Prepare credit line cards to include:
   a. Customer's aggregate banker's acceptance liability.
   b. Banker's acceptances aggregating the customer's total liability, listing:
      - Current balance of the acceptance.
        — Indicate any prepayments (anticipations) and portions sold under participation certificate.
      - Date the acceptance was created.
      - Tenor of the acceptance (give exact maturity date, if specified).
      - Type of acceptance.
        — Import.
        — Export.
        — Third country shipment.
        — Domestic shipment.
        — Storage.
        — To create dollar exchange.
        — Working capital and/or pre-export.
        — Refinancing of sight letters of credit.
        — Current status of the acceptance.
7. Obtain the following information, if applicable to banker's acceptances, which may necessitate inclusion of additional customers (borrowers) in the credit review:
   a. Delinquencies.
   b. Participations purchased and sold (including syndicate participations).
      - Acceptance participations sold.
      - Acceptance pool participations (borrowings).
   c. Loan commitments and other contingent liabilities.
   d. Extensions of credit to major stockholders, officers, directors and their interests.
   e. Extensions of credit to executive officers, directors and their interests of correspondent banks.
   f. Miscellaneous loan debit and credit suspense accounts.
   g. Criticized shared national credits (applicable foreign credits).
   h. Interagency Country Exposure Review Committee determinations.
   i. Extensions of credit considered "problem loans" by management.
   j. Information on directors, executive officers, principal shareholders and their interests.
   k. Specific guidelines in the lending policy pertaining to banker's acceptances.
   l. Each officer's current lending authority.
   m. The current fee structure.
   n. Any useful information resulting from the review of the minutes of the Loan and Discount Committee or any similar committee.
   o. Reports furnished to the Loan and Discount Committee or any similar committee.
   p. Reports furnished to the directorate.
   q. Loans criticized during the previous examination.
8. Review the information received and perform the following for:
   a. Participations purchased and sold:
      - Test participation certificates and records and determine that the parties share in the risks and contractual payments according to the agreement.
      - Determine that the books and records of the bank properly reflect the bank's liability.
      - Investigate any participations sold immediately prior to the date of examination to determine if any were sold to

avoid possible criticism during the examination.

b. Loan commitments (including acceptance commitments) and contingent liabilities.
   - Analyze the commitment or contingent liability if the borrower has been advised of the commitment together with the combined amounts of the current loan balance, if any.

c. Banker's acceptances created for officers and directors of other banks:
   - Investigate any circumstances which indicate preferential treatment.

d. Miscellaneous loan debit and credit suspense accounts:
   - Discuss with management any large or old items relating to banker's acceptances.

e. Shared national credits:
   - Compare the schedule of banker's acceptances included in the Uniform Review of National Credits Program to the sample selection to determine which banker's acceptances in the sample are portions of shared national credits (including applicable foreign credits).
   - For each banker's acceptance so identified, transcribe appropriate information from the schedule to line sheets and return the schedule. No further examination procedures are necessary for this area.

f. Cross-border lending:
   - Review credit risk without regard to cross-border considerations which will be analyzed separately. No further examination procedures are necessary in this area.

g. Loans criticized during the previous examination:
   - Determine disposition of banker's acceptances so criticized by transcribing:
     — current balance and payment status, or
     — date the banker's acceptance was repaid and the source of repayment.

9. Transcribe or compare information from the above schedules to credit line cards, where appropriate, and indicate any past-due status.
10. Prepare a credit line card for any banker's acceptance not in the sample which, based on information derived from the above schedules, requires an in-depth review.
11. Obtain liability and other information on common borrowers from examiners assigned to cash items, overdrafts, and other loan areas and, together, decide who will review the borrowing relationship. Pass or retain completed credit line cards.
12. Obtain credit files for all borrowers for whom credit line cards were prepared and complete credit line cards, where appropriate. To analyze the loans, perform the following procedures:
    a. Analyze balance sheet and profit and loss figures as shown in current and preceding financial statements, and determine the existence of any unfavorable trends.
    b. Relate items or groups of items in the current financial statements to other items or groups of items set forth in the statements, and determine the existence of any favorable or adverse ratios.
    c. Review components of the balance sheet as shown in the current financial statements and determine the reasonableness of each item as it relates to the total financial structure.
    d. Review supporting information for the major balance sheet items and the techniques used in consolidation and determine the primary sources of repayment and evaluate their adequacy.
    e. Review compliance with the provisions of acceptance agreements.
    f. Review the digest of officer's memoranda, mercantile reports, credit checks and correspondence to determine the existence of any problems which might deter the contractual liquidation program.
    g. Relate any collateral values to outstanding debt, including margin and cash collateral deposits.
    h. Compare fees charged to the fee schedule(s) and determine that the terms are within established guidelines.
    i. Compare the amount of banker's acceptances outstanding with the lending officer's authority.
    j. Analyze secondary support afforded by guarantors.
    k. Ascertain compliance with the bank's established banker's acceptance policy.

13. For banker's acceptances in the sample, check the central liability file on borrowers indebted above the cutoff and on borrowers displaying credit weaknesses or suspected of having additional liability in loan areas.
14. Transcribe significant liability and other information on officers, principals and affiliations of appropriate obligors contained in the sample. Cross-reference line sheets to borrowers, where appropriate.
15. Determine compliance with laws, regulations, and eligibility requirements regarding banker's acceptance financing by performing the following steps:
    a. Determine bank compliance with state limits or the aggregate amount of acceptances that may be created for any one customer, and acceptances created to furnish dollar exchange.
    b. Determine compliance with stipulated aggregate liability limitations on acceptances outstanding. (See Federal Reserve Act, section 13 for single person and aggregate limitation provisions.)
    c. Determine which acceptances are ineligible and therefore subject to loan limitations imposed by state law. In general, an eligible banker's acceptance is one which must arise out of a transaction described in section 13 of the Federal Reserve Act. For details of eligibility requirements, refer to the operating provisions of the Federal Open Market Committee and interpretations of the Board of Governors of the Federal Reserve System. Eligibility can be determined by reviewing documentary evidence detailing the nature of the transaction underlying the credit extended. This evidence may be correspondence, title documents or document transmittal letters which provide sufficient detail to judge eligibility according to established criteria. Details provided should cover:
        - Value of merchandise.
        - Description of merchandise.
        - Origin and destination of shipment.
        - Date of shipment.
        - Certification that the merchandise is not being financed elsewhere.
    d. Ensure that all of the bank's own acceptances discounted that are not rediscounted, whether eligible or ineligible, are booked as loans and thus subject to the loan limitations imposed by state law.
    e. Determine if state law imposes loan limitations on eligible acceptances of other banks purchased.
    f. Review acceptance participation agreements to determine if the purchaser has recourse to the bank in the event of default by the account party, in which case the liability would be considered a borrowing. Such borrowings may be subject to limitations on indebtedness of member banks imposed by state law.
    g. Determine acceptances issued on behalf of an affiliate which constitute extensions of credit under section 23A of the Federal Reserve Act.
16. Perform appropriate procedural steps in the Concentration of Credits section.
17. Discuss with appropriate officer and prepare summaries in appropriate report form of:
    a. Violations of laws and regulations.
    b. Acceptances not supported by current and complete financial information.
    c. Acceptances on which collateral documentation is deficient.
    d. Concentrations of credit.
    e. Criticized loans.
    f. Inadequately collateralized acceptances, if applicable.
    g. Banker's acceptances created for major shareholders, employees, officers, directors and related interests.
    h. Banker's acceptances which, for any other reason, are questionable as to quality and ultimate collection.
18. Evaluate the bank with respect to:
    a. The adequacy of written policies relating to banker's acceptances.
    b. The manner in which bank officers are operating in conformance with established policy.
    c. Adverse trends within the banker's acceptance department.
    d. The accuracy and completeness of the schedules obtained.
    e. Internal control deficiencies or exceptions.
    f. Recommended corrective action when policies, practices or procedures are deficient.
    g. The quality of departmental management.
    h. Other matters of significance.
19. Update the workpapers with any information that will facilitate future examinations.

Review the bank's internal controls, policies, practices and procedures for creating and servicing banker's acceptances. The bank's system should be documented in a complete and concise manner and include, where appropriate, narrative descriptions, flowcharts, copies of forms used and other pertinent information.

POLICIES

1. Has the board of directors, consistent with its duties and responsibilities, adopted written banker's acceptance policies that:
   a. Establish procedures for reviewing banker's acceptance applications?
   b. Define qualified customers?
   c. Establish minimum standards for documentation in accordance with the Uniform Commercial Code?
2. Are banker's acceptance policies reviewed at least annually to determine if they are compatible with changing market conditions?

RECORDS

3. Is the preparation and posting of subsidiary banker's acceptance records performed or reviewed by persons who do not also:
   a. Issue official checks or drafts?
   b. Handle cash?
4. Are the subsidiary banker's acceptance records balanced daily with the appropriate general ledger accounts and reconciling items adequately investigated by persons who do not normally handle acceptances and post records?
5. Are acceptance delinquencies prepared for and reviewed by management on a timely basis?
6. Are inquiries about acceptance balances received and investigated by persons who do not normally handle settlements or post records?
7. Are bookkeeping adjustments checked and approved by an appropriate officer?
8. Is a daily record maintained summarizing acceptance transactions details, i.e., bankers acceptances created, payments received and fees collected, to support applicable general ledger account entries?
9. Are acceptances of other banks that have been purchased in the open market segregated on the bank's records from the bank's own acceptances created?
10. Are prepayments (anticipations) on outstanding banker's acceptances netted against the appropriate asset account "Customer Liability for Acceptances" (or loans and discounts, depending upon whether or not the bank has discounted its own acceptance), and do they continue to be shown as a liability "Bank's Liability on Acceptances"?
11. Are banker's acceptance record copies and liability ledger trial balances prepared and reconciled monthly with control accounts by employees who do not process or record acceptance transactions?

FEES

12. Is the preparation and posting of fees and discounts performed or reviewed by persons who do not also:
    a. Issue official checks or drafts?
    b. Handle cash?
13. Are any independent fee and discount computations made and compared or adequately tested to initial fee and discount records by persons who do not also:
    a. Issue official checks or drafts?
    b. Handle cash?

COLLATERAL

See International—Loans and Current Account Advances section.

OTHER

14. Are acceptance record copies, own acceptances discounted (purchased), and acceptances of other banks purchased safeguarded during banking hours and locked in the vault overnight?

15. Are blank (pre-signed) customer drafts properly safeguarded?
16. Are any acceptance fee rebates approved by an officer?
17. Does the bank have an internal review system that:
    a. Re-examines collateral and supporting documentation held for negotiability and proper assignment?
    b. Test checks the values assigned to collateral at frequent intervals?
    c. Determines that lending officers are periodically advised of maturing banker's acceptances or acceptance lines.
18. Does the bank's acceptance filing system provide for the identification of each acceptance, e.g., by consecutive numbering and applicable letter of credit, to provide a proper audit trail?

CONCLUSION

19. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
20. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

U.S. banks and their overseas branches maintain interest-bearing time deposits, known as ''due from banks—time,'' with foreign banks and overseas branches of U.S. banks. These assets may also be referred to as placements, placings, interbank placements (deposits), call money, or redeposits. Due from banks—time deposits have maturities ranging from one day to several months or years. Certain examination procedures, internal control considerations, and verification procedures in the domestic due from banks section (section 2010) are relevant to international due from banks—time. However, the specialized nature of foreign deposits necessitates additional examination procedures.

Constraints are placed on the amount member banks may deposit with domestic depository institutions. A member bank may not keep on deposit with any depository institution not having access to the Federal Reserve discount window more than 10 percent of its paid-in and unimpaired capital and surplus funds. State member banks may keep on deposit with foreign banks an amount exceeding that 10 percent limitation.

Due from banks—time deposit activities became important with the growth of the Eurodollar market. The bulk of due from banks—time deposits now consists of Eurodollars with smaller amounts in other Eurocurrencies. Other Eurocurrency time deposits are placed in substantially the same manner as Eurodollar deposits, but may be subject to differing exchange control regulations depending on the location of the office making the deposit.

Eurodollar deposits are sometimes linked with foreign-exchange transactions. As a result, the Eurocurrency deposit trader will frequently work closely with the foreign-exchange trader when making the deposit decision. Foreign-exchange brokers may act as intermediaries if warranted by market conditions, local customers, the size of the bank, or other factors.

Due from banks—time deposits are treated as deposits in the Report of Condition, but contain the same credit and country risks as loans or extensions of credit. Consequently, a prudently managed bank should place deposits only with other sound and well-managed banks. The deposit traders should be provided with a list of approved banks with which funds can be deposited up to specific limits. Due from banks—time deposits differ from other types of credit extensions because they often represent deposits of relatively short maturity, which normally receive first priority on repayment in case of insolvency. Nevertheless, as credit and transfer risk exists, exposure limits are to be established by credit officers and not by foreign-exchange or deposit traders. These limits must be reviewed regularly by credit officers, particularly during periods of money market uncertainty or rapidly changing economic and political conditions. Incoming confirmations of transactions from depository institutions must be carefully verified against bank records to protect against fraud and error. Similarly, a systematic follow-up on nonreceipt of incoming confirmations should be closely monitored.

1. To determine if the policies, practices, procedures, and internal controls for due from banks—time (interbank placements and call money) are adequate.
2. To determine if bank officers and employees are operating in conformance with the established guidelines.
3. To determine that all due from banks—time accounts are reasonably stated and represent funds on deposit with other banks.
4. To determine whether the bank evaluates the credit quality of banks with which time accounts are maintained.
5. To determine the scope and adequacy of the internal and external audit function as it applies to international due from banks—time.
6. To determine compliance with laws and regulations.
7. To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws, rulings, or regulations have been cited.

1. If selected for implementation, complete or update the Due from Banks—Time (placement and call money) section of the Internal Control Questionnaire.
2. Determine the scope of the examination based on the evaluation of internal controls and the work performed by internal and external auditors.
3. Test for compliance with policies, practices, procedures and internal controls in conjunction with performing the remaining examination procedures. Also, obtain a listing of any deficiencies noted in the latest review by internal and external auditors from the examiner assigned to the audit review and determine if appropriate corrections have been made.
4. Obtain a trial balance of the customer liability records pertaining to due from banks—time by currency and maturity and:
   a. Reconcile balance to department controls and general ledger.
   b. Review reconciling items for reasonableness.
5. Determine those due from banks—time deposits that are unconfirmed as of examination date and:
   - Determine why incoming matching confirmations are lacking.
   - Review the extent of follow-up procedures.
6. Using an appropriate technique, select deposit customers for examination.
7. Prepare credit line cards on the customers selected for review to include the following:
   a. Name of bank and location.
   b. Customer's aggregate due from bank-time liability.
   c. For each due from bank—time deposit placement comprising the customer's total exposure to the bank, record the following information:
      - Amount.
      - Currency.
      - Inception date.
      - Value date.
      - Maturity date.
      - Interest rate.
8. Determine whether selected customers are:
   a. Affiliates of the bank or other banks.
   b. Banks and not finance companies or commercial borrowers.
9. Obtain and review the following information, if applicable:
   a. Matured and unpaid due from banks—time deposits.
   b. Miscellaneous loan debit and credit suspense accounts.
   c. Interagency Country Exposure Review Committee determinations.
   d. Due from banks—time deposit placements that are considered problem assets by management.
   e. Specific guidelines stated in bank policy relating to due from banks—time.
   f. A current listing of due from banks—time approved customer lines.
   g. The current interest rate structure.
   h. Any useful information resulting from the review of the minutes of the Loan and Discount Committee or any similar committee.
   i. Reports furnished to the Board of Directors.
   j. Due from banks—time deposit placements that were criticized during the previous examination.
   k. A listing of due from banks—time deposits that were previously charged-off.
10. Transcribe or compare information from the above schedules to credit line cards where appropriate, and indicate any cancelled bank lines.
11. Prepare credit line cards for any due from bank—time not in the sample which, based on information derived from the above schedules, requires an in-depth review.
12. Obtain liability and other information on common borrowers from examiners assigned to cash items, overdrafts, and loan areas and decide who will review the borrowing relationship. Pass or retain completed credit line cards.
13. Obtain credit files for all borrowers for whom credit line cards were prepared and complete credit line cards where appropriate. To analyze due from banks—time, perform the following procedures:
    a. Analyze balance sheet and profit and loss figures as shown in current and preceding financial statements, and determine

the existence of any favorable or adverse trends.

b. Relate items or groups of items in the current financial statements to other items or groups of items set forth in the statements, and determine the existence of any favorable or adverse ratios.
c. Review components of the balance sheet as shown in the current financial statements, and determine the reasonableness of each item as it relates to the customer's total financial structure.
d. Review supporting information for the major balance sheet items and the techniques used in consolidation, and determine the primary sources of repayment and evaluate their adequacy.
e. Compare each bank's balance sheet, profit and loss items and ratios with those of comparable banks in the same country to help identify banks which may be overextended.
f. Review compliance with provisions of due from banks—time deposit agreements.
g. Review digest of officers' memoranda, mercantile reports, credit checks and correspondence to determine the existence of any problems which might deter the contractual liquidation program.
h. Compare interest rate(s) charged to the interest rate schedule(s), and determine that the terms are within established guidelines.
i. Compare the amount of due from banks—time deposits with:
   - Lending officer's authority.
   - Depositor's limit established by the bank.
j. Detail the major owners of the bank and whether there is any support by the government.
k. Ascertain compliance with established bank policy.

14. For banks in the sample, check the customer central liability reporting system for any other indebtedness.
15. Transcribe significant liability and other information on officers, principals and affiliates of banks contained in the sample. Cross-reference line cards to banks (borrowers), where appropriate.
16. Determine compliance with state laws and regulations pertaining to due from banks—time.
17. Determine the existence of any concentration of time deposits with other banks. Include due from banks—demand (nostro), time deposits and any call money in computation. For concentrations exceeding 25 percent of the bank's capital structure, forward information to examiners assigned "Concentrations of Credit" for possible inclusion in the report of examination.
18. Discuss with appropriate officer(s) and prepare summaries in appropriate report form of:
    a. Matured and unpaid due from banks—time deposits.
    b. Violations of laws and regulations.
    c. Due from banks—time deposits not supported by current and complete financial information.
    d. Due from banks—time deposits on which documentation is deficient.
    e. Concentrations.
    f. Criticized credits (portions applicable to due from banks—time deposits).
    g. Due from banks—time deposits which, for any other reason, are questionable as to quality and ultimate repayment.
    h. Other matters regarding the condition of the department.
19. Evaluate the bank with respect to:
    a. The adequacy of written policies relating to due from banks—time.
    b. The manner in which bank officers are operating in conformance with established policy.
    c. Adverse trends within the due from banks—time department.
    d. The accuracy and completeness of the schedules.
    e. Internal control deficiencies or exceptions.
    f. Recommended corrective action when policies, practices or procedures are found to be deficient.
    g. The quality of departmental management.
    h. Other matters of significance.
20. Update the workpapers with any information that will facilitate future examinations.

Review the bank's internal controls, policies, practices and procedures regarding due from banks—time. The bank's system should be documented in a complete and concise manner and include, where appropriate, narrative descriptions, flowcharts, copies of forms used and other pertinent information. Items marked with an asterisk require substantiation by observation or testing.

POLICIES

1. Has the board of directors, consistent with its duties and responsibilities, adopted written policies for international due from banks—time that:
   a. Establish maximum limits of the aggregate amount of due from bank—time deposits for each:
      - The bank?
      - The currency of deposit?
      - The country of deposit?

   b. Restrict due from bank—time deposits to only those customers for whom lines have been established?
   c. Establish definite procedures for:
      - Balancing of accounts?
      - Holdover deals?
      - Rendering of reports to management, external auditors and regulating agencies?
      - Accounting cutoff deadlines?
      - Handling of interest?

CERTIFICATES OF DEPOSIT

2. Are bank issued certificates of deposits safeguarded as other negotiable investment instruments?
3. Are safekeeping receipts for certificates of deposits issued, but held by others, checked to the original purchase order for accuracy?

DEALING ROOM INSTRUCTIONS

(Although dealing room and instructions functions must be separate, often foreign exchange and due from bank—time activities relating to those functions are combined.)

4. Are dealer slips and contract/confirmation sets relating to due from banks—time numbered sequentially and checked periodically?
5. Is a positions clerk present in the dealing room to maintain dealers' memoranda records of due from bank—time deposits?
6. Is due from banks—time "instructions" (operations) organizationally and physically separate from the foreign exchange dealers?

*7. Do good communications appear to exist between the dealing room and instructions to assure:
   a. An effective working relationship with operations and management to ensure adequate control and management information?
   b. Coordination with operations regarding correct delivery/settlement instructions?

*8. Does operations maintain all official accounting records relating to due from banks—time?

*9. Does operations:
   a. Balance official records against dealing room memoranda records as scheduled by management?
   b. Check confirmations for errors?
   c. Receive, review and control dealer's slips?
   d. Handle all payments and receipts?

*10. Are confirmations compared to the general ledger entries for accuracy?

CONFIRMATIONS

*11. Does operations monitor follow-up on non-receipt of incoming confirmations?

*12. Are outgoing and incoming confirmations ever handled by dealers who initiate due from bank—time transactions?

*13. Does the bank check that there are no confirmation deals dated:
   a. Prior to the bank's own due from bank—time deal dates?
   b. After the bank's own due from bank—time deal dates?

TESTING ARRANGEMENTS

(See the Wire Transfer section.)

SIGNATURE BOOKS

*14. Are customer signature books updated with regard to those with whom regular business is transacted?

*15. Does the bank check signatures on incoming confirmations for authenticity? (Many banks do not check signatures on incoming confirmations.)

*16. Does the bank check signatures for deals with non-bank customers?

*17. Are banks that do not sign confirmations asked to confirm such practice in writing over an authorized signature?

ACCOUNT RECORDS

*18. Are subsidiary records reconciled with the general ledger accounts and reconciling items adequately investigated by persons who do not post transactions to such records?

19. Is a due from foreign bank—time deposit trial balance prepared on a periodic basis (if so, indicate frequency _______)?

20. Is a daily reconcilement made of due from bank—time deposit controls to the general ledger?

21. Are reconciliations reviewed by an officer independent of the reconciliation?

OTHER

22. Are individual interest computations checked or adequately tested by persons independent of those functions?

23. Are accrual balances for due from banks—time verified periodically by an authorized official (if so, indicate frequency _______)?

24. Do all internal entries require the approval of appropriate officials?

CONCLUSION

25. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.

26. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

INTRODUCTION

Letters of credit are the most widely used instrument to finance foreign transactions. The two major types of letters of credit are the commercial documentary letter of credit and the standby letter of credit.

COMMERCIAL DOCUMENTARY LETTERS OF CREDIT

This type of letter of credit is used most commonly to finance a commercial contract for the shipment of goods from seller to buyer. A commercial documentary letter of credit is a letter addressed by a bank (issuing bank) on behalf of its customer, a buyer of merchandise (account party), to a seller (beneficiary) authorizing the seller to draw drafts up to a stipulated amount under specified terms. The beneficiary will be paid when the terms of the letter of credit are met and the required documents are submitted to the paying bank.

Generally, the issuance of letters of credit is governed by article 5 of the Uniform Commercial Code (UCC). However, if the credit is issued under New York law, the credit will be governed instead by the Uniform Customs and Practice for Documentary Credits (UCP). The parties may also stipulate that the UCP rather than the UCC applies. Letters of credit may also be governed by foreign law. Generally, letters of credit are—

- signed and in writing,
- in favor of a definite beneficiary,
- for a specific amount of money, and
- in a form clearly stating how payment to the beneficiary is to be made and under what conditions.

In addition, they are issued with a definite expiration date.

Commercial letters of credit are issued in either irrevocable or revocable form. Once the beneficiary receives an irrevocable letter of credit, it cannot be canceled or amended without the beneficiary's consent. Conversely, a revocable letter of credit can be canceled or amended by the issuing bank at any time without notice to or consent from the customer or the beneficiary.

An irrevocable letter of credit constitutes a definite commitment by the issuing bank to pay, provided the beneficiary complies with the letter's terms and conditions. In contrast, the revocable credit is not truly a bank credit but serves as a device that provides the buyer and seller with a means of settling payments. Since a revocable credit can be canceled or changed without notice, the beneficiary should not rely on the credit but rather on the willingness and ability of the buyer to meet the terms of the underlying contract.

The letter of credit may be sent to the beneficiary directly by the issuing bank or through the issuing bank's correspondent (advising bank) located in the same place as the beneficiary. The advising bank gives notice of the issuance of a letter of credit without assuming any obligation to honor demands for payment. Advised letters of credit will bear a notation by the advising bank that it makes "no engagement" or words to that effect. An irrevocable advised letter of credit is, therefore, an undertaking to pay by the issuing bank, but not by the advising bank.

Some beneficiaries (sellers), particularly those not familiar with the issuing bank, request the buyer to have the irrevocable credit issued in the buyer's country and "confirmed" by a bank in the seller's country. Confirmed letters of credit are evidenced by the confirming bank's notation: "We undertake that all drafts drawn . . . will be honored by us" or similar words. The beneficiary of a confirmed credit has a definite commitment to pay from a bank in his or her country and need not be concerned with the willingness or ability of the issuing bank to pay. An advising bank may add its confirmation and be designated in the letter as the paying bank.

Payment terms of a letter of credit usually vary from sight to 180 days, although other terms are sometimes used. The letter will specify on which bank drafts are to be drawn. If the draft is drawn at sight, the bank will effect payment upon presentation of the draft, provided the terms of the credit have been met. If the draft is drawn on a time basis, the bank will accept the draft (by stamping "Accepted" on the face of the draft), which then can be held by the seller or the bank until maturity. Alternatively, the accepted draft can be sold or discounted.

(See section 7060, ''International—Banker's Acceptances.'')

Certain categories of commercial letters of credit, such as back-to-back and red clause credits, contain an element of risk, and banks should exercise caution in their negotiation. Similarly, deferred-payment letters of credit, which become direct assets and liabilities of a bank after presentation and receipt of the beneficiary's documents, involve greater potential risk when coupled with the length of time the credit is outstanding.

A transferable letter of credit enables the original beneficiary to transfer the rights of payment to one or more beneficiaries. Frequently, the beneficiary is a middleman who does not own the goods at the time the letter of credit is issued. Thus, the beneficiary may seek to use the letter of credit to finance the acquisition of the goods. Under the UCP, a transferable letter of credit may be transferred only once unless otherwise stated.

A revolving letter of credit allows for monthly shipments with payments being either cumulative or noncumulative. In the case of cumulative credits, undrawn amounts carry over to future periods. However, most letters of credit are nonrevolving and are valid for one transaction. Since the maximum exposure under an irrevocable revolving credit can be large, most revolving credits are issued in revocable form.

Documentation is of paramount importance in all letter of credit transactions. The bank is required to examine all documents with care to determine that they conform to all of the terms and conditions of the letter of credit. Many letters of credit are part of continuous transactions, evolving from letters of credit to sight drafts or acceptances or to notes and advances covered by trust receipts or warehouse receipts. Ultimate repayment often depends on the eventual sale of the goods involved. Thus, the proper handling and accuracy of the documents required under the letter of credit is of primary concern.

STANDBY LETTERS OF CREDIT

A standby letter of credit guarantees payment to the beneficiary by the issuing bank in the event of default or nonperformance by the account party (the bank's customer). Although a standby letter of credit may arise from a commercial transaction, it is not linked directly to the shipment of goods from seller to buyer. It may cover performance of a construction contract, serve as an assurance to a bank that the seller will honor his or her obligations under warranties, or relate to the performance of a purely monetary obligation, for example, when the credit is used to guarantee payment of commercial paper at maturity.

Under all letters of credit, the banker expects the customer to be financially able to meet his or her commitments. A banker's payment under a commercial credit for the customer's account is usually reimbursed immediately by the customer and does not become a loan. However, the bank makes payment on a standby letter of credit only when the customer, having defaulted on his or her primary obligation, is unable to reimburse it.

A standby letter of credit transaction involves greater potential risk for the issuing bank than a commercial documentary letter of credit. Unless the transaction is fully secured, the issuer of a standby letter of credit retains nothing of value to protect against loss, whereas a commercial documentary letter of credit provides the bank with title to the goods being shipped. To reduce the risk of a standby letter of credit, the issuing bank's credit analysis of the account party should be equivalent to the analysis of a borrower in an ordinary loan situation.

The standby letter of credit transactions of state member banks are subject to the legal restrictions of Regulation H and section 23A of the Federal Reserve Act. For reporting purposes, standby letters of credit are shown as contingent liabilities in the issuer's Report of Condition.

Under the revised capital/risk assets guidelines, banks now must allocate capital against standby letters of credit. See the capital adequacy guidelines of November 1995 for information concerning capital allocation requirements against standby letters of credit.

ANTI-BOYCOTT REGULATIONS

The Export Administration Act of 1973 prohibits banks from taking or knowingly agreeing to take actions that support any boycott against a country friendly to the United States. Under anti-boycott regulations (which are issued by the Department of Commerce and enforced by the

Office of Anti-Boycott Compliance), U.S. banks are required to report letters of credit they receive that include illegal boycott terms or conditions and should establish an ongoing program to review all letters of credit. These regulations apply to both domestic and overseas branches of all U.S. banks.

The anti-boycott provisions prohibit banks from opening, negotiating, confirming, or paying international letters of credit that contain illegal terms or conditions. The improper language is most often seen in documentary letters of credit, sight reimbursements, and pass-on letters of credit, but may also appear in drafts and wire payments. Often, a bank's customer may try to add improper language orally rather than in writing. Boycott language includes clauses or requirements such as—

- certification that the goods are not of a particular origin, such as Israeli or South African;
- certification that any supplier or provider of services does not appear on the Arab blacklist;
- the condition, "Do not negotiate with blacklisted banks," or words to that effect;
- a request not to ship goods on an Israeli carrier or on a vessel or carrier that calls at Israel en route to a boycotting country; and
- a request for a certificate stating the origin of the goods or the destination of the goods.

International—Letters of Credit
Examination Objectives
Effective date May 1996

Section 7080.2

1. To determine if objectives, policies, practices, procedures, and internal controls for letters of credit are adequate.
2. To determine whether bank officers are operating in conformance with established guidelines.
3. To determine the scope and adequacy of the audit function.
4. To evaluate the portfolio for documentation and collateral sufficiency, credit quality, and collectibility.
5. To determine compliance with applicable laws and regulations.
6. To recommend corrective action when objectives, policies, practices, procedures, or internal controls are deficient or when violations of laws or regulations are noted.

1. If selected for implementation, complete or update the Letters of Credit section of the Internal Control Questionnaire.
2. Based on the evaluation of internal controls and the work performed by internal and external auditors, determine the scope of the examination.
3. Test for compliance with policies, practices, procedures and internal controls in conjunction with performing the remaining examination procedures. Also obtain a listing of any deficiencies noted in the latest review done by internal and external auditors from the examiner assigned to the audit review and determine if appropriate corrections have been made.
4. Obtain a trial balance of the customer liability records and:
   a. Reconcile balances to department controls and the general ledger.
   b. Review reconciling items for reasonableness.
5. Using an appropriate technique, select customers for examination.
6. Prepare examiners' credit line cards for each customer selected to include:
   a. Total line available for letters of credit.
   b. Total outstanding letters of credit.
      - Undrawn amount.
      - Date of issuance.
      - Expiration date of the credit.
      - Name of the beneficiary.
      - Tenor of the drafts to be drawn.
      - Purpose for the credit.
      - Issued or confirmed.
      - Revocable or irrevocable.
      - Negotiable or non-negotiable.
      - Revolving.
        — Cumulative or noncumulative.
      - Transferable.
      - Assignable.
      - Amendments.
      - Issued on behalf of domestic banks.
      - Application (with official approval) is on file and in agreement with letter of credit terms.
      - Bank's copy is initialed by the officer who signed the original letter of credit.
7. Obtain the following information if it is applicable to the letter of credit department. Such information may necessitate inclusion of additional customers in the credit review.
   a. Delinquencies.
   b. Participations purchased and sold since the preceding examination (including syndicate participations).
   c. Loan commitments and other contingent liabilities.
   d. Letters of credit issued (or confirmed) for major shareholders, officers, directors and their related interests.
   e. Letters of credit issued (or confirmed) for employees, officers and directors of other banks.
   f. Miscellaneous loan debit and credit suspense accounts.
   g. Criticized shared national credits (applicable foreign credits).
   h. Interagency Country Exposure Review Committee determinations.
   i. Letters of credit considered problems by management.
   j. Information on directors, executive officers, principal shareholders and their interests.
   k. Specific guidelines in the lending policies.
   l. Each officer's current lending authority.
   m. Current letter of credit commission and fee structure.
   n. Any useful information obtained from the review of the minutes of the Loan and Discount Committee or any similar committee.
   o. Reports furnished to the Loan and Discount Committee or any similar committee.
   p. Reports furnished to the board of directors.
   q. Loans criticized during the previous examination.
8. Review the information received and perform the following for:
   a. Participations purchased and sold (including syndicate participations).
      - Test participation certificates and records and determine that the parties share in the risks and contractual payments according to the agreement.

- Determine that the books and records of the bank properly show the bank's liability.
- Investigate any participations sold immediately prior to the date of examination to determine if any were sold to avoid possible criticism during the examination.

b. Loan commitments and other contingent liabilities:
- Analyze the commitment or contingent liability if the borrower has been advised of the commitment and the combined amounts of the current loan balance (if any) and the commitment or other contingent liability exceeds the cutoff.

c. Letters of credit issued (or confirmed) for officers, directors and their interests:
- Investigate any circumstances which indicate preferential treatment.

d. Letters of credit issued (or confirmed) for officers and directors of other banks.
- Investigate any circumstances which indicate preferential treatment.

e. Miscellaneous loan debit and credit suspense accounts relating to letters or credit.
- Determine liability to the bank on drafts paid under letters of credit for work which the bank has not been reimbursed by the customer.
- Investigate any large or old items.

f. Shared national credits:
- Compare the schedule of letters of credit included in the program to the bank's reports of unexpired letters of credit.
- For each letter of credit so identified, transcribe appropriate information to line cards. No further examination procedures are necessary in this area.

g. Interagency Country Exposure Review Committee credits:
- Identify any credits that were selected for review that are criticized for transfer risk reasons by the Interagency Country Exposure Review Committee.

h. Letters of credit criticized during the previous examination:
- Determine disposition of letters of credit so criticized by transcribing:
  - — Current balance and payment status, or
  - — Date the letter of credit was drawn down (refinanced), paid, expired or cancelled, and the source of repayment.

9. Transcribe or compare information from the above schedules to credit line cards, where appropriate, and indicate any past due status relating to letters of credit.
10. Prepare credit line cards for any letter of credit not in the sample which, based on information derived from the above schedules, requires an in-depth review.
11. Obtain liability and other information on common borrowers from examiners assigned to cash items, overdrafts, and loan areas and decide who will review the borrowing relationship. Pass or retain examination credit line cards.
12. Obtain credit files for all bank customers for whom credit line cards were prepared and complete credit line cards, where appropriate. To analyze the letters of credit, perform the following procedures:
    a. Analyze balance sheet and profit and loss items as shown in current and preceding financial statements, and determine the existence of any favorable or adverse trends.
    b. Relate items or groups of items in the current financial statements to other items or groups of items set forth in the statements, and determine the existence of any favorable or adverse ratios.
    c. Review components of the balance sheet as shown in the current financial statements, and determine the reasonableness of each item as it relates to the total financial structure.
    d. Review supporting information for the major balance sheet items and the techniques used in consolidation, and determine the primary sources of repayment and evaluate their adequacy.
    e. Review compliance with provisions of letter of credit agreements.
    f. Review digest of officers' memoranda, mercantile reports, credit checkings and correspondence to determine the existence of any problems which might deter the contractual liquidation program.
    g. Relate any collateral values, including margin and cash collateral deposits, to outstanding letter of credit debt.
    h. Compare fees charged to the fee schedule(s), and determine that terms are within established guidelines.

i. Compare the amount of letters of credit outstanding with the lending officer's authority.
j. Analyze any secondary support afforded by guarantors.
k. Ascertain compliance with the bank's established commercial loan policy.
l. Analyze the following specific types of letters of credit (when applicable) to determine the following:
   - For red-clause letters of credit (packing credits)—
     - — is clean advance or anticipatory drawing finance to the beneficiary (exporter or agent) authorized under the letter of credit?
     - — does the beneficiary undertake to deliver, within the expiration date, the shipping documents called for in the letter of credit?
     - — does the foreign bank make advances to the beneficiary, and is it paid by drawing its own draft on the opening bank, or is the beneficiary authorized to draw its draft on the issuing bank, and are the drafts received charged to the importer?
   - For traveler's letters of credit—
     - — is a traveler's letter of credit authorizing the issuing bank's correspondent to negotiate drafts drawn by the beneficiary named in the credit, up to a specified amount, upon proper identification?
     - — is the customer furnished with a list of the issuing bank's correspondents abroad?
     - — is the letter of credit prepaid in full?
   - For back-to-back letters of credit—
     - — is the backing letter of credit properly assigned as collateral to the bank issuing the letter of credit?
     - — are the terms of the letter of credit issued identical to the backing credit, except that—
       - the beneficiary and account party are different,
       - the amount may be less but not more than the backing credit,
       - the expiration date is reduced by sufficient time to allow completion of the transaction before the backing letter of credit expires, and
     - — the beneficiary of the backing letter of credit is a regular customer of the bank opening the second letter of credit?
   - For standby letters of credit—
     - — do they represent undertakings to pay up to a specific amount on presentation of a draft (or drafts) or documents before a specified date?
     - — do they represent obligations to a beneficiary on the part of the issuer to—
       - repay money borrowed by or advanced to, or for the account of, a party; or
       - make payment on account of any indebtedness undertaken by the account party, or make payment on account of default by the account party in the performance of an obligation, for example, default on loans, performance of contracts, or relating to maritime liens?
   - For deferred-payment letters of credit (trade-related)—
     - — does the letter of credit call for drawing of sight drafts with the provison that such drafts are not to be presented until a specified period after presentation and surrender of shipping documents to the bank?
     - — is the bank's liability for outstanding letters of credit calling for deferred payment reflected as a contingent liability until presentation of such documents?
     - — has the bank received, approved, and acknowledged receipt of the documents, thereby becoming directly liable to pay the beneficiary at a determinable future date (or dates)?
     - — will payment be made to the beneficiary in a specified number of months or quarterly, semiannually, annually, or beyond? (If the bank has advanced money to the beneficiary against the deferred-payment letter of credit, with its proceeds assigned as collateral to repay the advance, the transaction should be treated as a loan rather than a

deferred-payment letter of credit).

- For clean deferred-payment letters of credit—
  - — do such deferred-payment credits call for future payment against simple receipt without documents evidencing an underlying trade transaction?
  - — are such letters of credit shown as direct liabilities on the bank's records when drafts are presented by the beneficiary and received by the bank?
- For authority to purchase—
  - — is the authority to purchase with recourse to the drawer, without recourse to the drawer, or without recourse to the drawer but confirmed by the negotiating bank?
- For Agency for International Development (AID) letters of credit—
  - — does the bank have an AID letter of commitment authorizing the transaction?
  - — has the bank checked to make sure that all documents, including those presented by the beneficiary, comply with the terms of both the letter of credit and the AID commitment?
  - — does a letter of agreement between the bank and the foreign government exist, whereby the bank has recourse if AID fails to reimburse the bank?
- For Commodity Credit Corporation (CCC) letters of credit—
  - — does the bank have a CCC letter of commitment authorizing the bank under examination to issue letters of credit to beneficiaries supplying eligible commodities to foreign importers?
  - — in instances where the bank has issued standby letters of credit in favor of the CCC, have the following requirements been met:
    - Has at least 10 percent of the financed amount been confirmed, i.e., guaranteed by a U.S. bank, for commercial credit risk? Is the total value of the credit advised through a U.S. bank?
- For the Export-Import Bank (Eximbank) of the United States—
  - — does the bank have an agency agreement from Eximbank stating—
    - that Eximbank has entered into a line of credit with a foreign borrower,
    - the amount of the line,
    - that the bank has been designated to issue the letter of credit (or credits), and
    - that any payments made under an Eximbank-approved letter of credit will be reimbursed by Eximbank?
  - — has the bank checked to make sure that all documents, including those presented by the beneficiary, comply with the terms of both the letter of credit and the Eximbank agreement?
- For advised (notified) letters of credit—
  - — is the bank only advising the beneficiary without responsibility on its part? (These banks should not be examined unless the bank has notified the letter-of-credit terms erroneously to the beneficiary, thus resulting in a possible liability for the bank.)
- For other types of letters of credit—
  - — do any of the following U.S. government agencies and international organizations reimburse the bank for issuing letters of credit on their behalf:
    - International Bank for Reconstruction and Development (World Bank)
    - Inter-American Development Bank
    - Overseas Private Investment Corporation

13. For loans in the sample, check the central liability file on borrowers who are indebted above the cutoff, or on borrowers who display credit weaknesses or are suspected of having additional liability in other loan areas.
14. Transcribe significant liability and other information on officers, principals, and affiliations of appropriate obligors contained in the sample. Cross-reference line cards to borrowers, where appropriate.
15. Determine compliance with section 208.24 of Regulation H regarding standby letters of

credit by performing the following steps:

a. Determine which letters of credit are standby letters of credit as defined by section 208.24(a) of Regulation H.
b. Determine that the amount of standby letters of credit does not exceed the legal limitations on loans imposed by the state (including limitations to any one customer or on aggregate extensions of credit).
   - Combine standby letters of credit with any other nonexcepted loans to the account party by the issuing bank for the purpose of applying state loan limitations to any one customer.
   - A standby letter of credit is not subject to loan limitations imposed by state law in the following instances:
     — Before or at the time of issuance of the credit, the issuing bank is paid an amount equal to the bank's maximum liability under the standby letter of credit.
     — Before or at the time of issuance, the bank has set aside sufficient funds in a segregated, clearly earmarked deposit account to cover the bank's maximum liability under the standby letter of credit.
c. Determine, for standby letters of credit that constitute extensions of credit under section 23A of the Federal Reserve Act when issued on behalf of an affiliate, that—
   - the legal lending limits pertaining to loans to affiliates have not been exceeded, and
   - appropriate collateral requirements have been met.
d. Determine that the bank maintains adequate control and clearly earmarked subsidiary records of its standby letters of credit in conformance with section 208.24 of Regulation H.
e. Determine that the credit standing of the account party under any standby letter of credit is the subject of credit analysis that is equivalent to that applicable to a potential borrower in an ordinary loan situation.

16. Perform the appropriate procedural steps in the ''Concentration of Credits'' section.
17. Discuss with the appropriate officer (or officers) and prepare summaries in appropriate report form of—
    a. letters of credit not supported by current and complete financial information,
    b. letters of credit on which collateral documentation is deficient,
    c. inadequately collateralized letters of credit,
    d. criticized letters of credit,
    e. concentrations of credit,
    f. letters of credit issued in favor of major shareholders, employees, officers, directors, and their interests,
    g. letters of credit which, for any other reason, are questionable in quality,
    h. violations of laws and regulations, and
    i. other matters regarding the condition of the letters-of-credit department.
18. Prepare and give to the examiner-in-charge a written evaluation of the letters-of-credit department with respect to—
    a. the adequacy of written policies relating to letters of credit;
    b. the manner in which bank officers are operating in conformance with established policies;
    c. delinquencies relating to letters of credit, segregating those considered ''A'' paper;
    d. adverse trends within the letter-of-credit department;
    e. the accuracy and completeness of the schedules obtained;
    f. internal-control deficiencies or exceptions;
    g. recommended corrective action when policies, practices, or procedures are deficient;
    h. the quality of departmental management; and
    i. other matters of significance.
19. Update the workpapers with any information that will facilitate future examinations.

Review the bank's internal controls, policies, practices and procedures for letters of credit issued and confirmed. The bank's system should be documented in a complete and concise manner and include, where appropriate, narrative descriptions, flowcharts, copies of forms used and other pertinent information. Items marked with an asterisk require substantiation by observation or testing.

POLICIES

1. Has the board of directors, consistent with its duties and responsibilities, adopted written letter of credit policies that:
   a. Establish procedures for reviewing letter of credit applications?
   b. Define qualified customers?
   c. Establish minimum standards for documentation in accordance with the Uniform Commercial Code?
2. Are letter of credit policies reviewed at least annually to determine if they are compatible with changing market conditions?

RECORDS

*3. Is the preparation and posting of subsidiary letter of credit records performed or reviewed by persons who do not also:
   a. Issue official checks or drafts?
   b. Handle cash?

*4. Are the subsidiary letter of credit records (control totals) balanced daily with the appropriate general ledger accounts and reconciling items adequately investigated by persons who do not normally handle letters of credit and post records?

*5. Are delinquencies arising from the nonpayment of instruments relating to letters of credit prepared for and reviewed by management on a timely basis?

*6. Are inquiries regarding letter of credit balances received and investigated by persons who do not normally process documents, handle settlements or post records?

*7. Are bookkeeping adjustments checked and approved by an apropriate officer?

*8. Is a daily record maintained summarizing letter of credit transaction details, i.e., letters of credit issued, payments received, and commissions and fees collected, to support applicable general ledger account entries?

9. Are frequent letter of credit record copies and liability ledger trial balances prepared and reconciled monthly with control accounts by employees who do not process or record letter of credit transactions?

COMMISSIONS

*10. Is the preparation and posting of commission records performed or reviewed by persons who do not also:
   a. Issue official checks or drafts?
   b. Handle cash?

11. Are any independent commission computations made and compared or adequately tested to initial commission records by persons who do not also:
   a. Issue official checks or drafts?
   b. Handle cash?

DOCUMENTATION

12. Are terms, dates, weights, description of merchandise, etc. shown on invoices, shipping documents, delivery receipts and bills of lading scrutinized for differences with those detailed in the letters of credit instruments?
13. Are procedures in effect to determine if:
   a. The above documents are signed when required?
   b. All copies of letters of credit are initialed by the officer who signed the original letter of credit?
   c. All amendments to letters of credit are approved by an officer?

COLLATERAL

(See International—Loans and Current Account Advances section.)

DEFERRED PAYMENT LETTERS OF CREDIT

*14. Are deferred payment letters of credit:
   a. Recorded as direct liabilities of the bank after it acknowledges receipt of the beneficiary's documents?
   b. Included in ''Other Assets'' and ''Other Liabilities'' in the call report?

STANDBY LETTERS OF CREDIT

*15. Are standby letters of credit segregated or readily identifiable from other types of letters of credit and/or guarantees?

OTHER

16. Are outstanding letter of credit record copies and unissued forms safeguarded during banking hours and locked in the vault overnight?
*17. Are advised letters of credit recorded as memoranda accounts separate from letters of credit issued or confirmed by the bank?
18. Are letters of credit which have been issued with reliance upon a domestic bank, whether on behalf of, at the request of, or under an agency agreement with the domestic bank, recorded as contingent liabilities under the name of that domestic bank?
19. Are any commission rebates approved by an officer?
20. Does the bank have an internal review system that:
   a. Re-examines collateral items for negotiability and proper assignment?
   b. Test check values assigned to collateral when the letter of credit is issued or confirmed and at frequent intervals thereafter?
   c. Determines that customer payments of letters of credit issued are promptly posted?
   d. Determines all delinquencies arising from the non-payment of instruments relating to letters of credit?
21. Are all letters of credit recorded and assigned consecutive numbers?
22. Are lending officers frequently informed of maturing letters of credit and letter of credit lines?

CONCLUSION

23. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
24. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

State member banks may not issue guarantees and sureties except for those that may be incidental or usual in conducting banking business, such as when a bank has a substantial interest in the performance of the transaction involved or has a segregated deposit sufficient in amount to cover its total potential liability. A state member bank also may guarantee or endorse notes or other obligations sold by the bank for its own account. The amount of the obligations covered by the guaranty or endorsement is to be recorded as a liability on the bank's records. These liabilities are included in computing the aggregate indebtedness of the bank, which may be subject to limitations imposed by state law. Furthermore, a state member bank is permitted to guarantee the deposits and liabilities of its Edge Act and agreement corporations and of its corporate instrumentalities in foreign countries.

A foreign branch of a member bank may engage in certain activities under Regulation K (12 CFR 211) in addition to its general banking powers to the extent that they are consistent with its charter. Those additional activities include guaranteeing a customer's debts or agreeing to make payment on the occurrence of readily ascertainable events, including, but not limited to, nonpayment of taxes, rentals, customs duties, the cost of transportation and loss, or the nonconformance of shipping documents. The guarantee or agreement must specify maximum monetary liability. The liabilities outstanding are subject to loan limitations on any one customer imposed by state law.

A common example of a guarantee is a shipside bond. Frequently, in an international sale of goods, the merchandise arrives at the importer's (buyer's) port before the arrival of correct and complete bills of lading. In these instances, it is customary for the importer (buyer) to obtain immediate possession of the goods by providing the shipping company with a bank guarantee, often called a shipside bond, that holds the shipping company blameless for damage resulting from release of the goods without proper or complete documents. Usually, the bank's guarantee relies on a counter-guarantee issued to the bank by the importer.

All types of guarantees issued are to be recorded as contingent liabilities by the bank. Usually, the party for whom the guarantee was issued will reimburse the bank should it be required to pay under the guarantee; however, in certain situations, some other designated party may reimburse the bank. That other party may be designated in the guarantee agreement with the bank or in the guarantee instrument itself. The bank may also be reimbursed from segregated deposits held, from pledged collateral, or by a counter-guarantor. Letters of credit, as distinguished from guarantees, are discussed in section 7080, ''International—Letters of Credit.''

1. To determine if policies, practices, procedures, and internal controls for guarantees issued are adequate.
2. To determine if bank officers are operating in conformance with established guidelines.
3. To evaluate the portfolio of guarantees for credit quality, collectibility, and collateral sufficiency.
4. To determine the scope and adequacy of the audit function as it applies to guarantees.
5. To determine compliance with applicable laws and regulations.
6. To recommend corrective action when objectives, policies, practices, procedures, or internal controls are deficient and when violations of laws and regulations have been cited.

1. If selected for implementation, complete or update the Guarantees Issued section of the Internal Control Questionnaire.
2. Determine the scope of the examination based upon the evaluation of internal controls and the work performed by internal and external auditors.
3. Test for compliance with policies, practices, procedures and internal controls in conjunction with performing the remaining examination procedures. Also, obtain a listing of any deficiencies noted in the latest review done by internal and external auditors from the examiner assigned to the audit review and determine if appropriate corrections have been made.
4. Obtain a trial balance of the customer (account party) liability records and:
   a. Reconcile balances to department controls and the general ledger.
   b. Review reconciling items for reasonableness.
5. Using an appropriate technique, select guarantee account parties for examination.
6. Prepare credit line cards to include:
   a. Total line available for guarantees.
   b. Total outstanding guarantees.
7. Obtain the following information if it is applicable to the guarantees issued area:
   a. Loan commitments and contingent liabilities.
   b. Miscellaneous loan debit and credit suspense accounts.
   c. Criticized shared national credits.
   d. Interagency Country Exposure Review Committee determinations.
   e. Loans considered ‘‘problem loans’’ by management.
   f. Specific guidelines in the lending policy.
   g. Each officer’s current lending authority.
   h. Any useful information resulting from the review of the minutes of the Loan and Discount Committee or any similar committee.
   i. Reports furnished to the Loan and Discount Committee or any similar committee.
   j. Reports furnished to the board of directors.
   k. Loans criticized during the previous examination.
8. Review the information received and perform the following for:
   a. Miscellaneous loan debit and credit suspense accounts:
      - Determine any liability to the bank resulting from guarantees paid by the bank for which it has not been reimbursed by an account party.
      - Discuss with management any large or old items.
      - Perform additional procedures as considered appropriate.
   b. Shared national credits:
      - Compare the schedule of guarantees issued included in the program to the bank’s reports of unexpired guarantees.
      - For each guarantee so identified, transcribe appropriate information to line cards. No further examination procedures are necessary for these items.
   c. Interagency Country Exposure Review Committee Credits:
      - Identify any guarantees that were selected for review that are criticized for transfer risk reason by the Interagency Country Exposure Review Committee.
9. Transcribe or compare information from the above schedules to credit line cards, where appropriate, and indicate any past due status.
10. Prepare credit line cards for any guarantee not in the sample which, based on information derived from the above schedules, requires an in-depth review.
11. Obtain liability and other information on common borrowers from examiners assigned to cash items, overdrafts, loans and current account advances, due from foreign banks—time, and other loan areas and decide who will review the borrowing relationship. Pass on or retain completed credit line cards.
12. Obtain credit files for all customers (account parties) for whom credit line cards were prepared and complete credit line cards, where appropriate. To analyze the guarantees, perform the following procedures:
    a. Analyze balance sheet and profit and loss figures as shown in current and preced-

ing financial statements, and determine the existence of any favorable or adverse trends.
   b. Relate items or groups of items in the current financial statements to other items or groups of items set forth in the statements, and determine the existence of any favorable or adverse ratios.
   c. Review components of the balance sheet as reflected in the current financial statements, and determine the reasonableness of each item as it relates to the total financial structure.
   d. Review supporting information for the major balance sheet items and the techniques used in consolidation. Determine the primary sources of repayment and evaluate the adequacy of those sources.
   e. Determine compliance with the provisions of guarantee agreements.
   f. Review digest of officers' memoranda, mercantile reports, credit checkings and correspondence to determine the existence of any problems which might deter the contractual liquidation program.
   g. Relate collateral values, if any, to outstanding guarantee.
   h. Compare fees charged to the bank's fee schedule and determine that the terms are within established guidelines.
   i. Compare the original amount of the guarantee with the lending officer's authority.
   j. Analyze support afforded by counterguarantors.
   k. Ascertain compliance with the bank's established guarantee issued policy.

13. For guarantees issued in the sample, check central liability file on borrower(s) indebted above the cutoff or borrower(s) displaying credit weakness or suspected of having additional liability in loan areas.
14. Transcribe significant liability and other information on officers, principals and affiliations of appropriate account parties contained in the sample. Cross-reference line cards to borrowers, where appropriate.
15. Determine compliance with state laws and regulations pertaining to guarantees issued by performing the following steps:
    a. Determine that the obligations covered by such guarantees or endorsements are shown as contingent liabilities on the records and in the reports of condition of the bank and that such liabilities are included in computing the aggregate indebtedness of the bank, if such limitations are imposed by state law.
    b. Determine which guarantees are subject to individual loan limitations to any one customer by state law. Combine guarantees with any other extensions of credit to the account party by the issuing bank subject to loan limitations imposed by state law.
16. Perform appropriate procedural steps in the Concentration of Credits section, as applicable.
17. Discuss with appropriate officers and prepare summaries in appropriate report form of:
    a. Guarantees not supported by current and complete financial information.
    b. Guarantees on which collateral documentation is deficient.
    c. Concentrations of credit.
    d. Criticized guarantees.
    e. Inadequately collateraled guarantees, if applicable.
    f. Guarantees issued in favor of major shareholders, employees, officers, directors and related interests.
    g. Guarantees, which for any other reason, are questionable as to quality and ultimate collection.
    h. Violations of laws and regulations.
18. Evaluate the bank with respect to:
    a. The adequacy of written policies relating to guarantees issued.
    b. The manner in which bank officers are operating in conformance with established policy.
    c. Adverse trends within the guarantees issued department.
    d. The accuracy and completeness of the schedules obtained.
    e. Internal control deficiencies or exceptions.
    f. Recommended corrective action when policies, practices or procedures are deficient.
    g. The quality of departmental management.
    h. Other matters of significance.
19. Update the workpapers with any information that will facilitate future examinations.

Review the bank's internal controls, policies, practices and procedures for issuing and servicing guarantees. The bank's system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used and other pertinent information. Items marked with an asterisk require substantiation by observation or testing.

POLICIES

1. Has the board of directors, consistent with its duties and responsibilities, adopted written policies pertaining to guarantees issued that:
   a. Establish procedures for reviewing guarantee applications?
   b. Define qualified guarantee account parties?
   c. Establish minimum standards for documentation in accordance with the Uniform Commercial Code?
2. Are guarantees issued policies reviewed at least annually to determine if they are compatible with changing market conditions?

RECORDS

*3. Is the preparation and posting of subsidiary guarantee records performed or reviewed by persons who do not also:
   a. Issue official checks or drafts?
   b. Handle cash?

*4. Are the subsidiary guarantees issued records balanced daily with the general ledger and are reconciling items adequately investigated by persons who do not normally handle guarantees?

*5. Are guarantee delinquencies prepared for and reviewed by management on a timely basis?

6. Are inquiries regarding guarantee balances received and investigated by persons who do not normally handle guarantees or post records?

*7. Are bookkeeping adjustments checked and approved by an appropriate officer?

*8. Is a daily record maintained summarizing guarantee transaction details, i.e., guarantees issued, guarantees cancelled or renewed, payment made under guarantees and fees collected, which support general ledger entries?

9. Are frequent guarantee instrument and liability ledger trial balances prepared and are they reconciled monthly with control accounts by persons who do not process or record guarantee transactions?

GUARANTEE FEES

*10. Is the preparation and posting of fees collected records performed or reviewed by persons who do not also:
   a. Issue official checks or drafts?
   b. Handle cash?

11. Are independent fee computations made, compared or adequately tested to initial fee records by persons who do not also:
   a. Issue official checks or drafts?
   b. Handle cash?

COLLATERAL

(See International—Loans and Current Account Advances section.)

OTHER

12. Are guarantees issued instruments safeguarded during banking hours and locked in the vault overnight?
13. Are all guarantees issued recorded as liabilities and assigned consecutive numbers?
14. Are all guarantees issued recorded on individual customer (account party) liability ledgers?

CONCLUSION

15. Is the foregoing information an adequate basis for evaluating internal control in that

there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.

16. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

INTRODUCTION

This section is designed to provide examiners with the basic principles and risks associated with foreign exchange trading. By its very nature, foreign exchange trading involves risk. The examiner's primary function is to understand that risk and ensure that bank management, by means of policies, limits, and systems, is controlling that risk in a prudent manner. For the purpose of this section, foreign currency money market functions will be combined with foreign exchange activities since the principles and risks are virtually the same.

In order to evaluate a bank's foreign exchange and controls, the examiner needs a basic understanding of the foreign exchange market, the commercial bank's role in the market, trading fundamentals, and the principal risks involved in trading.

The foreign exchange market exists to service the foreign currency needs of importers, exporters, manufacturers, and retailers. Foreign exchange transactions arising from international trade and investment are frequently large and recurrent.

Large or small, all foreign exchange transactions represent the exchange of one country's money for another's. The exchange rate is simply the price of one currency in terms of another.

Until the late 1970s, foreign exchange rates in this country were normally expressed and quoted in dollars per unit of foreign currency, also known as ''U.S. Terms.'' Under this method, for example, the rate for French Francs would be expressed as Fl = U.S.$1.5500. However, because of vastly improved communications and a rapidly expanding market, it became necessary for traders worldwide to quote rates in a uniform manner. As a result, American foreign exchange traders began using foreign currency units per dollar or ''European Terms'' for most rates. Using European terms, the quote in this example would be U.S.$1 = F.64516. Thus, European terms represent the value of the U.S. dollar in units of the foreign currency. A quote in European terms is simply the reciprocal of a quote in U.S. terms. One major exception to this shift is the British pound sterling which, for historical purposes, is always quoted in U.S. terms such as 1£ = $1.7450.)

Any commercial bank which maintains due from bank balances, commonly known as ''nostro'' accounts, in foreign countries in the local currency has the capability of engaging in foreign exchange. The majority of U.S. banks restrict foreign exchange to the servicing of their customers' foreign currency needs. The banks will simply sell the currency at a rate slightly above the market and subsequently offset the amount and maturity of the transaction through a purchase from another correspondent bank at market rates. This level of activity involves virtually no exposure as currency positions are covered within minutes. A small profit is usually generated from the rate differential, but the activity is clearly designated as a service center.

Greater emphasis is placed on foreign exchange activity by regional banks. The servicing of the corporate customers' needs is also a priority, but most regional banks also participate in the interbank market. These banks look at the trading function as a profit center as well as a service. Such banks usually employ several experienced traders and, unlike the previous group, will take positions in given currencies based on anticipated rate movements.

Multinational banks assume, by far, the most significant role in the foreign exchange marketplace. While still servicing customer needs, these banks are heavily engaged in the interbank market and look to their foreign exchange trading operation for sizeable profits. Such banks trade foreign exchange on a global basis through international branch networks.

A major aspect of any foreign exchange review is the ability of the examiner to determine if the bank has the capability to adequately handle the level of its foreign exchange volume and the extent of the exposures taken. This judgment is, by necessity, subjective; however, it must take into consideration asset size, capital base, customer volume in foreign exchange, depth and experience of traders, and management understanding of and commitment to trading. The fundamental principles of foreign exchange trading outlined below are designed to assist the examiner in this analysis.

SPOT TRADING

Buying and selling foreign exchange at market rates for immediate delivery represents spot trading. In reality, spot trades have a ''value date'' (maturity or delivery date) of two to five business days (one for Canada and Mexico). Foreign exchange rates that represent the present market value for the currency are known as spot rates. The risk of spot trading results from rate movements occurring when the bank's position in foreign currency is not balanced with regard to exchange bought and sold. Such unbalanced positions are referred to as net open positions and are defined as follows:

Net Open Positions—A bank has a net position in a foreign currency when its assets, including spot and future contracts to purchase, and its liabilities, including spot and future contracts to sell, in that currency are not equal. An excess of assets over liabilities is called a net ''long'' position and liabilities in excess of assets a net ''short'' position. A ''long'' position in a foreign currency which is depreciating will result in an exchange loss relative to book value because, with each day, that position (asset) is convertible into fewer units of local currency. Similarly, a ''short'' position in a foreign currency which is appreciating represents an exchange loss relative to book value because, with each day, satisfaction of that position

CONSOLIDATED FOREIGN EXCHANGE POSITION, MAY 4, 19XX

Amounts in thousands

	Assets/Purchases		*Liabilities/Sales*	
Monetary Unit, Overnight Limit and Description	*Foreign Amount*	*U.S. $ Equivalent of Local Currency Book Value*	*Foreign Amount*	*U.S. $ Equivalent of Local Currency Book Value*
WEST GERMAN MARKS ($3,000M)				
Ledger Accounts	563,437	239,461	645,013	274,310
Spot Contracts	23,502	9,802	15,973	6,709
Forward Contracts	790,250	331,905	712,533	296,342
	1,377,189	581,168	1,373,519	577,361
Net Position (long)	3,670	3,807		
CANADIAN DOLLARS ($6,000M)				
Ledger Accounts	1,016,076	1,017,525	1,029,835	1,030,057
Spot Contracts	330,021	328,972	216,225	217,246
Forward Contracts	1,202,013	1,203,226	1,301,279	1,302,522
	2,548,110	2,549,723	2,547,339	2,549,825
Net Position (long)	771			102
SWISS FRANC ($250M)				
Ledger Accounts[1]	31,768	11,932	36,052	13,571
Spot Contracts	1,526	593	2,566	969
Forward Contracts	11,174	4,274	6,545	2,521
	44,468	16,799	45,163	17,061
Net Position (short)[2]			695	262

1. Does not include a Swiss Franc 1,000M (U.S. $386M) unhedged investment in a Swiss subsidiary and Swiss Franc 573M (U.S. $217M) unhedged investment in branch fixed assets. The unhedged term ''long'' position was approved by senior bank management.

2. Net overnight position in excess of established limit. Formally approved as a special situation by senior management prior to the transaction.

(liability) will cost more units of local currency. (Examples of net open position schedules appropriate for use in preparing the report of examination appear on the preceding page.)

It is important to remember that the net open position consists of both balance sheet accounts and contingent liabilities. For most banks, the nostro accounts represent the principal assets; however, foreign currency loans as well as any other assets or liability accounts denominated in foreign currency which are sizeable in certain banks, must be included. All future foreign exchange contracts outstanding are contingents. When a contract matures, the entries are posted to a nostro account in the appropriate currency.

Each time a bank enters into a spot foreign exchange contract, its net open position is changed. For example, assume that Bank A opens its business day with a balanced net open position in pound sterling (assets plus purchased contracts equal liabilities plus sold contracts). This is often referred to as a ‘‘flat’’ position. Bank A then receives a telephone call from Bank B requesting a ‘‘market’’ in sterling. Because it is a participant in the interbank foreign exchange trading market, Bank A is a ‘‘market maker.’’ This means it will provide Bank B with a two-sided quote consisting of its bid and offer for sterling. If a different currency was requested, European terms would be the opposite as the bid and offer would be for dollars instead of the foreign currency. In determining the market given, Bank A’s trader of sterling will determine where the market presently is (from brokers and/or other banks) and attempt to anticipate where it is headed and whether Bank B is planning to buy or sell sterling.

When Bank A gives its quote on sterling, $1.7115–25 for example, it is saying that it will buy sterling (its bid) at $1.7115 or sell sterling at $1.7125 (its offer). If Bank B’s interest is to buy sterling and the given quote is appealing, it will buy sterling from Bank A at $1.7125 (Bank A’s offer of sterling). Note, that while Bank B may choose to buy, sell or pass as it wishes, it must do business on the terms established by Bank A. These terms will be in Bank A’s favor. As soon as Bank B announces it will purchase sterling at $1.7125, Bank A acquires a net open position (short) in sterling. Bank A must then decide whether to hold its short position (in anticipation of a decline in sterling) or cover its position. Should it wish to cover, it may call another bank and purchase the amount it sold to Bank B. However, in this case, as the calling bank, Bank A would buy its sterling from the offered side of the quote it receives and must buy it at $1.7125 or less to avoid a loss.

Banks engaging in interbank spot trading will often be involved with sizeable net open positions, though many for just brief periods. No matter how skilled the trader, each will encounter at least occasional losses. Knowing when to close a position and take a small loss before it becomes large is a necessary trait for a competent trader. Many banks employ a ‘‘stop loss policy’’ whereby a net open position must be covered if losses from it reach a certain level. While a trader’s forecast may ultimately prove correct within a day or week, rapid rate movements often force a loss within an hour or even minutes. Also, access to up to the minute information is vital for involvement in spot trading. Banks who lack the vast informational resouces of the largest multinationals may be particularly vulnerable to sudden spot rate movements prompted by inside information or even rumors. As a result, examiners should closely review banks where foreign exchange activities consist primarily of interbank spot trading.

FORWARD TRADING

A forward transaction differs from a spot transaction in that the value date is more than two to five business days in the future. The maturity of a foreign forward exchange contract can be a few days, months, or even years in some instances. The exchange rate is fixed at the time the transaction is agreed. But nostro accounts are not debited or credited, i.e., no money actually changes hands, until the maturity date of the contract. There will be a specific exchange rate for each forward maturity, and each of those rates will generally differ from today’s spot exhange rate. If the forward exchange rate for a currency is higher than the current spot rate, dealers say the currency is trading at a ‘‘premium’’ for that forward maturity. If the forward rate is below the spot rate, then the currency is said to be trading at a ‘‘discount.’’ For instance, sterling for value in three months is at a discount if the spot rate is $1.75 and the three-month forward rate is $1.72.

Banks active in the foreign exchange market find that interbank currency trading for any specific value date in the future is inefficient and engage in it only infrequently. Instead, for future maturities, banks trade among themselves as well as with some corporate customers on the basis of a transaction known as a ''swap.'' A swap transaction is a simultaneous purchase and sale of a certain amount of foreign currency for two different value dates. The key aspect is that the bank arranges the swap as a single transaction with a single counterparty, either another bank or a nonbank customer. This means that, unlike outright spot or forward transactions, a trader does not incur a net open position since the bank contracts both to pay and to receive the same amount of currency at specified rates.

A swap allows each party to use a currency for a period in exchange for another currency that is not needed during that time. Thus, the swap offers a useful investment facility for temporary idle currency balances of a corporation or a financial institution. Swaps also provide a mechanism for a bank to accommodate the outright forward transactions executed with customers or to bridge gaps in the maturity structure of its outstanding spot and forward contracts.

The two value dates in a swap transaction can be any two dates. But, in practice, markets exist only for a limited number of standard maturities. One of these standard types is called a ''spot against forward'' swap. In a spot against forward swap transaction, a trader buys or sells a currency for the spot value date and simultaneously sells or buys it back for a value date a week, a month, or three months later.

Another type of transaction of particular interest to professional market-making banks is called a ''tomorrow-next'' swap or a ''rollover.'' These are transactions in which the dealer buys or sells a currency for value the next business day and simultaneously sells or buys it back for value the day after. A more sophisticated type of swap is called a ''forward-forward'' in which the dealer buys or sells currency for one future date and sells or buys it back for another future date. Primarily, multinational banks specialize in transactions of that type.

Any swap transaction can be thought of as if it were a simultaneous borrowing and lending operation. For example, on September 11, Bank A ''swaps in'' three-month sterling in a spot against a forward transaction with Bank B. On September 13, Bank A pays dollars to Bank B's account at a New York bank and Bank A receives sterling for its account at a bank in London. On December 13, the swap is reversed. Bank A pays back the sterling to Bank B, while B pays back the dollars to A. In the meantime, Bank A has the use of the sterling, in effect ''borrowing'' sterling, while giving up use of the dollars, in effect ''lending'' the dollars. Banks recognize this close equivalence to actual short-term borrowing and lending. Many fold in swap transactions with other money market transactions in managing their global banking activities.

Forward exchange rates can be expressed in three ways. Like spot rates, outright forward prices are expressed in dollars and cents per currency unit or vice versa. Traders normally only quote forward prices to corporate customers or to small correspondent banks seeking to buy or sell a currency for a particular future date. For instance, a trader may quote an outright six-month rate to buy sterling of \$1.8450, while, by comparison, a quotation to buy spot sterling might be less (\$1.8200) or more (\$1.8625).

In swap transactions, the trader is only interested in the difference between spot and forward rates, the premium or discount, rather than the outright spot and forward rates themselves. Premiums and discounts expressed in points (\$0.0001 per pound sterling or DM 0.0001 per dollar) are called swap rates. For the first spot rate above, the premium is 250 points (\$0.0250). For the second, the discount is 175 points (\$0.0175).

Since, in a swap, a trader is effectively borrowing one currency and lending the other for the period between the two value dates, the premium or discount is often evaluated in terms of percent per annum. For the examples above, the premium of 250 points is equivalent to 2.75 percent per annum, while the discount of 175 points is equivalent to 1.88 percent per annum. To calculate the percentage premium for the first case:

- Take the swap rate (\$0.0250)
- Multiply by 12 months and divide by 6 months (a per annum basis)
- Divide by the spot rate (\$1.8200), and
- Multiply by 100 (to get a percent basis).

On a formula basis, this can be expressed as:

$$\text{\% per annum} = \frac{\text{Premium or Discount} \times 12 \times 100}{\text{Spot rate} \times \text{number of months of forward contract}}$$

As can be seen from the above, forward rates (premiums or discounts) are solely influenced by the interest rate differentials between the two countries involved. As a result, when the differential changes, forward contracts previously booked could now be covered at either a profit or loss. For example, assume an interest rate differential between sterling and dollars of 3 percent (with the sterling rate lower). Using this formula, with a spot rate of $1.80, the swap rate on a three month contract would be a premium of 135 points. Should that interest rate differential increase to 4 percent (by a drop in the sterling rate or an increase in the dollar rate), the premium would increase to 180 points. Therefore, a trader who bought sterling three months forward sterling at 135 points premium could now sell it at 180 points premium, or at a profit of 45 points (expressed as .0045).

Thus, the dealer responsible for forward trading must be able to analyze and project dollar interest rates as well as interest rates for the currency traded. Additionally, because forward premiums or discounts are based on interest rates differentials, they do not reflect anticipated movements in spot rates.

Active trading banks will, of course, have a large number of forward contracts outstanding. The portfolio of forward contracts is often called a ‘‘forward book.’’ As a result, these forward positions must be managed on a gap basis. Normally, banks will segment their forward books into 15-day periods and show the net (purchased forward contracts less sold ones) balance for each period. A typical forward book would look as follows:

Foreign Currency	*Maturity Date*	*Purchases*	*Sales*	*Net Position for Period*
England	Dec. 1–15	1 000 000	800 000	200 000
(amounts in)	16–31	700 000	900 000	(200 000)
pound sterling)	Jan. 1–15	1 500 000	500 000	1 000 000
	16–31	1 400 000	600 000	800 000
	Feb. 1–15	1 100 000	700 000	400 000
	16–28	1 400 000	400 000	1 000 000
	Mar. 1–31	200 000	1 300 000	(1 100 000)
	Apr. 1–30	400 000	1 600 000	(1 200 000)
	May 1–31	300 000	900 000	(600 000)
	June 1–30	350 000	450 000	(100 000)
	July 1–31	550 000	450 000	100 000
	Aug. 1–31	1 000 000	1 000 000	—
	Sept. 1–30	500 000	600 000	(100 000)
	Oct. 1–31	600 000	500 000	100 000
	Nov. 1–30	100 000	100 000	—
	Dec. 1–31	100 000	200 000	(100 000)
	Totals	11 200 000	11 000 000	200 000

In this forward book, volumes and net positions are limited with only the first three months segregated into 15-day periods with the remainder grouped monthly. The trader will use the forward book to manage his overall forward positions.

A forward book in an active currency may consist of numerous large contracts but, because of the risks in a net open position, total forward purchases will approximately equal total forward sales. (Note: In the above forward book, the net position is only £200,000.) What matters in reviewing a forward book is the distribution of the positions by period. In the above example, the forward sterling is long a net 3,200,000 for the first three months (December through February) and short a net 3,000,000 for the next four months (March through June). In this instance, the forward book is structured for an anticipated decline in dollar interest rates as compared with sterling interest rates since these sold positions could be offset (purchase of a forward contract to negate the sold forward position) at a lower price—either reduced premium or increased discount.

Trading forward foreign exchange thus involves projecting interest rate differentials and managing a forward book to be compatible with these projections. An understanding of these concepts is essential when looking at forward trading from risk and profitability aspects.

COMPUTING FOREIGN EXCHANGE PROFITS AND LOSSES

If traders did nothing but spot transactions and never took open positions from day to day, calculating profit or loss would be straightforward. For example: on January 21, the traders buy £1,000,000 spot at $1.75 and £3,000,000 at $1.74 and sell £2,000,000 at $1.7450 and £2,000,000 at $1.7380. On the spot value dates, two business days later, the bank's nostro or clearing account in London is credited and debited by £4,000,000 from the maturing transactions.

The sterling position is square, since debits and credits are equal. In New York, the bank pays $6,970,000 but receives only $6,966,000. There is a net loss of $4,000 on the four transactions. This is so because the bank's accountant would calculate that the traders acquired sterling at an average rate of $1.7425 =

$$\frac{£1{,}000{,}000 \times \$1.75 + £3{,}000{,}000 \times \$1.74}{£4{,}000{,}000}$$

Against that, the traders sold sterling at $1.7450, for a profit of $5,000 (i.e., $1.7450 – $1.7425 = $0.0025 × 2,000,000 = $5,000). Traders also sold another £2,000,000 at $1.7380 for a loss of $9,000 ($1.7380 – $1.7425 = –$0.0045 × £2,000,000 = –$9.000). In this instance, the computed net loss of $4,000 is precisely the same as the excess of dollar payments over dollar receipts.

In practice, computing profits and losses is far more complex for two basic reasons. Banks do not trade only for spot value—they also do forward contracts. Moreover, most major banks do not operate from day to day with completely square positions in each currency. Because of the way different forward contracts mature each day, it is unusual for payments and receipts to balance perfectly until the traders arrange swaps to achieve that result. Because some traders take a view about the future movements of a currency, short or long positions are built up; and, because of the changing influences on market developments and traders' decisions, long or short positions can be altered any number of times each and every day.

In this kind of fluid trading environment, a bank needs to establish accounting procedures for calculating profits and losses which can handle the problem of maturity mismatches and open foreign currency positions. The principles underlying the accounting procedures are much the same from bank to bank, although specific practices vary. The first principle is that banks do not formally calculate profits or losses daily; most compute profits and losses monthly. Some banks do make these calculations more frequently for management information purposes.

The next principle is that banks calculate profits or losses on the entire foreign exchange book as of the calculation date. On any day, the book includes all spot and forward contracts which have not yet matured, along with nostro balances in each currency. Each contract represents a purchase or sale of a foreign currency at a specified exchange rate.

On the profit calculation date, the bank's accountants revalue the foreign exchange book. They use the latest market exchange rates, spot and forward, for each value date on which contracts are outstanding. For each contract, the difference between the current market rate for the value date of the contract and the rate specified in the contract is calculated. For example, if the bank previously bought a currency, e.g., sterling at $1.75, and the current market rate for the relevant maturity is higher, e.g., sterling at $1.80, there is an unrealized profit.

These calculated unrealized profits and losses are amalgamated with the realized profits or rlosses that accrue every day as foreign exchange contracts mature. The net profit or loss, realized plus unrealized, is then incorporated in bank operating income, reflecting the net contribution of foreign exchange trading before expenses.

To recapitulate, a bank with a large number of spot and forward contracts and possibly with open positions in one or more currencies needs a formal method of computing unrealized profits and losses at regular intervals. It uses a revaluation procedure that, in effect, measures what the profits and losses would be if the bank covered in the market all outstanding positions that were not already covered. The revaluation procedure ensures that the bank's open positions show changes in exchange rates as they occur, rather than when open positions are eventually covered or when individual contracts mature. Periodic profit and loss calculations therefore provide bank management with ongoing insights into the performance of the trading function.

Following is an illustration of the revaluation procedure. Assume that on the revaluation date, January 15, Bank A had three outstanding contracts in its sterling book:

- A sale of £1,000,000 at $1.75 for value March 15.
- A purchase of £3,000,000 at $1.70 for value May 15.
- A sale of £1,000,000 at $1.65 for value August 15.

The book is ‘‘long’’ £1,000,000 since purchases of sterling are greater than sales. For now, the nostro account and the calculations of realized profits and losses are left aside.

To revalue the book, the accountants find on January 15 that two-month, four-month, and seven-month forward rates in the market are $1.80, $1.75, and $1.70, respectively. They proceed conceptually as if the traders were to cover the contracts at the going market rates, buying sterling to offset sales and selling sterling to offset purchases. On this basis, for the first contract, they compute an urealized loss of $50,000 ($1.75 – $1.80 = –$0.05 × £1,000,000). For the second contract, they compute an unrealized profit of $150,000 ($1.75 – $1.70 = $0.05 × £3,000,000). For the third contract, they compute an unrealized loss of $50,000 ($1.65 – $1.70 = $0.05 × £1,000,000). The net is an unrealized profit of $50,000 which is entered on the income statement as the trading profit.

The accountant's task actually is far more complicated. A foreign exchange book of a major bank may include hundreds of outstanding contracts in a dozen or more currencies. Value dates range from the next day to a year or more in the future. Market exchange rates are readily available for the ‘‘even’’ dates—one, two, three, six, twelve, and twenty-four months into the future. The Federal Reserve Bank of New York publishes such a daily series which can be used by bank accountants and examiners. But for ‘‘odd’’ dates, the accountant must approximate rates, possibly through a computer program that interpolates between even date quotations.

As contracts in the foreign exchange book mature, they affect the cash flow of the bank. Maturing purchase and sale contracts are treated asymmetrically. In a U.S. bank, which posts its profits and losses in dollars, maturing purchase contracts result in credits to its nostro account in that currency. Each day, the bank's accountants compute a new average acquisition rate for the nostro account based on existing holdings and all flows into the account that day. Maturing sale contracts result in debits to the nostro account. They yield a gain or loss measured against the average acquisition rate for funds available in the nostro account. The net realized profit or loss is placed in a suspense account which, at regular intervals, is incorporated into the bank's income statement along with the unrealized profits or losses resulting from the periodic revaluation of the foreign exchange book. In practice, the revaluation can be done on a worksheet as long as net positions for time periods and present market rates are known. While banks will revalue monthly and make the appropriate entries to income accounts, traders will spot-check their profitability more frequently. Examiners should understand the revaluation procedure for the necessary test checking of reported profits, as time restrictions do not normally allow for the proving of all of the bank's open positions.

To revalue the nostro accounts, which represent realized profit or loss, the net foreign currency balance is multiplied by the current spot rate and the result, or market value, is compared to the U.S. $ equivalent on the books to determine profit or loss as shown below:

Foreign Amount	*Spot Rate*	*Market Value*	*U.S. $ Equivalent Book Value of Ledger Accounts*	*Profit or Loss*
15,172	$1.7155	26,028	21,229	+4,799

The same principle holds true when comparing market value to book, even if credit balances exist. (A market value of −19.055 and a book value of −20,155 would result in a profit of 1,100.)

A worksheet revaluation of forward contracts, for unrealized profits, is an expansion of the forward book previously shown. All rates must be expressed in "U.S. terms."

FORWARD BOOK

Foreign Currency	*Maturity Date*	*Purchases*	*Sales*	*Net Position for Period*	*D-Discount P-Premium Rate*	*Profit*	*Loss*
England	Dec. 1–15	1 000 000	800 000	200 000	.0025 P	500	
	16–31	700 000	900 000	(200 000)	25 P		500
	Jan. 1–15	1 500 000	500 000	1 000 000	15 P	1,500	
	16–31	1 400 000	600 000	800 000	15 P	1,200	
	Feb. 1–15	1 100 000	700 000	400 000	5 P	200	
	16–28	1 400 000	400 000	1 000 000	5 P	500	
	Mar. 1–31	200 000	1 300 000	(1 100 000)	5 D	550	
	Apr. 1–30	400 000	1 600 000	(1 200 000)	15 D	1,800	
	May 1–31	300 000	900 000	(600 000)	30 D	1,800	
	June 1–30	350 000	450 000	(100 000)	45 D	450	
	July 1–31	550 000	450 000	100 000	5 P	50	
	Aug. 1–31	1 000 000	1 000 000	—	25 D	—	
	Sept. 1–30	500 000	600 000	(100 000)	0	—	
	Oct. 1–31	600 000	500 000	100 000	45 D		450
	Nov. 1–30	100 000	100 000	—	25 D	—	
	Dec. 1–31	100 000	200 000	(100 000)	5 P		50
	Totals	11 200 000	11 000 000	200 000		+7550	

In completing a worksheet in the above format, the following must be kept in mind:

- A long position at a premium = profit
- A short position at a premium = loss
- A long position at a discount = loss
- A short position at a discount = profit

The $7,550 is simply the profit that would be obtained if the forward book positions were fully liquidated at this time, i.e., purchases offset by sales. To calculate the profit, the unrealized profit from the previous month ($6,400 in this example) must be reversed. Thus, the sterling profit for this month would be:

$4,799	Nostro balance profit
7,550	Forward book profit (unrealized)
−6,400	Reversal of last month's forward book
$5,949	Sterling profit for the month

Most automated systems will eliminate the need for manual calculations. However, the resulting figure is only as accurate as the rates applied. As a result, examiners should test-check at least one major currency using independent rates (supplied by the Federal Reserve Bank of New York or another independent source). This should be done concurrently with the bank's own monthly revaluation. If a sizeable discrepancy results, rates and revaluation methods used by the bank should be reviewed with both management and the traders.

DEFINING AND CONTROLLING FOREIGN EXCHANGE RISKS

Foreign exchange trading encompasses a variety of risks. Exchange rate risk, maturity gaps and interest rate risk relate to spot and forward trading. The latter two risks relate to exposures inherent in all phases of international banking.

Exchange Rate Risk

Exchange rate risk is an inevitable consequence of trading in a world in which foreign currency values move up and down in response to shifting market supply and demand. When a bank's dealer buys or sells a foreign currency from another bank or nonbank customer, exposure from a net open position is created. Until the time that the position can be covered by selling or buying an equivalent amount of the same currency, the bank is exposed to the risk that the exchange rate might move against it. That risk exists even if the dealer immediately seeks to cover the position because, in a market in which exchange rates are constantly changing, a gap of just a few moments can be long enough to transform a potentially profitable transaction into a loss. Since exchange rate movements can readily accumulate in one direction, a position carried overnight or over a number of days entails greater risk than one carried a few minutes or hours. Again, the acid test of a good trader is to know when to take a small loss before it becomes larger.

At any time, the trading function of a bank may have long positions in some currencies and short positions in others. These positions do not offset each other, even though, in practice, some currencies do tend to move more or less together. The bank's traders recognize the possibility that the currencies in which they have long positions may fall in value and currencies in which they have short positions may rise. Consequently, gross trading exposure is measured by adding the absolute value of each currency position expressed in dollars. The individual currency positions and the gross dealing exposure must be controlled to avoid unacceptable risks.

To accomplish this, management limits the open positions dealers may take in each currency. Practices vary among banks, but, at a minimum, limits are established on the magnitude of open positions which can be carried from one day to the next (overnight limits). Several banks set separate limits on open positions dealers may take during the day. These are called "daylight" limits. Formal limits on gross dealing exposure also are established by some banks, while others review gross exposure more informally. The various limits may be administered flexibly, but the authority to approve a temporary departure from the norm is typically reserved for a senior officer.

For management and control purposes, most banks distinguish between positions arising from actual foreign exchange transactions (trading exposure) and the overall foreign currency exposure of the bank. The former includes the positions recorded by the bank's trading operations at the head office and at branches abroad. In addition to trading exposure, overall exposure incorporates all bank assets and liabilities denominated in foreign currencies including loans, investments, deposits, and the capital of foreign branches. Control of overall foreign currency exposure usually is the responsibility of a senior officer accountable to the bank's senior management.

Maturity Gaps and Interest Rate Risk

Interest rate risk arises whenever there are mismatches or gaps in the maturity structure of a bank's foreign exchange forward book. Managing maturity mismatches is an exacting task for a foreign exchange trader.

In practice, the problem of handling mismatches is involved. Eliminating maturity gaps on a contract-by-contract basis is impossible for an active trading bank. Its foreign exchange book may include hundreds of outstanding contracts. Some will mature each business day. Since the book is changing continually as new transactions are made, the maturity gap structure also changes constantly.

While remaining alert to unusually large mismatches in maturities that call for special action, traders generally balance the net daily payments and receipts for each currency through the use of rollovers. Rollovers simplify the handling of the flow of maturing contracts and reduce the number of transactions needed to balance the book. Reliance on day-to-day swaps is a relatively sound procedure as long as interest rate changes are gradual and the size and length of maturity gaps are controlled. However, it does leave the bank exposed to sudden changes in relative interest rates between the United States and other countries, which influence market quotations for swap transactions and, consequently, the cost of bridging the maturity gaps in the foreign exchange book.

The problem of containing interest rate risk is familiar to major money market banks. Their business often involves borrowing short-term and lending longer-term to benefit from the normal tendency of interest rates to be higher for longer maturities. But in foreign exchange trading, it is not just the maturity pattern of interest rates for one currency that counts. Rather, in handling maturity gaps, the differential between interest rates for two currencies is decisive. So the problem is more complex.

To control interest rate risk, senior management generally imposes limits on the magnitude of mismatches in the foreign exchange book. Procedures vary, but separate limits are often set on a day-to-day basis for contracts maturing during the following week or two and for each consecutive half-monthly period for contracts maturing later. At the same time, management relies on branch officers abroad, domestic money market experts, and its Economic Research Department to provide an ongoing analysis of interest rate trends.

Credit Risk

When a bank books a foreign exchange contract, it faces a risk, however small, that the counterparty will not perform according to the terms of the contract. In both instances, there is a credit risk, although, in the foreign exchange case no extension of credit is intended. To limit credit risk, a careful evaluation of the creditworthiness of the customer is essential. Just as no bank can lend unlimited amounts to a single customer, no bank would want to trade unlimited amounts of foreign exchange with one counterparty.

Credit risk arises whenever a bank's counterparty is unable or unwilling to fulfill its contractual obligations. That happens most blatantly when a corporate customer enters bankruptcy or a bank counterparty is declared insolvent. In any foreign exchange transaction, each counterparty agrees to deliver a certain amount of currency to the other on a particular date. Every contract is immediately entered into the bank's foreign exchange book. In balancing its trading position, a bank counts on that contract being carried out in accordance with the agreed upon terms. If the contract is not liquidated, then the bank's position is unbalanced and the bank is exposed to the risk of changes in the exchange rates. To put itself in the same position it would have been in if the contract had been performed, a bank must arrange for a new transaction. The new transaction may have to be arranged at an adverse exchange rate. The trustee for a bankrupt company may perform only contracts which are advantageous to the company and disclaim those contracts which are disadvantageous.

Another and potentially more pernicious form of credit risk stems from the time zone differences between the United States and foreign nations. Inevitably, a bank selling sterling, for instance, must pay pounds to a counterparty earlier in the day than it will be credited with dollars in New York. In the intervening hours, a company can go into bankruptcy or a bank can be declared insolvent. Thus, the dollars may never be credited.

Managing credit risk is the joint responsibility of the bank's trading department and its credit officers. A bank normally deals with corporations and banks with which it has an established relationship. Dealing limits are set for each counterparty and are adjusted in response to changes in its financial condition. In addition, some banks set separate limits on the value of contracts that may mature on a single day with a particular customer. Some banks, recognizing credit risk increases as maturities lengthen, restrict dealings with certain customers to spot transactions or require compensating balances on forward transactions. A bank's procedures for evaluating credit risk and minimizing exposure are reviewed by supervisory authorities as part of the regular examination process.

Transfer Risk

At one time or another, virtually every country has interfered with international transactions in its currency. Interference might take the form of regulation of the local exchange market, restrictions on foreign investment by residents, or limits on inflows of investment funds from abroad. Governments take such measures for a variety of reasons: to improve control over the domestic banking system, or to influence the pattern of receipts and payments between residents and foreigners. Restrictions on the exchange market or on international transactions generally are intended to affect the level or movement of the exchange rate.

Changes in regulations or restrictions usually do have an important exchange market impact. From the viewpoint of a commercial bank's foreign currency traders, most disruptive are changes in rules which interfere with the normal payments mechanism. Traders make foreign exchange contracts on the expectation that both parties will perform according to the terms of the contract. But if government regulations change and a counterparty is either forbidden to perform as expected or is required to do something extra, then a trader might be left with an unintended open position or an unintended maturity mismatch. As described in the previous section, dealing with unintended long or short positions can be costly.

Other changes in official regulations do not in the first instance, affect the payments mechanism, but they do influence international investment transactions. Consequently, when one of the factors affecting the buying or selling of a currency changes, the exchange rate is likely to respond. Currency traders usually try to limit open positions and maturity gap mismatches, whenever modifications in official regulations appear likely. Nevertheless, changes in controls often are unpredictable; and unanticipated changes in regulations can spark significant exchange rate response.

Monitoring and responding to changing official exchange controls abroad has to be done by a well-run foreign exchange trading function. Most U.S. banks have judged that the simplest approach is to avoid trading in those currencies for which the market is heavily regulated. This decision is reflected in turnover statistics which show that trading is concentrated in the major currencies subject to the fewest controls; generally the West German deutsche mark, Canadian dollar, British pound sterling, Swiss franc, French franc, Italian lira, Japanese yen, Dutch guilder, and Danish kroner.

POLICY

The relative importance of each of those risk determinants varies with each currency traded and with the country of each counterparty. Senior bank management must fully understand the risks involved in foreign exchange and money market operations and must establish, in writing, its goals and policies regarding those risks. Management must be able to defend logically the basis upon which such policies are formed. It is imperative that responsible officers, traders, clerks and auditors fully understand the intent as well as the detail set forth in those directives.

At a minimum, policies should define dealing limits and reporting requirements as well as accounting and audit and control systems to provide for proper surveillance over those limits and exceptions thereto.

Limits must be established for overnight net positions in each currency. Depending on the size of the limits and the manner in which they are calculated, a smaller aggregate position limit for all currencies may be desirable. An aggregate limit should not permit the netting of short against long positions, but should require that they be added to determine conformance to that limit. Many U.S. banks consider whether to establish daylight (intraday) position limits only if efficient computerization and input systems are in effect to incorporate each trade into the appropriate currency position at nearly the precise moment it is transacted.

Gap (net inflow and outflow) limits must be instituted to control the risk of adverse rate movement and liquidity pressures for each currency for each daily, weekly, and biweekly future time frame designated in the bank's maturity reports. Such limits might range from stated absolute amounts for each time frame to weighted limits which emphasize increasing rate movement exposure applicable to the relative distance into the future in which the gap appears.

Aggregate trading and placement limits must be established for each customer, based primarily on the amount of business considered to be appropriate to its creditworthiness and, secondly, on the volume of its foreign currency needs. In addition, absolute sub-limits should be placed upon the amount of that customer's business which may be settled on one day. Should the customer be unable to meet obligations on one day, the trader will:

- Be forewarned against delivery prior to receipt of customer funds on the remaining contracts outstanding, and
- Have an opportunity to determine whether alternate cover must be obtained to meet third-party transactions which may initially have provided cover for the remaining transactions with that customer.

It is difficult to monitor aggregate volume limits effectively and ensure compliance with settlement limits for a large number of customers. An effective settlement limit program for at least those relationships which possess a greater potential for late delivery or default should be enacted by senior management.

REPORTS

Properly designed reports are the most important supervisory tool available to management. They must be prepared in a concise, uniform and accurate manner and submitted punctually. Management should receive daily net position reports for each currency traded. Normally, position reports should include all foreign currency balance sheet items and future contracts as well as afterhour and holdover transactions, excepting fixed assets and equity investments. The hedging of those investments is usually a management decision outside the normal responsibility of the traders. The reports should be prepared by the foreign exchange and money market bookkeeping section and reconciled daily to the trader's blotter. In the event that formal position reports cannot be submitted at the end of a business day, management should be apprised of the traders estimated position at the end of each day and especially before weekends and holidays.

Gap or maturity reports are essential to the proper management of a bank's liquidity in each foreign currency and significant maturity gaps may affect overall liquidity. Those reports should show daily gaps for at least the first two weeks to one month. Beyond that time, gap periods of a maximum of two weeks each are preferred. Gap reports are generally accurate only for the day on which they are prepared. Therefore, it is essential that banks have the capability to produce detailed management reports daily. Loans, deposits and future contracts as well as commitments to take or place deposits should be reflected in the periods in which they are scheduled for rollover or interest adjustment. In most instances, an additional report showing those items at final maturity is desirable in analyzing the bank's medium- and longer-term dependence on money market funding sources.

Exception reports must be promptly generated upon the creation of excesses to position limits, gap limits and customer trading and settlement limits. Excesses over any established limits should conform to overall policy guidelines and should receive prior approval by the responsible supervisory officers. If prior approval is not possible, evidence of subsequent officer concurrence or disagreement as well as any corrective action should be available for audit review and management records.

REVALUATION AND ACCOUNTING SYSTEMS

Revaluation and accounting systems should be in place to accurately determine actual as well as estimated future profits and losses and to present them in such a manner as to facilitate proper income analysis by management, bank supervisory personnel and the public. As previously described, a bank's revaluation procedure should be test-checked at the time of monthly revaluation using independently obtained rates. While methods and systems may vary to some degree within banks, all revaluation systems should incorporate the following two aspects:

- Actual realized profit or loss as determined by applying current spot rates to balance sheet accounts as well as contracts of near maturities. Adjustments to the local currency book values would either be allocated and posted to each of the applicable local currency ledger accounts or, for short interim periods, be charged to a separate foreign exchange adjustment account with an offset to the profit and loss account.
- Unrealized (estimated future) profit or loss on future transactions as determined by applying the appropriate forward rates to the net positions shown for each future period appearing in the bank's gap or maturity reports. The account ‘‘estimated profit (loss) on foreign exchange—futures’’ is to be charged for the amount of the adjustment with an offset to the profit and loss account. Provided that the amount of that adjustment is the difference between the existing forward rates and the actual contract rates, each month's entries merely involve reversing the adjustment from the prior revaluation and entering the new figures.

SPECIALIZED TRANSACTIONS

Financial Swaps

A financial swap is the combination of a spot purchase or sale against a forward sale or purchase of one currency in exchange for another. It is merely trading one currency (lending) for another currency (borrowing) for that period of time between which the spot exchange is made and the forward contract matures. The swap is the simple identification of one transaction contracted at the spot rate with another transaction contracted at the forward rate to establish the exchange cost or profit related to the temporary movement of funds into another currency and back again. That exchange (swap) profit or cost must then be applied to the rate of interest earned on the loan or investment for which the exchange was used. For example, the true yield of an investment for 90 days in United Kingdom Treasury bills cannot be determined without having considered the cost or profit resulting from the swap needed to make pounds sterling available for that investment. Likewise, the trading profits or losses generated by the trader cannot be determined if financial swap profits and expenses are charged to the exchange function rather than being allocated to the department whose loans or investments the swap actually funded.

Arbitrage

As it pertains to money markets and foreign exchange, arbitrage may take several forms. The creation of an open position in a currency in anticipation of a favorable future movement in the exchange rate, in addition to being speculative, is sometimes referred to as "arbitrage in time." Buying a currency in one market and simultaneously selling it for a profit in another market is called "arbitrage in space." Slightly more involved is the practice of interest arbitrage which involves the movement of funds from one currency to another so they may be invested at a higher yield. The real yield advantage in such a situation is not determined merely by the difference in interest rates between the two investment choices, but rather by subtracting the cost of transferring funds into the desired currency and back again (the swap cost) from the interest differential. For example, there is no arbitrage incentive involved in swapping from dollars into the other currency at a 60 point per month discount (swap cost) which exactly offsets the 3 percent gain in interest. However, should the swap rate move to 40 points per month (or 480 points per year), the investment might become attractive. This can be tested by converting the swap rate to an annual percentage rate:

$$\frac{\text{Discount or Premium} \times 360 \times 100}{\text{Spot rate} \times \text{No. of days of future contract}} = \%\ \text{P.A.}$$

$$\frac{.0040 \times 360 \times 100}{2.4000 \times 30} = 2\%\ \text{P.A.}$$

This results in a true yield incentive of 1 percent, 3 percent less the swap cost of 2 percent.

Unless the bank's accounting system can identify swap costs or profits and allocate them to the investments for which they were entered, both the earnings on those investments and the earnings upon which the trader's performance are measured will be misstated.

Options

Option contracts permit a bank to contract to buy from or sell to a customer when that customer can only generally predict the dates when the currency will be required. The option contract specifies the dates, and the rate cited is that which, in the judgment of the trader at the time of making the contract, contains the least exposure for the bank. This type of contract is commonly requested by commercial customers who wish to cover drafts drawn under letters of credit denominated in a foreign currency. Such contracts involve more risk as there is no way for the bank to acquire a precisely matching cover.

Compensated Contracts

There are occasions when both parties are agreeable to altering the terms of an existing contract. Such alterations should be approved by a bank officer without responsibilities in the trading room and the operations personnel must be advised of each compromise to avoid settlement in accordance with the original instructions and terms.

OTHER RELATED MATTERS

Departmental Organization and Control

It is imperative that there be a distinct separation of duties and responsibilities between the trading and the accounting and confirmation functions within the department. Many opportunities exist to avoid established limits and policies or for personal financial gain, whether by speculating beyond loosely controlled limits, concealing contracts because of poor confirmation procedures or by simple fraud. Periodic audits and examinations are no substitute for the existence of sound safeguards.

Supervision of Branches and Subsidiaries

Whether a bank maintains central control over all foreign-exchange and money market activities at the head office or elects to decentralize that control, the policies, systems, internal controls, and reporting procedures should not differ among separate offices within the bank.

The bank should be apprised of its worldwide positions by daily summary reports. Detailed net position and maturity gap reports should be received periodically in order to prepare consolidated positions, as required, and to monitor individual unit trading volume and funding methods. Information provided in the Treasury Department monthly foreign-currency reports is adequate for the preparation of reports of examination and can be adapted easily to reporting for currencies other than those specified in the reporting instructions.

FEDERAL FINANCIAL INSTITUTIONS EXAMINATION COUNCIL UNIFORM GUIDELINES

The ''Uniform Guideline on Internal Control for Foreign Exchange in Commercial Banks,'' as adopted by the three federal bank regulatory agencies, established minimum standards for documentation, accounting, and auditing for foreign exchange. Most of these standards have already been incorporated into the Foreign Exchange Internal Control Questionnaire in this section.

(*Source: Excerpts from ''Foreign Exchange Markets in the United States'' by Roger M. Kubarych of the Federal Reserve Bank of New York have been incorporated into this section.*)

1. To determine if the policies, practices, procedures and internal controls regarding foreign exchange activities are adequate.
2. To determine if bank officers, traders and clerks are operating within the established guidelines.
3. To determine the extent of risk attributable to net open positions, maturity gaps and counterparty credit weakness.
4. To determine the scope and adequacy of the audit function.
5. To determine if the revaluation and accounting systems are adequate and accurately reflect the results of the trading operation.
6. To determine compliance with laws and regulations.
7. To initiate corrective action when policies, practices, procedures or internal controls are deficient, or when violations of laws or regulations have been noted.

1. If selected for implementation, complete or update the foreign exchange section of the Internal Control Questionnaire.
2. Based on the evaluation of internal controls and the work performed by internal and external auditors, determine the scope of the examination.
3. Test for compliance with policies, practices, procedures and internal controls in conjunction with the remaining examination procedures. Also obtain a listing of any deficiencies noted in the latest review done by internal/external auditors, and determine if appropriate corrections have been made.
4. Obtain a trial balance, including local currency book values, of customer spot and future contract liabilities by customer and by maturities and:
   a. Agree or reconcile balances to appropriate subsidiary controls and to the general ledger.
   b. Review reconciling items for reasonableness.
5. Review foreign currency and appropriate local currency subsidiary control ledgers to determine that for each local currency entry there is an accompanying foreign currency entry unless they represent:
   a. Brokerage charges to the local currency ledger.
   b. Profit and loss adjustments to the local currency ledger.
   c. Correction of errors in either ledger.
6. Provide liability and other information on common borrowers to the examiner assigned to "International—Loans and Current Account Advances."
7. Identify those contracts with counterparties who are affiliates of or otherwise relatead to the bank, its directors, officers, employees, or major shareholders, and
   a. Compare the contracted rates with available rates for the same transaction date or with other similar contracts entered as of the same transaction date.
   b. Investigate any instances involving off-market rates.
8. Perform an independent revaluation of at least one major currency using rates obtained from independent sources, and compare results to the accounting department's monthly foreign exchange profit and loss entries.
9. Check the most recent revaluation workpapers and resultant accounting entries to determine that:
   a. Foreign currency amounts and book values were properly reconciled to subsidiary ledger controls.
   b. Rates used are representative of market rates as of revaluation date.
   c. Arithmetic is correct.
   d. Profit and loss results are separately recorded and reported to management for:
      - Realized profit or loss, i.e., that which is determined through the application of spot rates.
      - Unrealized (estimated future) profit and loss, i.e., that which is determined through the application of forward rates.
   e. Financial swap related assets, liabilities and future contracts are excluded from the normal revaluation process so that the results identified in step 9d reflect more accurately the trader's outright dealing performance.
   f. Financial swap related costs and profits are:
      - Amortized over the life of the applicable swap.
      - Appropriately accounted for as interest income and expense on loans, securities, etc. Test financial swap income and expense calculations and verify the accounting entries.
10. Review workpapers for selected revaluations performed since last examination. Test-check and, if satisfied that they are accurate,
    a. Analyze combined realized earnings to determine that profits are commensurate with risks taken.
    b. Analyze monthly unrealized revaluation results (forecasts) to determine that:
       - The resulting amount for the last revaluation, if loss, is not large.
       - An increasing loss trend over previous revaluations does not exist. (Although month-to-month variations are not uncommon, an increasing unrealized loss trend could indicate that a trader is

caught in a loss position and is pursuing a notion that a negative trend in the exchange rate for that currency will reverse and, if combined with an ever multiplying increase in volume, might eventually be able to repay accumulated losses.)

11. Obtain the percentage of total contracts outstanding (dollar value of purchases plus sales that are with corporate customers). Analyze this percentage in regard to trend and comparison, if possible, to banks with similar trading volume. Ascertain if corporate volume is commensurate with written policy in regards to purpose and scope of the foreign exchange trading function.
12. Determine compliance with laws and regulations pertaining to foreign exchange activities by performing the following for Foreign Currency Forms FC–1, FC–1a, FC–2, and FC–2a:
    a. Obtain the most recently prepared monthly and weekly reports and review for accuracy.
    b. Select random bank-prepared daily net position reports for Wednesdays and month-end business days and test to see that:
        - Reports are being filed as required.
        - Reports are accurate.

        Be aware of instances in which net positions are generally large but reduced as of Wednesday and month-end reporting dates.
13. Discuss with appropriate officers and prepare in appropriate report format:
    a. Net position schedules.
    b. Maturity gap schedules.
    c. Frequent or sizeable excesses over any established limits.
    d. Any limits deemed excessive relative to:
        - Management's policy goals regarding the nature and volume of business intended.
        - The bank's capital structure.
        - The creditworthiness of trading counterparties.
        - Individual currencies which are subject to or are experiencing relatively sporadic rate changes.
        - Individual currencies for which limited spot and future markets exist.
        - Experience of traders.
        - The bank's foreign exchange earnings record.
    e. The absence of any limits deemed appropriate in present and foreseeable circumstances.
    f. Customers whose obligations are otherwise previously classified or intended to be criticized.
    g. Foreign exchange contracts which, for any other reason, are questionable in quality or ultimate settlement.
    h. Violations of laws and regulations.
    i. Deficiencies in internal controls.
    j. Other matters regarding the efficiency and general condition of the foreign exchange eepartment.
14. Update the workpapers with any information that will facilitate future examinations.

A review of the bank's internal controls, policies, practices and procedures regarding foreign exchange trading is essential to ensure no excessive risk or exposures exist. The bank's systems should be documented in a complete and concise manner and include, where appropriate, narrative descriptions, flowcharts, copies of forms used and other pertinent information. Items marked with an asterisk are particularly significant and require substantiation by observation or testing.

POLICIES

1. Has the board of directors, consistent with its responsibilities, adopted written policies governing:
   a. Trading limits, including:
      - Overall trading volume?
      - Overnight net position limits per currency?
      - Intra-day net position limits per currency?
      - Aggregate net position limit for all currencies combined?
      - Maturity gap limits per currency?
      - Individual customer aggregate trading limits, including spot transactions?
      - Written approval of excesses to above limits?

   b. Segregation of duties among traders, bookkeepers and confirmation personnel?
   c. Accounting and revaluation procedures?
   d. Management reporting requirements?
2. Do policies attempt to minimize:
   a. Undue pressure on traders to meet specific budgeted earnings goals?
   b. Undue pressure on traders, by account officers, to provide preferred rates to certain customers?

*3. Are traders prohibited from dealing with customers for whom trading lines have not been established?

4. Are all personnel, except perhaps the head trader, prohibited from effecting transactions via off-premises communication facilities?
5. Is approval by a non-trading officer required for all compensated transactions?
6. Do credit approval procedures exist for settlement (delivery) risk either in the form of settlement limits or other specific management controls?
7. Does a policy procedure exist to ensure that, in case of an uncertain or emergency situation, the bank's delivery will not be made before receipt of counterpart funds?
8. Do the above policies apply to all branch offices as well as majority-owned or controlled subsidiaries of the bank?
9. Does the bank have written policies covering:
   a. Foreign exchange transactions with its own employees?
   b. Foreign exchange transactions with members of its board of directors?
   c. Its traders' personal foreign exchange activities?
   d. Its employees' personal business relationships with foreign exchange and money brokers with whom the bank trades?

*10. Are the above policies understood and uniformly interpreted by all traders as well as accounting and auditing personnel?

TRADING FUNCTION

11. Is a trader's position sheet maintained for each currency traded?

*12. Does management receive a trader's position report at the end of each trading day?

*13. Does the trader's position report reflect the same day's holdover and after-hours transactions?

14. Are trader's dealing tickets prenumbered?
    a. If so, are records and controls adequate to ascertain their proper sequential and authorized use?

    *b. Regardless of whether or not prenumbered,
      - Are dealing tickets time date stamped, as completed, or
      - Are dealing tickets otherwise identified with the number of the resultant contract to provide a proper audit trail?

ACCOUNTING AND REPORTING

*15. Is there a definite segregation of duties, responsibility and authority between the trading room and the accounting and reporting functions within the division and/or branch?

16. Are contract forms prenumbered (if so, are records and controls adequate to ensure their proper sequential and authorized use)?

17. Are contracts signed by personnel other than the traders?

*18. Are after-hours or holdover contracts posted as of the dates contracted?

*19. Do accounting personnel prepare a daily position report, for each applicable currency, from the bank's general ledger and:
   a. Do reports include all accounts denominated in foreign currency?
   b. Are those reports reconciled daily to the trader's position reports?
   c. Are identified or unreconciled differences reported immediately to management and to the head trader?
   d. Are all counterparty non-deliveries on expected settlements reported immediately to management and to the head trader?

*20. Are maturity gap reports prepared for liquidity and foreign exchange managers at least biweekly to include:
   a. Loans and deposits reflected in the appropriate forward maturity periods along with foreign exchange contracts?
   b. Loans, deposits and foreign exchange contracts (specify whether reflected in the maturity periods in which they fall due or in which they are scheduled for rollover ___________)?
   c. Commitments to accept or place deposits reflected in the appropriate maturity periods by both value and maturity dates?
   d. All those items (specify whether as of the day on which they mature or bi-weekly or monthly maturity periods ___________)?
   e. All those items as of the day on which they mature, if necessary, i.e., in the event of a severe liquidity situation?

*21. Does the accounting system render excesses of all limits identified at step 1 immediately to appropriate management and is officer approval required?

*22. Are local currency equivalent subsidiary records for foreign exchange contracts balanced daily to the appropriate general ledger account(s)?

*23. Are foreign exchange record copy and customer liability ledger trial balances prepared and reconciled monthly to subsidiary control accounts by employees who do not process or record foreign exchange transactions?

24. Do the accounting and filing systems provide for easy identification of ''financial swap'' related assets, liabilities and future contracts by stamping contracts or maintaining a control register?

CONFIRMATIONS

25. Is there a designated ''confirmation clerk'' within the accounting section of the division or branch?
   *a. Incoming confirmations:
      • Are incoming confirmations delivered directly to the confirmation clerk and not to trading personnel?
      • Are signatures on incoming confirmations verified with signature cards for:
         — Authenticity?
         — Compliance with advised signatory authorizations of the counterparty?
      • Are all data on each incoming confirmation verified with file copies of contracts to include:
         — Name?
         — Currency denomination and amount?
         — Rate?
         — Transaction date?
         — Preparation date if different from transaction date?
         — Maturity date?
         — Delivery instructions, if applicable?
      • Are discrepancies directed to an officer apart from the trading function for resolution?
      • Is a confirmation discrepancy log or other record maintained to reflect the identity and disposition of each discrepancy?

- Are telex tapes retained for at least 90 days as ready reference to rates and delivery instructions?

*b. Outgoing confirmations:
- Are outgoing confirmations mailed/telexed on the day during which each trade is effected?
- Are outgoing confirmations addressed to the attention of persons other than trading personnel at counterparty locations?
- Does the accounting and/or filing system adequately segregate and/or identify booked contracts for which no incoming confirmations have been received?
- Are follow-up confirmations sent by the confirmation clerk if no corresponding, incoming confirmation is received within a limited number of days after the contract is effected (if so, specify ___________)?
- Is involvement by the auditing department required if no confirmation is received within a limited number of days after the transmittal of the second request referred to above (if so, specify ___________)?
- Are confirmation forms sent in duplicate to customers who do not normally confirm?
- Are return copies required to be signed?

REVALUATIONS

*26. Are revaluations of foreign currency accounts performed at least monthly?

a. Does the revaluation system provide for segregation of and separate accounting for:
- Realized profits and losses, i.e., those which are determined through the application of spot rates?
- Unrealized profits and losses, i.e., those which are determined through the application of forward rates?

b. Are financial swap related assets, liabilities and future contracts excluded from the revaluation process so that the results identified in step 26a above more accurately reflect the trader's outright dealing performance?

c. Are financial swap costs and profits:
- Amortized over the life of the applicable swap?
- Appropriately accounted for as interest income and expense on loans, securities, etc?

d. Are rates provided by, or at least verified with, sources other than the traders?

OTHER

*27. Is the bank's system capable of adequately disclosing sudden increases in trading volume by any one trader?

28. Do such increases require officer review to insure that the trader is not doubling volume in an attempt to regain losses in his or her positions?

29. Does the bank retain information on, and authorizations for, all overdraft charges and brokerage bills within the last 12 months?

30. Does an appropriate officer review a comparison of brokerage charges, monthly, to determine if an inordinate share of the bank's business is directed to or handled by one broker?

CONCLUSION

31. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.

32. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

International—Purchases, Sales, Trading, Swaps, Rentals, and Options of LDC Assets

Effective date September 1992

Section 7110.1

The prospects for full LDC debt repayment decreased during the mid-1980s because of depressed commodity prices and inflated interest rates. The market value of public and private sector LDC loans fell sharply below book value to the point where those loans became deeply discounted. A secondary market for trading LDC debt evolved and reached a degree of maturity in 1987 when banks significantly increased their loan loss reserves for their exposures to LDCs. Financial institutions in the United States and overseas, including commercial, merchant and investment banks, began to actively purchase, sell, swap and rent debt obligations of less developed countries for their own account and as intermediaries for others. U.S. multinational banks with significant LDC loan exposures established LDC trading units which initially had the primary responsibility to decrease the banks' LDC portfolios. As the secondary market matured, these units not only traded for their own accounts but became market makers and/or active participants in purchasing, selling, swapping and renting LDC debt. An options market based on LDC debt also is emerging.

The LDC debt market, once dismissed as illiquid, has evolved from a trickle of activity between 1985 through 1988, to a turnover of approximately $100 billion during 1990. This momentum is expected to continue as participants in this market have realized the potential for generating substantial profits in trading LDC debt. The majority of this paper is Latin American, followed by Eastern European and African obligations. Debt of approximately 30 countries in 300 instruments may be handled by an active participant.

The LDC trading arena includes a broad range of counterparties. Although multinational banks with significant LDC debt exposures are the most active participants in the market, the number of intermediaries and principals has grown substantially. International financial institutions, corporations, high net worth individuals and public sector entities are primarily engaged in buying, selling and renting LDC debt for their own account.

The price of LDC paper, which is almost always at a discount from face amount, may vary widely, depending on the issuer and maturity of the instrument and the country of risk. Prices (and liquidity) in the LDC debt market are influenced by a multitude of factors such as the ability/intent of public and private sector borrowers to service the debt, availability of debt-equity exchange programs, anticipated refinancing of existing debt programs and the underlying political and economic conditions in the developing countries.

Banks generally participate in this market to decrease their LDC exposures; however, some banks are also motivated to:

- Generate trading profits from the spread between the bid and offer prices
- Produce fee and commission revenues from acting as intermediaries for principals and brokers
- Participate in swap programs to facilitate debt/equity market development

Pricing, liquidity, potential conflicts of interest, violation of U.S. and foreign country laws and operational inefficiencies are the major problems faced by banks which are active market participants. The lack of liquidity in the secondary market for LDC paper could present a variety of risks to market participants. In the absence of depth in the market, the judgement of the trader is a significant factor in determining the current price of thinly traded issues. The reliance on one individual to determine prices and using those amounts to revalue the position, could result in under or overstating the profit and loss and the valuation of the position itself. A conflict of interest could result in potential future liability if there is no clear segregation of duties and responsibilities between a bank's trading in LDC assets and its role on debt renegotiation committees.

Access to LDC debt rescheduling information could give a bank unfair advantage over other creditor banks, which do not participate in the restructuring process. Another concern is the potential for a bank or its employees to knowingly or inadvertently violate U.S. or foreign country laws or aid or abet violations by its customers or trading partners. It is clear that banks have a responsibility to determine that they deal only with reputable counterparties. The relative newness of the market and the absence of industry guidelines pose challenges to both bank managements and the bank supervisory agencies.

International—Purchases, Sales, Trading, Swaps, Rentals, and Options of LDC Assets
Examination Objectives
Effective date September 1992

Section 7110.2

The objectives of conducting an examination of LDC asset purchases, sales, trading, swaps, rentals and options should include the following:

1. To determine if LDC asset purchases, sales, trading, swaps, rental and options policies, procedures and internal controls are adequate.
2. To evaluate the ability of the bank's reporting system to adequately monitor compliance to established policies, procedures and limits.
3. To review the bank's reporting system to determine whether it is adequate and effective.
4. To ascertain, to the extent possible, whether LDC trading activities are in compliance with applicable U.S. and local foreign laws.
5. To determine the extent of involvement by committees responsible for LDC trading activity in strategy and planning. For example, have contingency plans been developed if the need arises to liquidate a portfolio of LDC paper.
6. To identify potential conflicts of interest liability between those on committees for debt renegotiations or those acting as agents for the debtor country and those on the portfolio sales personnel and LDC debt traders.
7. To determine whether accounting procedures that have been established properly identify and account for loan sales, purchases, swaps, rentals and other LDC trading activity. Compare these accounting procedures to industry practices.
8. To ascertain that outstandings and traders' positions are reconciled to the official records of the bank.
9. To evaluate the LDC asset purchases, sales, trading, swaps or rentals for profitability.
10. To review the revaluation process utilized in determining profitability.
11. To determine the adequacy of the bank's risk management as it relates to LDC activities. Evaluate the bank's ability to monitor and control the following risks:
    a. Market risk
    b. Credit risk
    c. Settlement risk
    d. Liquidity risk
    e. Operational risk
    f. Legal risk
12. To review and assess the adequacy of the audit coverage with respect to the frequency and scope of the audit program, experience of auditors, quality of audit reports and effectiveness of management follow-up. Determine the extent of the outside accountants involvement in reviewing these activities.
13. To determine if sufficient legal documentation exists to establish an enforceable agreement, and to ascertain the nature of and purpose behind the underlying transaction.
14. To review the bank's procedures for conducting due diligence on nonbank parties.
15. To determine the sufficiency of the bank's transaction files.
16. To determine if the bank allows sales, borrowing or substitutions from its loan portfolio to its trading positions. If yes, how is the pricing on the loan portfolio done? Does the bank have the proper accounting and tracking procedures in place?
17. To review any unusual charges/fees and any split of fees or unusual destination of a payment.
18. To review margin lending practices and policies of banks offering financing to customers dealing in LDC debt.
19. To review bank's policies and procedures regarding traders' ability to trade in LDC debt for their own personal account to ensure that adequate controls are in place to avoid conflicts of interest and diversion of bank's corporate opportunities to traders' personal benefit.

International—Purchases, Sales, Trading, Swaps, Rentals, and Options of LDC Assets

Examination Procedures

Effective date September 1992

Section 7110.3

An examination of a bank's LDC asset purchases, sales, trading, swaps, rental, and options program should focus on written policies, accounting, management reporting, conflict of interest, risk management, and internal controls. In addition, the examiners should address the general nature, volume and importance of these activities.

1. Evaluate the adequacy of the bank's written policies regarding its LDC trading activity and determine whether:
   a. The objectives, strategy and philosophy adhere to those approved by the bank's board of directors.
   b. All documentation and legal requirements (both local and foreign) regarding this activity have been addressed.
   c. An approval process has been established to execute unusual or complex transactions in LDC paper that lacks liquidity or has some unusual feature.
   d. The policy stipulates the options available if the need arises to remove the asset from inventory.
2. Review the bank's accounting policy for LDC transactions.
   a. Review the accounting and reporting guidelines to assure that all aspects of this activity are captured on the books of the bank.
   b. Review the subsidiary ledgers and reconcile these with the general ledger and contingent accounts.
   c. Reconcile the traders position sheet with the general ledger accounts.
   d. Review the accounting procedures governing the bank borrowing LDC debt from its own portfolio and purchasing or borrowing from a third party.
   e. Determine if the revaluation process is conducted separately from the trading process and that the resultant gains or losses are properly recorded.
3. Determine whether the bank has addressed the ‘‘conflict of interest’’ issue sufficiently, so that trading activities are not being influenced by other areas of the bank that may be negotiating debt restructuring activities or that may have provided advice to such country on financial or economic matters. Are the same individuals participating as members of a debt renegotiating committee or acting in an agency capacity for the debtor country also involved in or communicating with those trading, swapping and renting LDC debt?
   a. Does the policy address all the roles that the bank performs? Has management established procedures to identify the responsibility of renegotiating committee members, agency personnel, portfolio sales personnel and LDC debt traders?
4. Review the bank's procedures to ensure that it is complying with local and sovereign laws.
   a. Is the bank aware of local and foreign laws governing the trading of a particular country's debt? Are there records demonstrating that legal personnel are reviewing transactions to determine compliance with U.S. and foreign laws? To what extent is this information disseminated to traders?
   b. Is the bank assuring itself that trading partners are not violating these laws or are using the bank to circumvent compliance with applicable laws and regulations?
5. Evaluate management's understanding of the risks associated with LDC asset purchases, sales, trading, swaps, options and rentals. Determine whether all risks have been considered and assess management's ability to monitor and control them. The following risks should be considered:
   a. *Market Risk*—The relevant risk interval for counterparty exposure is the time period from trade date to final settlement date. The exposure is a function of the change in the price during the risk interval. Determine how the bank monitors and controls its exposure to an increase in price, if it is buying, and decrease in price, if selling.
   b. *Credit Risk*—Does the bank require credit approval from appropriate lending officers for each counterparty? Review counterparty credit lines for proper approval.

Review margin lending practices as related to LDC debt sales.

c. *Settlement Risk*—While it occurs only when purchasing LDC assets, examiners should determine how the bank protects itself from this risk.

d. *Liquidity Risk*—Have restrictions been placed on dealing in LDC debt which is not actively traded?

e. *Operating Risk*—Review the bank's policies and procedures for deficiencies. Assure that all operating groups supporting this activity are adhering to established guidelines.

f. *Legal Risk*—Has counsel reviewed all segments of this activity from a legal perspective?

6. Determine whether the bank's LDC trading activities are subject to regular audits.
   a. Obtain copies of all recent audits and review their findings;
   b. Determine whether the audit procedures covering these activities are sufficiently comprehensive; and
   c. Determine whether management has taken appropriate action to resolve significant audit concerns.
7. Evaluate the bank's internal control policies and procedures with emphasis on:
   a. Are traders' lines and LDC debt limits established by country, type of paper and customer?
   b. Are limits established by credit officers who are independent of the LDC trading function?
   c. Determine that exceptions to established limits have been properly reported and approved.
8. Evaluate the policies and procedures governing traders' behavior:
   a. What type of controls are in place with regard to after hour trading?
   b. Describe the bank's procedures for recording phone conversations. Are traders permitted to override the recording devices? How long are these recordings retained?
   c. Describe the bank's policy regarding traders' remuneration.
   d. What types of procedures and policies have the bank implemented to address self-dealing in LDC debt by traders?
   e. In what manner are the traders educated about the bank's policies and procedures?
9. Describe the type of LDC transactions entered into by the bank:
   a. Does the bank engage in fronting (i.e., sales of participations, etc.) transactions? When engaging in fronting transactions, does the bank conduct the proper legal analysis regarding whether such transaction would violate any U.S. or foreign laws or restructuring agreements? Does the bank inquire as to the customer's purpose for acquiring LDC debt in fronting transactions?
   b. Does the bank engage in parking transactions through a third party or another banking unit? Does the bank permit other financial institutions to park debt with it?
10. Evaluate the private banking unit/group's involvement in LDC transactions:
    a. How are the private banking clients obtained?
    b. What types of LDC transactions does the bank enter into for its private banking clients? Does the bank inquire as to purpose of transactions entered into for private banking clients?
    c. What type of scrutiny is performed to assure that the bank "knows its private banking clients?"
11. Describe the types of fees which the bank pays when engaging in LDC transactions:
    a. What are the amounts of broker fees? Are these fees easily determinable? Are these fees in line with the industry practices?
    b. Does the bank have any other type of fee arrangements (i.e., specially negotiated fees, partnerships, etc.)?
    c. Has the bank diversified its use of brokers adequately?
12. Evaluate broker involvement in the LDC trading activity and review the fee structure on transactions.

FIRST-DAY LETTER

Please provide the following information regarding your bank's LDC asset sales, purchases, swaps, options, and rental programs as of (*examination date*).

1. A complete inventory, broken down by country, of all LDC paper held in the trading account and the investment account.
2. A listing of all sales/purchases of LDC paper that identifies the assets or commitments sold/bought and inventory by (a) obligor, (b) face amount, (c) maturity, (d) price, (e) closing date, (f) counterparty names, and (g) the names and address of the assignor and assignee.

   Sales from the bank's own portfolio should be reported separately from transactions of the LDC trading unit.
3. Listing of all rentals of and options held on LDC paper.
4. A copy of the bank's specific policies and procedures for LDC asset purchases, sales, swaps, options and rentals.
5. A copy of all rules of conduct, procedures and policies governing LDC activities.
6. An organizational chart and the names and titles of individuals designated as responsible for LDC trading activities.
7. A listing and brief description of all management information reports covering these activities and copies of these reports.
8. Describe accounting policies and operating procedures if the LDC trading unit borrows from the bank's loan portfolio to effect delivery or borrows/lends LDC debt from/to third parties.
9. Information broken down by trading location/profit center showing the volume of LDC assets purchased, sold, swapped and rented during the two prior years, the current year to date and a projection of the volume of activity for the balance of this year and next year.
10. A listing of all limits, including the bank's overall inventory limit, country limits, type of paper limit, customer settlement limit and trader limits. Indicate the policy regarding the review dates of limits. A list of any exception reports to these limits and management's responses to exceptions.
11. A listing of principal counterparties and approved counterparty lines.
12. A list of brokers used and indicate the approximate percentage of total business conducted with each and the fees paid to such brokers.
13. Copies of any standard documents used by the bank in its LDC asset sales, purchases, swaps and rentals.
14. A copy of trading policies. If the bank is a market maker, list the type of LDC debt in which it makes a market.
15. A listing of all general ledger contingency and memoranda accounts, income and expense accounts to record LDC asset sales, swaps and renting transactions.
16. Income and expenses of LDC trading activities for the two prior years and year-to-date.
17. Copies of the most recent audit reports conducted by both the internal and external auditors, including management responses on the bank's LDC asset trading activities.
18. A copy of the internal and external audit programs and procedures used for the audits of these activities.
19. If conducted outside of the United States, any information submitted to local regulatory authorities regarding the LDC trading function should be requested.
20. Copies of any legal opinions rendered on specific transactions and a list of any pending litigations.
21. A copy of the industry association's rules and regulations.

Statutes and Regulations Administered by the Federal Reserve

Effective date May 2000

Section 8000.1

Following is a table of statutes and regulations that apply to the Federal Reserve System and to banking institutions that the Federal Reserve Board supervises and regulates. The table consists of five columns:

Statute. The name of the law as enacted by Congress and the section.

U.S. Code citation. The section of the United States Code where the statute can be found.

Description. A summary of the particular section of the statute.

FRB regulation. The implementing regulation, usually the Federal Reserve regulation, and the appropriate citation from the Code of Federal Regulations (CFR).

FRRS locator number. The location of the statute, regulation, or other reference in the *Federal Reserve Regulatory Service* (FRRS).

Statute	*U.S. Code Citation*	*Description*	*FRB Regulation*	*FRRS Locator Number*
Federal Election Campaign Act	2 USC 441b	Limits political contributions by member banks.		
Foreign Gifts and Decorations Act	5 USC 7342	Restricts Board members' and employees' acceptance of foreign gifts and decorations.	Rules Regarding Foreign Gifts and Decorations, 12 CFR 264b	8-610 et seq.
Federal Reserve Act, sec. 10, para. 8	12 USC 1	Issuance of national currency and Federal Reserve notes under general supervision of FRB.		1-084
National Bank Act, as amended by the Banking Act of 1935	12 USC 51b-1	Impairment of the capital of national banks and state member banks.	Reg H, Membership of State Banking Institutions in the Federal Reserve System, 12 CFR 208.4	1-307 3-159
National Bank Act, as amended by the Banking Acts of 1933 and 1935	12 USC 71a	Specific criteria for director selection and qualification for national banks and state member banks.		1-292
Emergency Banking Act of 1933, sec. 4	12 USC 95	Provides the president with power to require member banks to suspend operations during an emergency period.		1-323
Trading with the Enemy Act, sec. 5	12 USC 95a	Provides the president with wartime powers over banking.		1-440 1-441

Statute	U.S. Code Citation	Description	FRB Regulation	FRRS Locator Number
Federal Reserve Act, sec. 1; Banking Act of 1933, sec. 2	12 USC 221, 221a	Definition of basic terms in Federal Reserve Act, including "bank" and "affiliate."		1-002 1-309
Federal Reserve Act, sec. 2, paras. 1, 2, 3, and 13	12 USC 222–225, 281–282	Federal Reserve Bank organization; requirement that all national banks be members.		1-004 et seq. 1-016
Federal Reserve Act, sec. 2A, para. 1	12 USC 225a	Requires Federal Reserve and the Federal Open Market Committee to— • maintain long-run growth of the monetary and credit aggregates to advance the economy's long-run potential; and • report semiannually to each house of Congress on monetary and credit aggregate ranges.	Open Market Operations of Federal Reserve Banks, 12 CFR 270	1-017 8-823 et seq.
Federal Reserve Act, sec. 10, paras. 1–7 and 10	12 USC 241–247a	Creation and organization of Board of Governors; qualifications; terms of office; vacancies; assessments on Federal Reserve Banks; construction of Federal Reserve Board building; annual report to Congress; record of FOMC actions.	Rules of Organization	1-077–1-083 1-086 8-000 et seq.
Federal Reserve Act, sec. 11	12 USC 248	Powers of the Board of Governors.		1-091 et seq.
Federal Reserve Act, sec. 11(a)(1)	12 USC 248(a)(1)	Authorizes Board to examine and require reports of Reserve Banks and member banks.	Reg H, Membership of State Banking Institutions in the Federal Reserve System, 12 CFR 208	1-092 3-150 et seq.
Federal Reserve Act, sec. 11(a)(2)	12 USC 248(a)(2)	Authorizes Board to require reports from any depository institution as necessary or desirable for monetary control purposes.	Reg D, Reserve Requirements of Depository Institutions, 12 CFR 204.3	1-092 2-159 et seq.
Federal Reserve Act, sec. 11(b)	12 USC 248(b)	Authorizes Board to permit Federal Reserve Banks to rediscount paper of other Federal Reserve Banks and to fix rates of interest for rediscounted paper.	Reg A, Extensions of Credit by Federal Reserve Banks, 12 CFR 201	1-093 2-001 et seq.

Statute	*U.S. Code Citation*	*Description*	*FRB Regulation*	*FRRS Locator Number*
Federal Reserve Act, sec. 11(c)	12 USC 248(c)	Authorizes Board to suspend reserve requirements.	Reg D, Reserve Requirements of Depository Institutions, 12 CFR 204	1-094 2-122 et seq.
Federal Reserve Act, sec. 11(d)	12 USC 248(d)	Authorizes Board to supervise and regulate the issue and retirement of Federal Reserve notes through the OCC.		1-095
Federal Reserve Act, sec. 11(m)	12 USC 248(m)	Authorizes Board to fix the percentage of individual member bank capital and surplus that may be represented by loans secured by stock or bond collateral. Limits amount of loans secured by nongovernmental stock or bond collateral to any individual to 15% of bank's capital and surplus.		1-104
Federal Reserve Act, sec. 16, para. 14	12 USC 248-1	Authorizes Board to promulgate regulations for the transfer of funds between Reserve Banks, and to act as or designate Reserve Banks to act as clearinghouses.	Reg J, Collection of Checks and Other Items by Federal Reserve Banks and Funds Transfer Through Fedwire, 12 CFR 210; fee schedules and pricing policies for Federal Reserve Banks	1-153 9-775 et seq.
Federal Reserve Act, sec. 11(e)–(*l*)	12 USC 248(e)–(*l*)	Authorizes Board to regulate the affairs of the various Reserve Banks, to delegate its responsibilities to the Reserve Banks, and to hire employees to carry out the Board's business.	Rules Regarding Delegation of Authority, 12 CFR 265	1-096 et seq. 8-102 et seq.
Federal Reserve Act, sec. 11A	12 USC 248a	Requires Federal Reserve to price various services provided by Reserve Banks to depository institutions (e.g., check-collection services, wire transfer of funds, etc.).	Fee Schedules and Pricing Policies for Federal Reserve Banks	1-105 1-105.1
Federal Reserve Act, sec. 11B	12 USC 248b	Requires annual independent audit of financial statements of Federal Reserve Board and Banks.		1-105.5
Federal Reserve Act, sec. 12, paras. 1 and 2	12 USC 261–262	Federal Advisory Council, creation and powers.		1-106 1-107

Statute	U.S. Code Citation	Description	FRB Regulation	FRRS Locator Number
Federal Reserve Act, sec. 12A	12 USC 263	Federal Open Market Committee, creation and powers. Federal Reserve Banks are required to comply with directives.	Federal Open Market Committee, 12 CFR 270–272	1-108 et seq. 8-800 et seq.
Federal Reserve Act, sec. 5, 6, paras. 1 and 2, and sec. 7	12 USC 287–290	Provisions regarding the issuance and cancellation of, and dividends on, Federal Reserve Bank stock.	Reg I, Issue and Cancellation of Capital Stock of Federal Reserve Banks, 12 CFR 209	1-045 et seq. 3-460 et seq.
Federal Reserve Act, sec. 4, paras. 6–22 and 24	12 USC 301–308	Selection, eligibility, duties, and powers of Federal Reserve Bank directors.	Reserve Bank Directors—Actions and Responsibilities, 12 CFR 264a	1-026–1-044 8-168 et seq.
Federal Reserve Act, sec. 4, para. 8	12 USC 301	Suspension of any member bank from use of Federal Reserve credit facilities for undue use of bank credit for speculation or any purpose inconsistent with maintenance of sound credit conditions.	Reg A, Extensions of Credit by Federal Reserve Banks, 12 CFR 201.6(b)	1-028 2-014
Federal Reserve Reform Act of 1977	12 USC 302	Establishes standards for selection of certain Reserve Bank directors.	Reserve Bank Directors—Actions and Responsibilities, 12 CFR 264a	1-030-1-032
Federal Reserve Act, sec. 9, paras. 1–5	12 USC 321–323	Eligibility requirements for membership in the Federal Reserve System and prohibition against establishment of branch except as authorized for national banks under National Bank Act. Authorizes Board to establish rules and regulations and impose conditions regarding membership.	Reg H, Membership of State Banking Institutions in the Federal Reserve System, 12 CFR 208	1-054 et seq. 3-150 et seq.
		Provides limits for standby letters of credit and ineligible acceptances and requires disclosure of amount of such credit.	Reg H, Membership of State Banking Institutions in the Federal Reserve System, 12 CFR 208.24	3-211 et seq.

Statute	*U.S. Code Citation*	*Description*	*FRB Regulation*	*FRRS Locator Number*
Federal Reserve Act, sec. 9, para. 6	12 USC 324	Applies to state member banks provisions of National Bank Act prohibiting national bank from lending on or purchasing its own stock (as provided in 12 USC 83, Rev. Stat. 5201) and relating to the withdrawl and impairment of the capital stock or payment of dividends (12 USC 55, Rev. Stat. 5205; 12 USC 56, Rev. Stat. 5204; and USC 60, Rev. Stat. 5199). Also authorizes Board to require filing and publication of reports of condition, income, and dividends.	Reg H, Membership of State Banking Institutions in the Federal Reserve System, 12 CFR 208	1-509 3-150 et seq.
Federal Reserve Act, sec. 9, paras. 7 and 8	12 USC 325–326	Subjects member banks to examination by the Board. Also provides for acceptance of examinations conducted by state authorities.	Reg H, Membership of State Banking Institutions in the Federal Reserve System, 12 CFR 208.64	1-060 1-061 3-380
Federal Reserve Act, sec. 9, paras. 9 and 10	12 USC 327–328	Forfeiture of membership in the System. Withdrawal and cancellation of membership.	Reg H, Membership of State Banking Institutions in the Federal Reserve System, 12 CFR 208.3(f); Reg I, Issue and Cancellation of Capital Stock of Federal Reserve Banks, 12 CFR 209.3	1-062 1-063 3-158 3-463 3-464
Federal Reserve Act, sec. 9, paras. 11 and 12	12 USC 329	Capital requirements for membership including requirement that state member bank have capital at least equal to that of a national bank under 12 USC 51, Rev. Stat. 5138, and 12 USC 51b-1. Prohibition on reduction of capital stock without prior Board approval.	Reg H, Membership of State Banking Institutions in the Fed eral Reserve System, 12 CFR 208.4	1-064 1-065 3-159
Federal Reserve Act, sec. 9, para. 13	12 USC 330	Laws to which member banks are subject. Provisions regarding the discount of paper of state member bank.		1-066
Federal Reserve Act, sec. 9, para. 14	12 USC 331	Prohibits member bank certification of checks drawn on an account with insufficient funds.		1-067

Statute	*U.S. Code Citation*	*Description*	*FRB Regulation*	*FRRS Locator Number*
Federal Reserve Act, sec. 9, para. 15	12 USC 332	Provisions authorizing member banks to act as depositaries of public monies.		1-068
Federal Reserve Act, sec. 9, para. 16	12 USC 333	Membership requirements for mutual savings banks.	Reg H, Membership of State Banking Institutions in the Federal Reserve System, 12 CFR 208.3(a)	1-069 3-154
Federal Reserve Act, sec. 9, paras. 17–19	12 USC 334	Reporting requirements for affiliates of member banks and civil money penalty for failure to file.	Reg H, Membership of State Banking Institutions in the Federal Reserve System, 12 CFR 208.3(e)	1-070–1-072 3-158
Federal Reserve Act, sec. 9, para. 20	12 USC 335	Applies to state member banks the restrictions and prohibitions in National Bank Act regarding the purchase, sale, underwriting, and holding of investment securities and stock (12 USC 24, Seventh, Rev. Stat. 5136).	Reg H, Membership of State Banking Institutions in the Fed eral Reserve System, 12 CFR 208.21(b)	1-073 3-202
Federal Reserve Act, sec. 9, para. 21	12 USC 336	Prohibits stapling of stock of a state member bank to that of another corporation.		1-074
Federal Reserve Act, sec. 9, para. 22	12 USC 338	Authorizes Board to examine the affairs of affiliates of state member bank. Refusal to permit examination may cause forfeiture of membership.		1-075
Federal Reserve Act, sec. 9, para. 23	12 USC 338a	Allows state member banks to make investments designed primarily to promote the public welfare.	Reg H, Membership of State Banking Institutions in the Federal Reserve System, 12 CFR 208.22	1-075.1 3-203 et seq.
Federal Reserve Act, sec. 9A	12 USC 339	Prohibits state member banks from participating in lotteries.		1-076
Federal Reserve Act, sec. 4, paras. 4 and 5	12 USC 341	Federal Reserve Bank powers and duties.		1-024 1-025

Statute	*U.S. Code Citation*	*Description*	*FRB Regulation*	*FRRS Locator Number*
Federal Reserve Act, sec. 13, para. 1	12 USC 342	Authorizes Federal Reserve Banks to receive and collect deposits, checks, drafts, notes, and bills. Also allows member and nonmember banks or other depository institutions to assess reasonable charges, to be determined and regulated by the Board, for collection of checks and other items and transfer of funds.	Reg J, Collection of Checks and Other Items by Federal Reserve Banks and Funds Transfers Through Fedwire, 12 CFR 210	1-111 9-775 et seq.
Federal Reserve Act, sec. 13, paras. 2–6, 8, 10, 12–14; and sec. 13A, paras. 1–5	12 USC 343–352	Federal Reserve Bank discount and rediscount authority; authorizes Reserve Banks to lend to depository institutions that pledge acceptable collateral and to make advances to member banks, depository institutions, branches and agencies of foreign banks, individuals, partnerships, and corporations. Also authorizes Reserve Banks to discount agricultural paper.	Reg A, Extensions of Credit by Federal Reserve Banks, 12 CFR 201	1-112–1-116 1-118 1-120 1-122–1-123.1 1-124–1-128 2-001 et seq.
Federal Reserve Act, sec. 14(g)	12 USC 348a	Authorizes Board to exercise supervision over all relationships and transactions between Reserve Banks and foreign banks and bankers.	Reg N, Relations with Foreign Banks and Bankers, 12 CFR 214	7-079.1 7-070 et seq.
Federal Reserve Act, sec. 13A	12 USC 348–352	Various provisions regarding authority of Federal Reserve Banks to discount and extend credit on agricultural paper.	Reg A, Extensions of Credit by Federal Reserve Banks, 12 CFR 201	1-124–1-128 2-001 et seq.
Federal Reserve Act, sec. 14 (a)–(f)	12 USC 353–359	Authorizes open market operations: Federal Reserve Banks may purchase and sell instruments eligible for use as collateral for discount window transactions. Sets terms and conditions for open market operations. Also authorizes the Secretary of the Treasury to borrow and sell, repurchase, and return U.S. obligations from Reserve Banks in order to meet short-term obligations of the Treasury Department.	Federal Open Market Committee Rules, 12 CFR 270–272, 281	1-129–1-135 8-805 et seq.

Statute	U.S. Code Citation	Description	FRB Regulation	FRRS Locator Number
Federal Reserve Act, sec. 16, para. 13	12 USC 360	Reserve Banks must receive checks and drafts at par. Pricing of services for clearing negotiable instruments.	Reg J, Collection of Checks and Other Items by Federal Reserve Banks and Funds Transfers Through Fedwire, 12 CFR 210	1-152 9-775 et seq.
Federal Reserve Act, sec. 19(i)	12 USC 371a	Prohibits payment of interest on demand deposits by member banks and authorizes automatic transfer of funds from savings to checking.	Reg Q, Prohibition Against Payment of Interest on Demand Deposits, 12 CFR 217	1-175 2-380 et seq.
Federal Reserve Act, sec. 19(j)	12 USC 371b	Regulates the advertising of interest on time and savings deposits.	Reg DD, Truth in Savings, 12 CFR 230.8	1-176 6-1927 et seq.
Federal Reserve Act, sec. 23	12 USC 371b-2	Requires the Board to prescribe standards to limit the risks posed by exposure of insured depository institutions to other depository institutions.	Reg F, Limitations on Interbank Liabilities, 12 CFR 206	3-040 3-001
Federal Reserve Act, sec. 23A	12 USC 371c	Restrictions on extensions of credit and other covered transactions between affiliates. The Board has rulemaking and exemptive authority.		1-201 et seq. 3-1110 et seq.
Federal Reserve Act, sec. 23B	12 USC 371c-1	Restrictions on transactions with or for the benefit of affiliates. Requires transactions to be conducted on arm's-length terms. The Board has rulemaking and exemptive authority.		1-206.1 et seq.
Federal Reserve Act, sec. 24A	12 USC 371d	Limits investment by member banks in bank premises, and limits loans to or upon the security of the stock of any corporation owning bank premises.		1-216
Federal Reserve Act, sec. 13, para. 7	12 USC 372	Provisions regulating and setting limits on the acceptance of drafts and bills by member banks and U.S. branches and agencies of foreign banks.	Reg A, Extensions of Credit by Federal Reserve Banks, 12 CFR 201	1-117 et seq. 2-001 et seq.

Statute	*U.S. Code Citation*	*Description*	*FRB Regulation*	*FRRS Locator Number*
Federal Reserve Act, sec. 19(e)	12 USC 374, 463	Member bank cannot act as agent for nonmember to obtain discount from a Reserve Bank. Also, limits the amount that a member bank can keep on deposit with a depository institution that is not authorized to have access to Federal Reserve advances under 12 USC 347b.	Reg A, Extensions of Credit by Federal Reserve Banks, 12 CFR 201	1-171 2-001 et seq.
Federal Reserve Act, sec. 19(d)	12 USC 374a	Member bank cannot act as agent for nonbank borrower in making loans on securities to investment securities dealers and brokers.		1-170
Federal Reserve Act, sec. 22(d)	12 USC 375	Provides that member banks may contract for, purchase from, or sell to any of their directors or to a firm of which a director is a member, any securities or other property, provided that the transaction is on terms not less favorable to the bank than those offered to others or when the transaction is approved by a majority of the directors who are not interested parties to the transaction. The Board may require disclosure of such transactions.		1-188 1-189
Federal Reserve Act, sec. 22(g)	12 USC 375a	Imposes lending limits and requirements for loans by member banks to their executive officers. Requires reports by executive officers for indebtedness at other banks.	Reg O, Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks, 12 CFR 215	3-1007 et seq. 3-960 et seq.
Federal Reserve Act, sec. 22(h)	12 USC 375b	Lending limits, prior board of directors' approval, and prohibition against preferential lending and overdrafts by member banks to their officers, directors, and principal shareholders and their related interests.	Reg O, Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks, 12 CFR 215	3-1011 et seq. 3-960 et seq.
Federal Reserve Act, sec. 22(e)	12 USC 376	Prohibits a member bank from paying to any director, officer, attorney, or employee a greater rate of interest on the deposits of such person than that paid to other depositors on similar deposits with such member bank.		1-190

Statute	U.S. Code Citation	Description	FRB Regulation	FRRS Locator Number
Banking Act of 1933 (Glass-Steagall Act), sec. 21(a)(1)	12 USC 378(a)(1)	Prohibits deposit taking by any person engaged in the business of issuing, underwriting, selling, or distributing securities.		1-311
Banking Act of 1933 (Glass-Steagall Act), sec. 21(a)(2)	12 USC 378(a)(2)	Prohibits any organization from engaging in the business of receiving deposits unless it is authorized to do so by law and is subject to examination.		1-311
Federal Reserve Act, sec. 15; and Act of July 16, 1943, sec. 3	12 USC 391, 392, 395	Authorizes Reserve Banks to act as fiscal agents and depositaries of the United States and other organizations.		1-138 1-139 1-280
Federal Reserve Act, sec. 16, paras.1–11	12 USC 411–421	Provides for the issuance, printing, custody, security, and destruction of Federal Reserve notes.		1-140 et seq.
Federal Reserve Act, sec. 16, para. 7	12 USC 417	Provides for custody and safekeeping of notes issued to and collateral deposited with reserve agent.		1-146
Federal Reserve Act, sec. 18	12 USC 441–448	Provides for the issuance, circulation, and redemption of certain bonds and notes of the United States.		1-158 et seq.
Federal Reserve Act, sec. 19(a)–(c), (f)–(h)	12 USC 461, 464–466	Authorizes Board to establish reserve requirements for all depository institutions, to define terms, and to require reporting with respect to the maintenance of reserves.	Reg D, Reserve Requirements for Depository Institutions, 12 CFR 204	1-167–1-169 1-172–1-174 2-122 et seq.
Federal Reserve Act, sec. 19(e)	12 USC 463	Limits deposits by member banks with a depository institution without access to Federal Reserve advances.		1-171
Federal Reserve Act, sec. 16, paras. 15–17	12 USC 467	Receipt of gold certificates and SDRs for credit with Federal Reserve System.		1-154 et seq.
Federal Reserve Act, sec. 21, para. 5	12 USC 483	Authorizes Federal Reserve Banks, with the approval of the Board, to provide for special examination of member banks.	Reg H, Membership of State Banking Institutions in the Federal Reserve System, 12 CFR 208.64	1-183 3-380

Statute	*U.S. Code Citation*	*Description*	*FRB Regulation*	*FRRS Locator Number*
Federal Reserve Act, sec. 21, para. 6	12 USC 484	Limits visitorial powers other than as authorized by law.		1-184
Federal Reserve Act, sec. 21, para. 7	12 USC 485	Provisions relating to the examination of Federal Reserve Banks.		1-185
Federal Reserve Act, sec. 21, para. 9	12 USC 486	Permits Board to waive requirements that affiliates of state member banks either submit reports to state member banks or submit to examination.	Reg H, Membership of State Banking Institutions in the Federal Reserve System, 12 CFR 208.3(e)(2)	1-187 3-158
Revised Statutes sec. 5208	12 USC 501	Prohibits any officer, director, agent, or employee of a Federal Reserve Bank or a member bank from certifying a check drawn on the Federal Reserve Bank or member bank if the drawee has insufficient funds on deposit with the Federal Reserve Bank or member bank to cover the face amount of such check.		1-293
Federal Reserve Act, sec. 2, paras. 6 and 7	12 USC 501a	Provides that penalty for violation of Federal Reserve Act by national bank is forfeiture of charter in a suit brought by the Comptroller at the direction of Board.		1-009 1-010
Federal Reserve Act, sec. 2, para. 4	12 USC 502	Liability of shareholders of Federal Reserve Bank for obligations of the Reserve Bank.		1-007
Federal Reserve Act, sec. 22(f)	12 USC 503	Provides for personal liability of directors and officers of a member bank for a knowing violation of 12 USC 375, 375a, 375b, 376 (Federal Reserve Act, sections 22(d), (e), (g), and (h)) or regulations of the Board made under authority thereof and various provisions of title 18 (Criminal Code).		1-191
Federal Reserve Act, sec. 29	12 USC 504	Civil money penalty provision for violation by member bank of sections 22 and 23A of the Federal Reserve Act.	Rules of Practice for Hearings, 12 CFR 263, section 263.1(e) and subpart C	1-262 et seq. 8-044 8-086.3 et seq.

Statute	*U.S. Code Citation*	*Description*	*FRB Regulation*	*FRRS Locator Number*
Federal Reserve Act, sec. 19(*l*)(1)	12 USC 505	Civil money penalty provisions for violation by member bank of section 19 of the Federal Reserve Act.	Rules of Practice for Hearings, 12 CFR 263, section 263.1(e)(2) and subpart C	1-177 8-044 8-086.3 et seq.
Federal Reserve Act, sec. 3; and sec. 10, para. 9	12 USC 521–522	Provisions regarding Federal Reserve Bank branches and buildings.		1-018 et seq. 1-085
Federal Reserve Act, sec. 7(c)	12 USC 531	Exempts Federal Reserve Banks from federal, state, and local taxes except on real property.		1-050
Federal Reserve Act, sec. 25	12 USC 601–604a	Authorizes national banks to establish foreign branches; to invest in foreign banks; and to invest in corporations engaged in international banking. These provisions apply to state member banks through 12 USC 335 and 321 (Federal Reserve Act, sec. 9, para. 20 and para. 3).	Reg K, International Banking Operations, subpart A, 12 CFR 211	1-217 et seq. 3-587 et seq.
Federal Reserve Act, sec. 25A (Edge Act)	12 USC 611–631	Authorizes member banks and foreign banks to establish corporations to engage in international banking and finance (Edge Act corporations); such corporations may conduct international banking operations through offices in the United States and overseas and may invest in foreign organizations. Edge corporations are subject to reserve requirements of Regulation D (12 CFR 204), limitations on interest on deposits of Regulation Q (12 CFR 217), and the Board's margin limitations.	Reg K, International Banking Operations, 12 CFR 211, subpart A	1-227 et seq. 3-587 et seq.
Federal Reserve Act, sec. 25B	12 USC 632	Governs disposition of property of a foreign state held by a Federal Reserve Bank; gives federal courts original jurisdiction over all civil suits involving Federal Reserve Banks or corporations engaged in international banking.	Reg N, Relations with Foreign Banks and Bankers, 12 CFR 214	1-252 et seq. 7-070 et seq.
Home Owners' Loan Act of 1933	12 USC 1470	Authorizes Board to regulate investment by state member banks in state housing corporations.		1-297.1 1-297.2

Statute	*U.S. Code Citation*	*Description*	*FRB Regulation*	*FRRS Locator Number*
National Housing Act of 1934, sec. 303(d)	12 USC 1718(d)	Authorizes insured banks to invest in the stock of the Federal National Mortgage Association.		1-298
National Housing Act of 1934	12 USC 1735f-5	Prohibits discrimination based on sex in the making of a federally related mortgage or loan. The combined income of spouses shall be considered in determining whether or not to extend mortgage credit.		
Federal Deposit Insurance Act, sec. 4(b)	12 USC 1814(b)	Requires state member banks that accept deposits to obtain insurance.		1-337
Federal Deposit Insurance Act, sec. 7(a)(3)	12 USC 1817(a)(3)	Requires quarterly reports of condition for insured banks to ensure safety and soundness.		1-341
Change in Bank Control Act, (Federal Deposit Insurance Act sec. 7(j))	12 USC 1817(j)	Requires prior notice to the appropriate agency for a proposed change in control of an insured bank or bank holding company. Establishes disapproval criteria and provides for civil money penalties for violations. Requires reports on loans secured by 25% or more of the stock of another insured bank.	Reg Y, Bank Holding Companies and Change in Bank Control, 12 CFR 225, subpart E	1-344 et seq. 4-051.8 et seq.
Federal Deposit Insurance Act, sec. 7(k)	12 USC 1817(k)	Reporting and public disclosure by insured banks of information concerning extensions of credit by the bank to its officers and principal shareholders and their related interests.	Reg O, Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks, 12 CFR 215, subpart B	3-1025 3-987 et seq.
Federal Deposit Insurance Act, sec. 8(b)–(n)	12 USC 1818(b)–(n)	Cease-and-desist authority over state member banks, bank holding companies, and their nonbank subsidiaries, Edge and agreement corporations, and foreign banks with state agencies or uninsured branches in the United States, and officers, directors, employees, agents, or others for violations of law or unsafe or unsound practices.	Rules of Practice for Hearings, 12 CFR 263	1-356 et seq. 8-043 et seq.

Statute	*U.S. Code Citation*	*Description*	*FRB Regulation*	*FRRS Locator Number*
Federal Deposit Insurance Act, sec. 8(e)	12 USC 1818(e)	Authorizes suspension, removal, or prohibition from participation of parties affiliated with state member banks, bank holding companies, and other institutions under the Board's jurisdiction for violations of law or unsafe or unsound practices.	Rules of Practice for Hearings, 12 CFR 263, subpart A	1-363 et seq. 8-043 et seq.
Federal Deposit Insurance Act, sec. 8(g)	12 USC 1818(g)	Authorizes suspension, removal, or prohibition from participation of parties affiliated with a state member bank who is charged with a felony.	Rules of Practice for Hearings, 12 CFR 263, subpart D	1-369 et seq. 8-086.9 et seq.
Federal Deposit Insurance Act, sec. 8(i)	12 USC 1818(i)	Provides for civil money penalty of up to $5,000 per day for violation of an order issued under 12 USC 1818(b), (c), (e), (g), or (s). Also provides for enforcement of an order.	Rules of Practice for Hearings, 12 CFR 263, subparts A and C	1-374 et seq. 8-043 et seq. 8-086.3 et seq.
Federal Deposit Insurance Act, sec. 8(r)	12 USC 1818(r)	Provides for removal of an officer, director, employee, or agent of a foreign bank for a violation of law or unsafe or unsound practice in the United States.	Rules of Practice for Hearings, 12 CFR 263, subpart A	1-383.1 et seq. 8-043 et seq.
Federal Deposit Insurance Act, sec. 10(c) and (d)	12 USC 1820(c) and (d)	Authorizes taking of testimony under oath and the issuance of subpoena in connection with bank examination.		1-385 1-385.01
Federal Deposit Insurance Act, sec. 13(f); Bank Holding Company Act of 1956, sec. 3(d)	12 USC 1823(f) and 1842(d)	Permits a bank holding company to acquire a failing bank in a state outside its principal state of banking operations.	Reg Y, Bank Holding Companies and Change in Bank Control, 12 CFR 225.13(c)	1-385.2 et seq. 4-069 4-024
Bank Merger Act of 1966	12 USC 1828(c)	Requires prior written agency approval for any insured bank merger or consolidation or the acquisition of assets by an insured bank. Establishes uniform approval standards and notice requirements.		1-386 et seq.
Federal Deposit Insurance Act, sec. 18(i)	12 USC 1828(i)	Requires prior written approval of the appropriate agencies for an insured bank to convert to an insured state bank if the bank will reduce or retire stock as part of the conversion.		1-396 1-397

Statute	*U.S. Code Citation*	*Description*	*FRB Regulation*	*FRRS Locator Number*
Federal Deposit Insurance Act, sec. 19	12 USC 1829	Prohibition against service, without FDIC approval, as director, officer, or employee of an insured bank upon conviction for crime involving dishonesty or breach of trust.		1-398.5 et seq.
Bank Secrecy Act of 1970; Currency and Foreign Transactions Reporting Act of 1978	12 USC 1829b 12 USC 1951–1959 31 USC 5311–5330	Requires insured banks and uninsured banks to maintain records on identities of account holders; requires reproductions or microfilm of checks and other instruments drawn on or presented to it, and other records for use in criminal, tax, or regulatory investigations. Requires the maintenance of appropriate types of records and the making of appropriate reports by businesses in the United States when records or reports have a high degree of usefulness in criminal, tax, or regulatory investigations or proceedings.	Financial Recordkeeping and Reporting of Currency and Foreign Transactions, 31 CFR 103 (Treasury reg)	3-1700 et seq.
Federal Deposit Insurance Act, sec. 38	12 USC 1831o	Prompt corrective action—defines the capital measures and capital levels used for determining supervisory actions.	Reg H, Membership of State Banking Institutions in the Federal Reserve System, 12 CFR 208.40	1-400.4 et seq. 3-325 3-326
Federal Deposit Insurace Act, sec. 39	12 USC 1831p-1	Safety-and-soundness standards. Requires banking agency to prescribe standards relating to banking operations, asset quality, earnings, and executive compensation.	Reg H, Membership of State Banking Institutions in the Federal Reserve System, 12 CFR 208, app. D-1	1-401 et seq. 3-1579.3
Consumer Checking Account Equity Act of 1980; Federal Reserve Act, sec. 19(i)	12 USC 1832, 371a	Authorizes depository institutions to offer NOW accounts and automatic transfers from savings to checking.		1-175
Bank Holding Company Act of 1956	12 USC 1841 et seq.	Governs acquisition of bank stock by companies and provides generally for the separation of banking and commerce by restricting the activities in which bank affiliates may engage.	Reg Y, Bank Holding Companies and Change in Bank Control, 12 CFR 225	4-001 et seq.

Statute	*U.S. Code Citation*	*Description*	*FRB Regulation*	*FRRS Locator Number*
Bank Holding Company Act of 1956, sec. 2(h)(2); International Banking Act of 1978	12 USC 1841(h)(2) 12 USC 3101 et seq.	Permits foreign banks that are subject to the International Banking Act to hold shares of a foreign nonbanking company that engages in business in the United States, provided that the U.S. activities are in the same line of business as the foreign activities of the foreign nonbank company. Exemption does not extend to securities activities or banking or financial operations.	Reg Y, Bank Holding Companies and Change in Bank Control, 12 CFR 225.22(h); Reg K, International Banking Operations, 12 CFR 211, subpart B	4-064 4-037 1-562 et seq. 3-671 3-630 et seq.
Bank Holding Company Act of 1956, sec. 3	12 USC 1842	Requires prior Board approval to become a bank holding company; to acquire more than 5% of another bank; to merge or consolidate bank holding companies. Requires notice of filing of applications to other regulators. Prohibits interstate acquisitions except in the case of failing institutions under 12 USC 1823(f) or where state law permits.	Reg Y, Bank Holding Companies and Change in Bank Control, 12 CFR 225, subpart B	4-066 et seq. 4-018 et seq.
Bank Holding Company Act of 1956, sec. 4	12 USC 1843	Generally prohibits acquisition of more than 5% of the shares of a nonbank company. Exceptions include shares of kind eligible for investment by national banks; and where Board finds the activities to be so closely related to banking as to be a proper incident thereto. The Board has delineated over 20 activities as closely related to banking.	Reg Y, Bank Holding Companies and Change in Bank Control, 12 CFR 225, subpart B	4-071 et seq. 4-018 et seq.
Bank Holding Company Act of 1956, sec. 4(a)(2)	12 USC 1843(a)(2)	Provides grandfather rights for nonbanking activities commenced before June 30, 1968.	Reg Y, Bank Holding Companies and Change in Bank Control, 12 CFR 225.22(g)	4-071 4-072 4-037
Bank Holding Company Act of 1956, sec. 4(c)(9)	12 USC 1843(c)(9)	Permits Board to grant further nonbanking exemptions to foreign banks if the exemptions are not substantially at variance with the purposes of the act and are in the public interest.	Reg Y, Bank Holding Companies and Change in Bank Control, 12 CFR 225.22(h); Reg K, International Banking Operations, 12 CFR 211, subpart B	4-078 4-037 et seq. 3-630 et seq.

Statute	*U.S. Code Citation*	*Description*	*FRB Regulation*	*FRRS Locator Number*
Bank Holding Company Act of 1956 sec. 4(c)(13)	12 USC 1843(c)(13)	Permits bank holding companies to acquire foreign companies that do no business in the United States except as an incident to their foreign business.	Reg K, International Banking Operations, 12 CFR 211.5	4-080 3-609 et seq.
Bank Holding Company Act of 1956, sec. 4(c)(14)	12 USC 1843(c)(14)	Permits bank holding companies to invest in export trading companies, i.e., companies exclusively engaged in matters relating to international trade and principally engaged in exporting.	Reg K, International Banking Operations, 12 CFR 211, subpart C	4-080.1 3-649 et seq.
General authority to consider safety and soundness		Prohibits redemption of bank holding company equity securities under certain circumstances without prior notice to Board in order to prevent unsafe or unsound reductions of capital.	Reg Y, Bank Holding Companies and Change in Bank Control, 12 CFR 225.4(b)	4-013 et seq.
Bank Holding Company Act sec. 4(k)–(o)	12 USC 1843(k)–(o)	Permits bank holding companies and foreign banks that qualify as financial holding companies to engage in securities, insurance, and other activities that are financial in nature or incidental to a financial activity and to make merchant banking investments.	Reg Y, Bank Holding Companies and Change in Bank Control, 12 CFR 225, subparts I and J	4-082.7 et seq. 4-056 et seq.
Bank Holding Company Act of 1956, sec. 5(a)–(d), (f)	12 USC 1844	Requires bank holding companies to register with Board and authorizes Board to issue regulations to carry out the purposes of the act, to require reports and conduct examinations of bank holding companies and their subsidiaries, and to take depositions and subpoena documents.	Reg Y, Bank Holding Companies and Change in Bank Control, 12 CFR 225; Rules of Practice for Hearings, 12 CFR 263	4-083–4-085 4-088 4-001 et seq. 8-043 et seq.
Bank Holding Company Act of 1956, sec. 5(e)	12 USC 1844(e)	Authorizes Board to require divestiture of nonbank subsidiaries or termination of nonbank activity if the Board determines that the subsidiary or activity constitutes a serious risk to the financial safety and soundness or stability of bank holding company.	Reg Y, Bank Holding Companies and Change in Bank Control, 12 CFR 225.4(a)	4-086 4-087 4-012
Bank Holding Company Act Amendments of 1970, sec. 106(b)	12 USC 1972	Prohibition against tie-in arrangements by banks. The Board has rulemaking and exemptive authority.	Reg Y, Bank Holding Companies and Change in Bank Control, 12 CFR 225.7	4-147 et seq. 4-017.1 4-017.2

Statute	*U.S. Code Citation*	*Description*	*FRB Regulation*	*FRRS Locator Number*
Bank Holding Company Act Amendments of 1970, sec. 106(b)(2)	12 USC 1972(2)	Prohibits preferential extensions of credit by insured banks based on correspondent account relationships.	Reg O, Loans to Executive Officers, Directors and Principal Shareholders of Member Banks, 12 CFR 215, subpart B	3-1018 et seq. 3-987 et seq.
Bank Holding Company Act Amendments of 1970, sec. 106(b)(2)(G)(i)	12 USC 1972(2)(G)(i)	Reporting and public disclosure requirements for executive officers and principal shareholders of insured banks with respect to extensions of credit from correspondent banks.	Reg O, Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks, 12 CFR 215, subpart B	3-1023 3-987 et seq.
Bank Holding Company Act Amendments of 1970, sec. 106(b)(2)(G)(ii)	12 USC 1972(2)(G)(ii)	Reporting and public disclosure requirements for insured banks regarding extensions of credit by correspondent banks to the reporting bank's officers and principal shareholders.	Reg O, Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks, 12 CFR 215, subpart B	3-1024 3-987 et seq.
Bank Service Company Act, sec. 1–7	12 USC 1861–1867	Permits insured banks to invest in a corporation that provides services for depository institutions; and, with the prior approval of the agency, in a bank service company that provides services to others that are authorized for its bank parent(s) only at locations where its bank parent(s) may perform such services.		1-324 et seq.
Bank Service Company Act, sec. 5	12 USC 1865	Requires prior Board approval for a member bank to invest in a bank service company that performs services permissible for bank holding companies under section 4(c)(8) of the BHC Act and at any geographic location other than where its parent could perform the service.		1-327.1

Statute	*U.S. Code Citation*	*Description*	*FRB Regulation*	*FRRS Locator Number*
Bank Protection Act of 1968, sec. 2–5	12 USC 1881–1884	Requires establishment of standards for installation, maintenance, and operation of bank security devices and procedures. Requires annual reports of compliance and appointment of a security officer.	Reg H, Membership of State Banking Institutions in the Federal Reserve System, 12 CFR 208.61	1-472 et seq. 3-371 et seq.
Credit Control Act	12 USC 1901–1909	Permits Board, upon authorization by the president, to regulate and control all extensions of credit, and to require reports regarding any extensions of credit. Authorizes imposition of civil money penalties on any person who violates the regulations or fails to report as required. (Expired June 30, 1982.)		1-535 et seq.
Real Estate Settlement Procedures Act	12 USC 2601–2617	Requires disclosure of all costs associated with purchases of real estate and prohibits payments of kickbacks and unearned fees in any transaction concerning a federally related mortgage.	Real Estate Settlement Procedures, 24 CFR 3500 (HUD reg)	6-1350 et seq. 6-1370 et seq.
Home Mortgage Disclosure Act	12 USC 2801–2811	Requires reports and public disclosure of the number and amount of mortgage loans made by depository institutions within a geographic area by census tract.	Reg C, Home Mortgage Disclosure, 12 CFR 203	6-228 et seq. 6-200 et seq.
Community Reinvestment Act	12 USC 2901–2905	Requires federal financial supervisory agencies to examine depository institutions to determine whether such institutions are meeting the credit needs of their communities; and requires such agencies to consider the records of such institutions in meeting community credit needs in acting on applications by such institutions for additional deposit facilities.	Reg BB, Community Reinvestment, 12 CFR 228	6-1247 et seq. 6-1220 et seq.
International Banking Act of 1978, sec. 1	12 USC 3101	Foreign banks required to designate a home office if they do not have deposit-taking offices. The Riegle-Neal Interstate Banking Act of 1994 removed geographic restrictions on interstate banking by foreign banks.	Reg K, International Banking Operations, 12 CFR 211.22	1-562 et seq. 3-633

Statute	*U.S. Code Citation*	*Description*	*FRB Regulation*	*FRRS Locator Number*
International Banking Act of 1978, sec. 5	12 USC 3103	Restricts the U.S. expansion of a foreign bank's deposit-taking capabilities across state lines; provides for establishment of limited branches that accept only those deposits permissible for an Edge corporation; and imposes prohibition contained in section 3(d) of the Bank Holding Company Act on acquisition of bank assets or shares outside the foreign bank's home state.	Reg K, International Banking Operations, 12 CFR 211, subpart B	1-565 et seq. 3-630 et seq.
International Banking Act of 1978, sec. 7(a)	12 USC 3105(a)	Subjects U.S. branches and agencies of foreign banks to reserve requirements and prohibition against payment of interest on demand deposits.	Reg D, Reserve Requirements of Depository Institutions, 12 CFR 204; Reg Q, Prohibition Against Payment of Interest on Demand Deposits, 12 CFR 217	1-567 2-122 et seq. 2-380 et seq.
International Banking Act of 1978, sec. 7(c); Federal Reserve Act, sec. 13, para. 14	12 USC 3105(c) 12 USC 347d	Gives Board authority to examine each U.S. branch, agency, or commercial lending company of a foreign bank. Requires each branch or agency to submit quarterly Reports of Condition. Subjects branches and agencies to prohibitions on underwriting and dealing in securities.		1-569 1-123.1
International Banking Act of 1978, sec. 8	12 USC 3106	Subjects foreign bank with a U.S. branch, agency, commercial lending company, or subsidiary bank to the Bank Holding Company Act; grandfathers certain activities and investments of foreign banks; prohibits tie-in arrangements under section 106(b) of the Bank Holding Company Act Amendments of 1970 (12 USC 1972).	Reg K, International Banking Operations, 12 CFR 211, subpart B	1-571 et seq. 3-630 et seq.
		Foreign banks permitted to establish U.S. representative offices without filing a formal application.	Reg K, International Banking Operations, 12 CFR 211.24	3-648.1

Statute	*U.S. Code Citation*	*Description*	*FRB Regulation*	*FRRS Locator Number*
		Criteria for "well-managed."	Reg K, International Banking Operations, 12 CFR 211.5	3-609 et seq.
		Criteria for evaluating the U.S. operations of foreign banks that the Board determines are not subject to comprehensive consolidated supervision or regulation.	Reg K, International Banking Operations, 12 CFR 211.30	3-648.7 et seq.
International Banking Act of 1978, sec. 9(b)	12 USC 3106a	Prohibits discrimination by U.S. offices of foreign banks and requires disapproval of applications by such foreign banks if banks do not agree to comply with antidiscrimination laws.		1-573.1
Depository Institutions Management Interlocks Act	12 USC 3201–3208	Prohibits management official interlocks between two depository organizations if they are not affiliated and are either very large or located in the same local area.	Reg L, Management Official Interlocks, 12 CFR 212	3-801 et seq. 3-775 et seq.
Federal Financial Institutions Examination Council Act	12 USC 3301–3308	Establishes a council to prescribe uniform principles, standards, and report forms for examination of financial institutions and to promote uniformity in other supervisory matters.	12 CFR 1101 (FFIEC reg)	
Right to Financial Privacy Act	12 USC 3401–3422	Establishes standards under which a federal government agency may obtain, and a financial institution may provide, information contained in financial records of a customer of the financial institution. Provides for cost reimbursement to institution for furnishing records of customers.	Reg S, Reimbursement to Financial Institutions for Assembling or Providing Financial Records, 12 CFR 219	6-1750 et seq. 3-1200 et seq.
Garn–St Germain Depository Institutions Act of 1982, sec. 204	12 USC 3503	Establishes a deposit account directly equivalent to a money market mutual fund and exempts such account from transaction account reserves, section 19(b) of the Federal Reserve Act (12 USC 461).	Reg D, Reserve Requirements of Depository Institutions, 12 CFR 204.2(d)(2)	2-138.1
Truth in Savings Act	12 USC 4301 et seq.	Requires clear and uniform disclosures about deposit accounts.	Reg DD, Truth in Savings, 12 CFR 230	6-1900 et seq.

Statute	*U.S. Code Citation*	*Description*	*FRB Regulation*	*FRRS Locator Number*
Federal Deposit Insurance Corporation Improvement Act, sec. 401–407	12 USC 4401–4407	Validates netting contracts among financial institutions and expands definition of "financial institution."	Payments System Risk Policy; Reg EE, Netting Eligibility for Financial Institutions, 12 CFR 231	9-1500 et seq. 9-1000 et seq. 9-1475 et seq.
Clayton Antitrust Act, sec. 7 and 8	15 USC 18, 19	Prohibits mergers, acquisitions, and similar transactions between banks that substantially lessens competition. Prohibits certain interlocking bank directorates.		1-404 et seq.
Robinson-Patman Anti-Discrimination Act, sec. 11	15 USC 21	Authorizes Board to take enforcement action against banks for discrimination in price, services, and facilities.		1-407 et seq.
Federal Trade Commission Act, sec. 18(f)	15 USC 57a(f)	Authorizes Board to adopt rules prohibiting unfair or deceptive acts or practices by banks and to take regulatory action to prohibit those acts or practices on its own motion and to mirror comparable rules adopted by Federal Trade Commission.	Reg AA, Unfair or Deceptive Acts or Practices, 12 CFR 227	6-1203 6-1204 6-1200 et seq.
Securities Exchange Act of 1934, sec. 17A	15 USC 78q-1	Provides for the registration of state member banks acting as transfer agents and municipal securities dealers; establishes procedure for registration and withdrawal of transfer agents and municipal securities dealers and sets forth enforcement authority over clearing agents, transfer agents, and municipal securities dealers.	Reg H, Membership of State Banking Institutions in the Federal Reserve System, 12 CFR 208, subpart C	5-173 et seq. 3-250 et seq.
Securities Exchange Act of 1934	15 USC 78b, 78c, 78i, 78j, 78*l*, 78p, 78r, 78t, 78u, 78w, 78x, 78aa, 78bb, 78dd, 78ff	Regulates transactions in bank securities to prevent unfair or manipulative practices, requires reports by publicly held banks, including securities registration statements, proxy statements, and periodic financial statements and reports by officers and directors regarding their shareholdings.	Reg H, Membership of State Banking Institutions in the Federal Reserve System, 12 CFR 208.36	5-001 et seq. 3-285 et seq.

Statute	*U.S. Code Citation*	*Description*	*FRB Regulation*	*FRRS Locator Number*
Securities Exchange Act of 1934, sec. 7 and 8	15 USC 78g, 78h	Authorizes Board to regulate amount of credit that may be extended to finance securities transactions; makes it unlawful for brokers, dealers, members of exchanges, or other persons to extend credit for the purpose of purchasing or carrying securities without complying with rules issued by the Board. Also makes it unlawful for any person to obtain an extension of credit in the United States or for a U.S. person or a foreign person controlled by or acting on behalf of a U.S. person to purchase various types of securities without complying with rules issued by the Board. Makes it unlawful for any registered broker, dealer, or member of a national securities exchange to (1) borrow on any registered security except from specified classes of banks, (2) arrange for the hypothecation of customer securities in contravention of Board rules, and (3) lend or arrange for the lending of a customer's securities in contravention of Board rules.	Reg T, Credit by Brokers and Dealers, 12 CFR 220; Reg U, Credit by Banks or Persons Other Than Brokers or Dealers for the Purpose of Purchasing or Carrying Margin Stocks, 12 CFR 221; Reg X, Borrowers of Securities Credit, 12 CFR 224	5-049 et seq. 5-392 et seq. 5-745 et seq. 5-970 et seq.
Securities Exchange Act of 1934, sec. 30A and 30B	15 USC 78dd-1, 78dd-2	Prohibits an issuer of securities registered under the Securities Exchange Act from giving anything of value to a foreign official to influence any act or decision of said official. Banking agencies have determined that such actions are considered unsafe and unsound practices.		5-248 et seq.
Public Utility Holding Company Act	15 USC 79q	Prohibits director and officer interlocks between a public utility holding company and a bank without SEC approval.		
Investment Company Act of 1940, sec. 10(c)	15 USC 80a-10	Prohibits a registered investment company from having a majority of its board of directors consist of officers, directors, or employees of any one bank.		5-262
Small Business Act, sec. 6	15 USC 635(a)	Authorizes Federal Reserve Banks to act as fiscal agents for the Small Business Administration.		1-277

Statute	U.S. Code Citation	Description	FRB Regulation	FRRS Locator Number
Small Business Investment Act, sec. 302	15 USC 682	Authorizes member banks to invest in Small Business Investment Companies up to 5% of bank's capital and surplus.		1-299
Truth in Lending Act	15 USC 1601–1646	Requires creditors to disclose to consumers the cost and terms of credit; gives consumers the right to cancel certain credit transactions; regulates credit card issuance and liability; prescribes certain requirements for advertising credit.	Reg Z, Truth in Lending, 12 CFR 226 (covers all creditors)	6-1030 et seq. 6-600 et seq.
Fair Credit Billing Act	15 USC 1666–1666j	Provides for fair and timely resolution of credit billing disputes; regulates certain credit card practices.	Reg Z, Truth in Lending, 12 CFR 226 (covers all creditors)	6-1109 et seq. 6-600 et seq.
Consumer Leasing Act	15 USC 1667–1667e	Requires accurate disclosure of consumer leasing terms; limits lessee liability; prescribes certain requirements for advertising consumer leases.	Reg M, Consumer Leasing, 12 CFR 213 (covers all lessors)	6-550 et seq. 6-500 et seq.
Fair Credit Reporting Act	15 USC 1681–1681t	Protects consumers against inaccurate or misleading information in credit files maintained by credit bureaus; requires these bureaus to allow credit applicants to correct erroneous reports.		6-1550 et seq.
Equal Credit Opportunity Act	15 USC 1691–1691f	Prohibits credit discrimination on the basis of race, color, religion, national origin, sex, marital status, or age or because of receipt of public assistance or exercise of rights under the consumer Credit Protection Act; requires creditors to notify applicants of action taken on the application.	Reg B, Equal Credit Opportunity, 12 CFR 202 (covers all creditors)	6-091 et seq. 6-001 et seq.
Equal Credit Opportunity Act, sec. 703(b)	15 USC 1691b	Authorizes Board to establish a Consumer Advisory Council to advise and consult with the Board on the Consumer Credit Protection Act and other consumer-related matters.	Rules of Organization and Procedure of the Consumer Advisory Council, 12 CFR 267	6-100 6-2500 et seq.
Fair Debt Collection Practices Act	15 USC 1692	Prohibits the use of abusive, deceptive, and unfair debt collection practices by third-party debt collectors.		6-1675 et seq.

Statute	*U.S. Code Citation*	*Description*	*FRB Regulation*	*FRRS Locator Number*
Electronic Fund Transfer Act	15 USC 1693–1693r	Prescribes disclosure and documentation requirements for institutions involved in electronic funds transfers; requires prompt resolution of errors on electronic transfer accounts; limits customer liability for unauthorized use of EFT card.	Reg E, Electronic Fund Transfers, 12 CFR 205	6-359 et seq. 6-300 et seq.
Emergency Loan Guarantee Act	15 USC 1841–1852	Creates the Emergency Loan Guarantee Board (composed of the secretary of the Treasury, chairman of the Federal Reserve Board, and chairman of the SEC) to guarantee loans for borrowers whose failure would adversely affect the economy. (Authority to enter into a guarantee ended 12/31/73.)		1-548 et seq.
Emergency Loan Guarantee Act, sec. 10	15 USC 1849	Authorizes Federal Reserve Banks to act as fiscal agents for the Loan Guarantee Board.		1-558
Criminal Code sec. 208	18 USC 208	Establishes standards of conduct for Reserve Bank directors in the exercise of their duties.	Reserve Bank Directors—Actions and Responsibilities, 12 CFR 264a	8-168 et seq.
Act of June 25, 1948	18 USC 212–215, 655, and 1906	Prohibits the offering of or acceptance by a bank examiner of a loan or gratuity, as well as theft or disclosure of confidential banking data by a bank examiner. Also prohibits bank officers, directors, employees, agents, or attorneys from receiving payment for procuring or attempting to procure a loan or extension of a loan for a third party.		1-451 et seq. 1-456 1-465
Bank Bribery Act	18 USC 215	Proscribes corrupt activity within financial institutions. Federal Reserve guidelines issued by the Board on October 21, 1987 (SR-87-36) inform state member banks and bank holding companies to develop codes or policies to alert bank or bank holding company officials about the bank bribery statute, as well as to establish and enforce standards relating to acceptable business practices.		1-454 3-1504

Statute	*U.S. Code Citation*	*Description*	*FRB Regulation*	*FRRS Locator Number*
Various statutes	22 USC 282d, 283d, 284d, 285d, 290g-5, 290i-5	Authorizes Reserve Banks to act as depositories and/or fiscal agents for various agencies, such as the International Finance Corporation, Inter-American Development Bank, International Development Association, Asian Development Bank, African Development Fund, and African Development Bank.		9-839 et seq.
Bretton Woods Agreements Act, sec. 4	22 USC 286b	Authorizes the chairman of the Board and others to establish the National Advisory Council on International Monetary and Financial Problems.		1-477–1-480
Bretton Woods Agreements Act, sec. 6	22 USC 286d	Authorizes Reserve Banks to act as fiscal agents or as a depository for the IMF and the International Bank for Reconstruction and Development.		9-836
Bretton Woods Agreements Act, sec. 8	22 USC 286f and Exec. Order 10033	Authorizes Board to require persons, by subpoena or otherwise, to provide information at the request of the president.		1-484 1-485
Special Drawing Rights Act of 1968	22 USC 286p	Authorizes issuance of special drawing rights to Reserve Bank.		1-290
Internal Revenue Code	26 USC 5703, 6302	Authorizes Reserve Banks to receive taxes imposed on tobacco products, any other tax under Internal Revenue laws, or state individual income taxes.		1-269
Bank Secrecy Act of 1970; Currency and Foreign Transactions Reporting Act of 1978	31 USC 5311–5322	Requires persons and financial institutions involved in the transmission of funds exceeding specified amounts to or from the United States to file reports with the secretary of the Treasury in order to further enforcement of criminal, tax, or other investigatory proceedings.	Financial Recordkeeping and Reporting of Currency and Foreign Transactions, 31 CFR 103 (Treasury reg)	3-1700 et seq. 3-1760 et seq.
Fair Housing Act	42 USC 3601–3619	Prohibits discrimination on the basis of race, color, religion, sex, or national origin in housing-related transactions; requires agencies to administer housing-related activities and programs in a way that affirmatively promotes the purposes of the act.		6-1450 et seq.

Statute	*U.S. Code Citation*	*Description*	*FRB Regulation*	*FRRS Locator Number*
Flood Disaster Protection Act; National Flood Insurance Act	42 USC 4003, 4012a, 4104a, 4106, 4128	Prohibits federally regulated lending institutions from making any loan secured by improved real estate or a mobile home located in designated flood hazard areas unless the property is covered by flood insurance. Also prohibits lending by such institutions in designated flood hazard areas without prior notice to purchasers of such property.	Reg H, Membership of State Banking Institutions in the Federal Reserve System, 12 CFR 208.25	1-331 et seq. 3-213 et seq.
Defense Production Act of 1950	50 App. USC 2091, 2152 et seq. Exec. Order 12919	Authorizes Board to establish interest rates, fees, and other charges on federally guaranteed loans for defense production under the act or executive order. Authorizes Federal Reserve Banks to act as fiscal agents for any guaranteeing agency, under the supervision of the Board.		

REFERENCE TABLE OF FEDERAL RESERVE ACT SECTIONS

U.S. Code Title 12, Section	*Federal Reserve Act, Section*	*U.S. Code Title 12, Section*	*Federal Reserve Act, Section*	*U.S. Code Title 12, Section*	*Federal Reserve Act, Section*	*U.S. Code Title 12, Section*	*Federal Reserve Act, Section*
1	10, ¶8	307	4, ¶22	359	14(f)	467	16, ¶¶15–17
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246	10, ¶6	338	9, ¶22	392	15, ¶2	604	25, ¶9
247	10, ¶7	338a	9, ¶23	393	15, ¶3	604a	25, ¶10
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248	11	341	4, ¶¶4, 5	412	16, ¶2	611a	25A, ¶13
248(o)	16, ¶14	342	13, ¶1	413	16, ¶3	612	25A, ¶2
248a	11A	343	13, ¶¶2, 3	414	16, ¶4	613	25A, ¶3
248b	11B	344	13, ¶4	415	16, ¶5	614	25A, ¶4
261	12, ¶1	345	13, ¶5	416	16, ¶6	615	25A, ¶¶5–9
262	12, ¶2	346	13, ¶6	417	16, ¶7	616	25A, ¶10
263	12A	347	13, ¶8	418	16, ¶8	617	25A, ¶11
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282	2, ¶3	347b	10B	420	16, ¶10	619	25A, ¶13
283	2, ¶9	347c	13, ¶13	421	16, ¶11	620	25A, ¶14
284	2, ¶10	347d	13, ¶14	441	18, ¶1	621	25A, ¶15
285	2, ¶11	348	13A, ¶1	442	18, ¶¶2, 3	622	25A, ¶16
286	2, ¶12	348a	14(g)	443	18, ¶4	623	25A, ¶17
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305	4, ¶20	357	14(d)	465	19(g)	632	25B
306	4, ¶21	358	14(e)	466	19(h)	633	25C

*Not codified to the Federal Reserve Act.

The information in this section is reprinted from a publication of the Bank Administration Institute (BAI), entitled "Statement of Principle and Standards for Internal Auditing in the Banking Industry."

A STATEMENT OF PRINCIPLE CONCERNING INTERNAL AUDITING IN THE BANKING INDUSTRY

Internal auditing is that management function which independently evaluates the adequacy, effectiveness and efficiency of the systems of control within an organization and the quality of ongoing operations.

The systems of control comprise the plan of organization and all methods and measures designed to:

- Provide reasonable assurance that assets are safeguarded, information (financial and other) is timely and reliable, and errors and irregularities are discovered and corrected promptly.
- Promote operational efficiency.
- Encourage compliance with managerial policies, laws, regulations, and sound fiduciary principles.

Ongoing operations comprise all activities involved in the conduct of the organization's business.

The internal auditor is accountable to the board of directors and executive management. This accountability precludes the auditor from organizational relationships that may conflict with the need for independence.

STANDARDS OF INTERNAL AUDITING IN THE BANKING INDUSTRY

Organization Standards

1. The organization shall have an internal audit function responsible for evaluating the adequacy, effectiveness and efficiency of its systems of control and the quality of ongoing operations.
2. The organization shall maintain an environment within which the auditor has the freedom to act.
3. The organization shall allocate sufficient resources to the audit function to enable it to conform to the standards of internal auditing.
4. The organization shall require management to respond formally to adverse audit findings and to take appropriate corrective action.
5. The organization's systems of control shall include measurement of audit effectiveness and efficiency.

Personal Standards

1. An internal auditor shall have adequate technical training and proficiency.
2. An internal auditor shall maintain a sufficiently independent state of mind to clearly demonstrate objectivity in matters affecting audit conclusions.
3. An internal auditor shall respect the confidentiality of information acquired while performing the audit function.
4. An internal auditor shall only engage in activities that do not conflict with the interests of the organization.
5. An internal auditor shall adhere to conduct that enhances the professional stature of internal auditing.
6. An internal auditor shall exercise due professional care in the performance of all duties and in the fulfillment of all responsibilities.

Performance Standards

1. The internal auditor shall prepare a formal audit plan that covers all significant organizational activities over an appropriate cycle of time.
2. The audit plan shall include an evaluation of controls within new systems and significant modifications to existing systems before they become operational.
3. Audit procedures shall provide sufficient and competent evidential matter to support conclusions regarding the adequacy, effectiveness and efficiency of the systems of control and the quality of ongoing operations.
4. The organization of the audit function and

related administrative practice shall provide for the proper supervision of persons performing audits and for the proper review of work performed.

Communication Standards

1. The auditor shall prepare a formal report on the scope and results of each audit performed.
2. Each audit report shall contain an opinion on the adequacy, effectiveness and efficiency of the systems of control and the quality of ongoing operations; the degree of compliance with previously evaluated systems of control; or an explanation of why an opinion cannot be expressed. When an adverse opinion is expressed, the report shall contain a statement about the exposures that may exist in the absence of corrective action.
3. The auditor shall communicate audit findings in a timely manner to the managers responsible for corrective action.
4. At least once each year the auditor shall make a summary report of audit activities to the board of directors and executive management. The report shall include an opinion on the overall condition of the organization's controls and operations.

COMMENTARY

The following comments are presented in order to promote the acceptance of the "Statement of Principle and Standards for Internal Auditing in the Banking Industry," to provide a context for the application of its concepts and to enhance the understanding of internal auditing. It is intended that the statement and the commentary will serve as a basis for the continuing advancement of the profession's influence and service.

Internal Auditing as a Discipline

Internal auditing is developing a broader perspective by recognizing that all operations are properly subject to control and within the scope of auditing. The internal auditor's concern for control should extend beyond accounting matters. This broader concept better serves the board of directors and executive management to whom the internal auditor is accountable. Bank Administration Institute believes the systems of control and ongoing operations, as defined herein, provide a preferred perspective for discussing internal auditing within the framework of the auditing discipline taken as a whole.

Concepts of Control

The systems of control exist to assure the achievement of intended results, to promote operating efficiency and to encourage compliance with policies and other established constraints. Although internal auditors have a definite interest in verifying the results of business activity, their primary concern must be the continuing effectiveness of the systems of control that influence business results. The important qualities that must be evaluated are adequacy, effectiveness and efficiency.

In evaluating adequacy, the auditor analyzes systems to determine that they include design features proper to the circumstances and reasonably sufficient to effect control. The evaluation of adequacy begins with the comparison of "what should be" to "what is." Initial audits and audits of proposed procedures or organization structures focus primarily on the adequacy of control.

In evaluating effectiveness, the auditor measures the degree of compliance with control features and the extent to which compliance serves the intended purposes. The question that must be answered is: "Do the controls work?"

In evaluating efficiency, the auditor judges the practicality of controls in terms of their cost relative to their intended benefit. It is not intended that the auditor should evaluate adequacy or effectiveness in absolute terms, nor is it intended that the auditor judge efficiency in absolute terms. An internal auditor's evaluation of efficiency is restricted to the controls themselves and does not extend to the measures of operating performance associated with the functioning of such controls. In judging efficiency, the internal auditor must conclude whether the benefits provided by the controls exceed their cost.

The systems of control and not the audit function:

- Provide reasonable assurance that assets are safeguarded, information (financial and other) is timely and reliable, and errors and irregularities are discovered and promptly corrected.

- Promote operational efficiency.
- Encourage adherence to managerial policies, laws, regulations and sound fiduciary principles.

Those members of management who are responsible for policy implementation are also responsible for the design and the maintenance of the systems of control. Internal auditors are responsible for that management function which independently evaluates the adequacy, effectiveness and efficiency of the systems of control. Internal auditors should make sure that those who rely on their opinions understand that no practical system can guarantee the quality of future performance.

Controls act as a positive force to facilitate successful operations as well as a negative one that restricts activities. Accordingly, the auditor should evaluate control systems in terms of the incentives they provide as well as the sanctions.

Safeguarding assets relates to physical, legal and all other protective means by which the organization assures the full realization of its resources.

All information should be subject to the systems of control. Timely information is that which anticipates a decision need and is available to the persons who will use it when they need it. Reliable information provides a sound basis for decision because of the authenticity of its source, the manner in which it is recorded and the form and content of its presentation.

The systems of control must detect and correct errors and irregularities when preventive controls fail. Sound systems of control contain safeguards that will counteract failures in other controls.

The systems of control should promote operational efficiency. The features of control systems that promote operational efficiency include the processes used to select and train personnel, establish procedures, set performance requirements, measure results and provide incentives.

Managerial policies, laws, regulations and sound fiduciary principles establish bounds within which the organization can conduct its business. The features of the control system that encourage compliance with these requirements include the separation of duties, the employment of persons likely to comply, the establishment of authority limits and the communication of expected conduct.

Ongoing Operations

Management must evaluate the quality of operations based on information provided by the control systems. Adequate control systems produce sufficient information to reliably appraise operations. To confirm that the control systems are adequate and effective, the internal auditor should independently evaluate the quality of ongoing operations. Only ongoing operations have future significance.

Internal auditors should express their opinion on whether the quality of ongoing operations is satisfactory or unsatisfactory. Satisfactory operations are those which, in the opinion of the auditor, require no extraordinary intervention by executive management or the directors. Conversely, unsatisfactory operations require extraordinary intervention before appropriate remedial action is likely to occur. A qualified opinion may be expressed by citing specific exceptions to satisfactory operations. Auditors may assess the quality of operations more precisely and report on grades of quality, provided the grades are clearly understood by management.

Circumstances may preclude the auditor from forming an opinion on the quality of ongoing operations. This, by itself, is significant because the information provided by the control systems should be adequate for the evaluation of ongoing operations.

Accountability

Accountability refers to the measures of effective audit performance. The organization standards of this statement define the conditions necessary to hold the auditor accountable for the other standards.

Only the board of directors can protect the auditor's need for independence; consequently, the board should be the final judge of the auditor's performance. The fact that the process of measurement may be done through an audit committee does not alter the auditor's ultimate accountability to the board.

Both the auditor and executive management have received a delegation of authority from the board: management to design and maintain systems of control; the auditor to evaluate these systems of control. Because the evaluation process exists to serve the design and maintenance responsibility, the auditor must also be accountable to executive management. This accountability, however, does not create the usual corollary right of the executive to directly apply sanctions or to otherwise restrict the auditor's functional independence. Such action, if necessary, must be decided by the board.

The auditor should be mindful that the audit function serves many users. The auditor has an obligation, if not accountability, to those users. The auditor's personal relationship with others should be characterized by integrity, open communication and mutual respect. User satisfaction should be an important consideration in the board's evaluation of audit performance.

Independence is a matter of personal quality rather than of rules. The auditor's relationships, as indicated by the plan of organization and by the way in which the work is conducted, must always be such that a presumption of independence logically follows in the mind of the observer.

Organization Standards

A banking organization can best evidence its support and commitment to the professional standards of internal auditing by formally adopting these standards.

The organization standards are prerequisites to the personal, performance and communication standards. The simply state that an internal auditor cannot be accountable for adherence to the other standards without the necessary resources and support of the organization.

Many banks cannot afford the services of a competent and independent internal auditor. It should be clearly understood that those banks are not in compliance with these standards. Their directors and executive management, therefore, bear the burden of providing additional supervision to assure the adequacy, effectiveness and efficiency of the systems of control and the quality of ongoing operations.

The organization shall provide and maintain an environment within which the internal auditor has the freedom to act. Persons whose duties and responsibilities are subject to audit cannot have the authority to regulate the scope of audit work nor the procedures considered necessary by the auditors. The auditor's responsibility to independently evaluate the systems of control must carry with it the authority to set the scope and choose the means of examination.

Budgeting should be based on a complete plan of audit that demonstrates fulfillment of the organization's audit needs and adherence to the standards of internal auditing. In committing resources to the internal audit function, the organization should expect the auditor to properly support requested allocations through the established budget process.

The audit process is not complete until the auditor is satisfied that audit findings have received appropriate attention. By requiring management to respond formally to audit findings, the organization contributes to the effectiveness of the audit function and increases the likelihood that the findings will receive appropriate attention.

The organization should measure the performance of its internal audit function in relation to the timeliness, efficiency and the quality of its work. Timeliness is indicated by scheduling the work in recognition of risk assessments and by the prompt issuance of reports. Efficiency is indicated by completing the work within the time budgeted. An efficient internal audit program also minimizes the time required by examiners and public accountants without affecting adequate coverage. Formal work programs, workpapers and the form and content of reports evidence the quality of an audit function. The organization should consider using the opinions formed by bank examiners, certified public accountants and other professional auditors to assist in this performance evaluation. Smaller banks may find the services offered by their correspondents include such evaluations.

Personal Standards

Personal standards relate to the qualifications of auditors, the quality of audit practice and the rules of professional conduct. They concern all persons who apply audit procedures under a delegation of authority from the board to support conclusions regarding the systems of control. Personal standards are prerequisites to performance and communication standards.

All persons engaged in the practice of internal auditing shall have the technical training and proficiency necessary to conduct their audit duties in accordance with these standards. Technical training and proficiency are separate requirements. Technical training relates to education; proficiency relates to the skill and judgment acquired through experience.

The qualified internal auditor will have successfully completed a course of study and training in disciplines having audit significance and will understand their application to banking. These disciplines include the principles of accounting, auditing, economics, finance, operations analysis, management, statistics, commercial law and computer science.

Experience is gained by working under the close supervision and review of an experienced professional. This relationship should make the job itself a vehicle for seasoning and refining the technical training acquired through formal education. On-the-job training should be carefully planned and organized. Those responsible for managing the audit function should define the elements of knowledge and judgment that may be gained from experience and establish a way to measure the resulting proficiency.

Proficiency is demonstrated by the proper exercise of professional judgment. It is difficult for users of professional services to accurately assess proficiency. Therefore, recognized professions, including internal auditing, provide certification programs for their practitioners. Each person engaged in the internal audit function can demonstrate proficiency by earning a professional designation such as chartered bank auditor, certified internal auditor or certified public accountant. The last two designations, however, require successful banking or related experience to demonstrate a practical knowledge of the industry.

The modern business environment demands that an internal auditor maintain proficiency by active participation in programs of continuing education and professional association.

There is no concept more important to internal auditing than independence. The essence of independence is intellectual honesty informing conclusions and expressing opinions. Conclusions must be reached fairly without bias or the propensity to prejudge circumstances. Opinions must be expressed forthrightly despite the conflicts that may arise. Although the appearance of independence relies on a plan of organization that grants the auditor freedom from conflicting accountabilities, the actual attainment of independence depends solely on the individual. The concept of independence is most fundamental to the definition and practice of auditing.

Independence is not isolation. Auditors should not allow their need for independence to inhibit the contacts and rapport necessary for a fully effective audit function.

Banking organizations properly require all employees to honor the confidentiality of financial and other information obtained during their employment. This requirement is all the more important for internal auditors because of the nature and scope of their work. Confidentiality also applies to the judicious use of information within the organization.

An internal auditor should not accept employment or participate in activities that compete or otherwise oppose the lawful objectives of the organization. Loyalty reflects integrity and credibility. Relationships which may, even by implication, raise doubt concerning the auditor's loyalty to the bank therefore must be avoided.

All members of a profession owe allegiance to their colleagues. The reputation of all depends to some degree on the conduct of each. Internal auditors develop professional recognition by supporting and participating in associations organized to serve their common needs. Each internal auditor is also obligated to maintain proficiency and awareness through self-education.

Due professional care imposes an ethical obligation on all auditors to demonstrate competency. Due care acts as a safeguard against negligence and oversight. Due professional care applies to the administrative practices that bear on the quality of audit results as well as to the use of audit procedures that provide sufficient competent evidence.

Due professional care is a subjective standard based on reasonableness. The duty of due professional care requires the auditor to know the extent of reliance that others within the organization place on audit results. When such reliance is unrealistic or misunderstood, the auditor should resolve the misunderstanding and temper unrealistic expectations.

The organization should require the presentation of audit findings in a manner that convinces management that the auditor exercised due professional care.

Performance Standards

The audit plan should be written and presented in a form that is suitable for critical review by audit committees, certified public accountants, regulatory examiners and others who must evaluate the adequacy of audit coverage.

An audit plan is based on a catalog of examinations that includes all significant activities of the organization classified by logical units for work scheduling. For example, demand deposit bookkeeping functions may be classified as three separate audits: overdraft control practices, confirmation of balances and bookkeeping operations.

The frequency of audit should be determined by reference to factors affecting risk, management information, customer satisfaction and the need to create an awareness of audit presence. Risk assessment involves audit judgment regarding how often and to what extent the systems of control must be evaluated.

In mature audit operations, the problem of balancing audit objectives with audit resources has usally been solved. Risk assessment in the context of audit planning does not normally change in the near range. The audit plan for each cycle does not prescribe a detailed listing of tests and procedures to be applied. These tactical steps are to be found in the work program.

The audit plan, which usually represents work contemplated for the current year, should present the information necessary to schedule and assign the work. It should cover resources requirements, administrative goals and objectives and the estimated costs of audit. Resource plans identify the number of persons needed, schedule their time (including such non-audit time as administration, vacation, lost days, staff training) and specify the level of ability. Administrative goals and objectives should reflect the audit implications of conditions that influence the organization. Audit costs should be identified in sufficient detail to encourage the audit manager to justify their cost and impact on the organization.

While cost justifying the audit plan, the auditor should recognize that the organization's cost of control includes its cost of auditing. In certain areas, efficiencies may best be achieved by strengthening the control systems as an alternative to audit coverage.

The audit plan shall include an evaluation of the adequacy of controls within new systems and significant modifications to existing systems before they become operational. This evaluation should include the controls designed into the conversion plan. Significant modifications are those that affect controls to an extent that audit concern is created regarding the organization's resulting exposure to loss.

The second performance standard concerns the timing of audit but not its scope. Identifying significant changes and establishing audit procedures is a matter of individual audit judgment. Modern complex systems are expensive to develop and maintain. Building adequate controls within the original design is usually less costly than adding them after the system is operational. The cost of evaluation, however, is usually no greater before implementation than after.

The reliability of audit results depends on the character of supporting evidence. Audit procedures should be selected and applied in a way that assures such evidence is sufficient and competent.

The term ''sufficient'' as used here means that enough evidence is assembled to assure that audit conclusions are well founded. The internal auditor's determination of what constitutes enough evidence is a matter of professional judgment relative to the controls and operations under evaluation. Frequently, sufficiency can be demonstrated by the application of statistical sampling techniques.

The term ''competent'' means relevant and valid. Competent evidence has the requisite ability to convince. Both the substance and the interrelationship of evidence demonstrate competence. Whereas sufficient is a quantitative concept, competent is a qualitative one.

Competency for audit purposes depends on the procedures used to obtain evidence. Direct knowledge, such as obtained by observation or inspection, is more reliable than indirect knowledge, such as obtained by confirmation and inquiry. Obtaining the most competent evidence, however, is not always feasible. Selecting and applying those procedures that collectively produce the most competent evidence under the circumstances demonstrates audits proficiency.

Audit work should be organized so that the objectives at each level of detail are clearly defined. Each phase of the work as well as the contribution of each person should be viewed by a superior. Audit management should review the audit programs, questionnaires and other planning features for completeness, applicability and efficiency. The reviewer should be satisfied that those who perform field work understand the systems under examination and the audit procedures that have been selected for application.

The auditor in charge of each assignment should perform a detailed review of the work as it is completed. No work should be accepted unless it complies with the standard of evidence. Audit management should conduct a comprehensive final review of the workpapers to determine that proper procedures were applied, sufficient evidence was assembled and all exceptions were properly evaluated in terms of their control significance. Audit management should also make interim field reviews.

Reviews must be documented. All auditors should appreciate the importance of the review process and perform their work in a manner that facilitates review. Review serves as an educational process as well as a control. Directors of banks employing only one auditor should supervise the auditor's work in a manner that provides a check on audit quality.

Communication Standards

The auditor has a responsibility to report the results of all audit work performed. Some auditors prefer to report only significant exceptions; however, this practice reinforces a negative view of the audit function. The auditor's responsibility to evaluate control systems and ongoing operations carries with it an obligation to report the results of that evaluation. Without a report, management does not have positive assurance that auditing is meeting its commitments. Consequently, management can only assume that adequate coverage is maintained and that the systems of control are functioning adequately, effectively and efficiently. By implication, audit reporting only on an exception basis extends the auditor's responsibility beyond what the actual work can support and causes misunderstanding.

Requiring auditors to express an opinion on the adequacy, effectiveness and efficiency of the systems of control and the quality of ongoing operations enables the board of directors, management and other interested parties to better judge the reliability of the control systems and ongoing operations. This service is a natural and logical part of the internal auditor's accountability.

Expressing an opinion imposes a serious obligation on the auditor. The requirement of due professional care extends to both the opinion and the commentary supporting it. Clear identification of the systems of control audited is the key to a meaningful opinion.

Each auditor should develop standard language for rendering an opinion. Standardization of language minimizes misunderstanding and promotes recognition of circumstances that require responsive action.

It is suggested that auditors develop their opinion statement along the following lines:

"In our opinion (the audit subject's) operating and accounting procedures include those practices usually necessary to provide adequate and efficient control. Also in our opinion, the degree of compliance with such procedures provided effective control during the (period of audit). We found the quality of ongoing operations satisfactory."

This opinion assumes the auditor has reviewed the systems of control before they became operational and is satisfied that they include design features proper to the circumstances and reasonably sufficient to effect control. The second sentence of the opinion addresses the degree of compliance with control features previously found adequate and efficient. Audits of operations that are subject to a common control system such as a typical branch bank audit need not include a review of the system each time a unit audit is performed. The auditor, however, should be satisfied that all modifications to the existing system that significantly affect control have been evaluated.

Auditors occasionally form adverse conclusions concerning the adequacy, effectiveness or efficiency of the systems of control or the quality of ongoing operations. In these cases, they should qualify their opinion and identify exposures that may exist in the absence of corrective action. Risk measures the degree to which exposures are uncontrolled. The applicable equation is: Exposure minus control equals risk. A calculated risk is taken only when the exposure is fully identified and the implications of the lack of control are understood. To make an adverse opinion clear and meaningful, therefore, the auditor must identify relevant exposures and explain their significance.

Every audit report should identify the area audited and disclose all matters the auditor believes require responsive action by the recipient. Auditors should clearly distinguish between those matters to which they take exception and those that are reported for other reasons. The degree of detail reported is largely a matter of judgment, influenced greatly by the preferences of management. Some managements prefer to have all audit findings reported no matter how minor. Others prefer only a general description of significant findings. Auditors must bear in mind that their ultimate accountability demands that findings of major significance be brought to the attention of executive management and the board of directors.

The standards do not require the auditor to recommend corrective action. In practice, however, auditors find that many managements expect suggestions for corrective action, particularly when the technincal aspects of controls are involved. By suggesting corrective action, the auditor demonstrates a positive approach to the organization's problems. In making suggestions, auditors should recognize that their recommendations may not be the only means of achieving the control purpose intended. The focus of concern should be the control purpose and not the particular means selected from a range of acceptable choices.

A draft of each audit report should be made available to the manager of those operations under examination. Findings should be discussed with the manager before final issuance of the report. Any revisions should be similarly reviewed. The final report must clearly present audit findings and avoid language that may imply a meaning inconsistent with the supporting evidence. A review and a discussion of the draft assure this result.

Auditors must establish the facts of their findings but do not have to obtain complete management acceptance of their comments before issuing a report. Auditors should be prepared for occasional conflict and disagreement.

The ease with which auditors can retrieve information, support fact and amplify findings validates the adequacy and the quality of audit evidence. The extent to which auditors gain acceptance of their comments ultimately measures the effectiveness of internal auditing's contribution to the organization.

The timeliness with which audit findings are reported is very important and often critical for effective response. When timeliness is critical, the auditor should communicate findings promptly and not await the preparation of a formal report. Findings should be communicated to the manager whose operation is directly affected.

The extent and frequency of audit reports required by the board of directors varies with the organization. At least annually, however, the auditor shall formally report to the board of directors and executive management. The board of directors and executive management are entitled to a report that measures audit performance against plan and provides information normally required to establish accountability. The auditor should use this opportunity to promote an understanding of the audit function and how it serves the organization.

In the summary report, the auditor should express an opinion on the overall condition of the organization's controls and ongoing operations. The report should present all known control problems of significance as well as an evaluation of corrective action taken. Although the report is formal, it should be presented personally to ensure proper interpretation and to provide the benefit that flows from the exchange of information and concerns.

Fraud and the Auditor's Responsibility

The auditor is charged with understanding the purposes of the business, the control practices usually necessary to achieve them, and the type of evidence that indicates they will continue to be achieved. The following questions are prerequisite to evaluating the systems of control: What is the purpose of the system? How is it controlled? What can go wrong?

Audit proficiency includes the ability to evaluate fraud exposures. Sufficient information is available in the literature on auditing concerning how frauds may be committed in banking. The auditor should be familiar with that literature.

The systems of control and not the internal audit function provide the primary assurance against fraud. Internal auditors, however, must evaluate the capability of the systems to achieve that end. When in doubt, the auditor should consider applying additional procedures to determine if fraud has actually occurred.

In fixing the internal auditor's responsibility for detecting fraud, it should be recognized that the internal auditor cannot be responsible for detecting irregular transactions for which there is no record, e.g., an unrecorded receipt of cash from a source for which there is no evidence of accountability; an isolated transaction that does not recur, e.g., a single fraudulent loan; or irregularities that are well concealed by collusion. However, in the usual course of the audit cycle, the internal auditor should detect irregularities that significantly affect the financial statements, repeatedly follow a suspicious pattern of concurrence, or those that can be detected by a reasonable audit sampling. Internal auditors must also accept responsibility for those irregularities that result from their failure to report known weaknesses in the systems of control.

In judging the preventive capacity of the control systems and the internal auditor's responsibility, the principle of relative risk should not be ignored, namely, costs must be balanced against intended benefit.

CONCLUSION

Professional internal auditors can contribute a wealth of information to their organizations over and above the assurance they provide by evaluating the quality of control systems and ongoing operations. The word, "audit," comes from the Latin word, *audire*, meaning to hear. Internal auditors should be good listeners and observers. They should demonstrate an in-depth understanding of the strengths and weaknesses of the organization, the accomplishments and current problems of its departments, the quality of its services, the pride and concerns of its people and the efficiencies and diseconomies of its operations. In turn, executives and directors should listen to professional internal auditors and capitalize on their observations.

The material in this section has been incorporated into the *Bank Secrecy Act Examination Manual*.

OVERVIEW

Since 1979, state member banks have been rated using the interagency Uniform Financial Institutions Ratings System (UFIRS), which was recommended by the Federal Reserve and other banking agencies. This rating system, referred to industry-wide by the acronym CAMEL, evaluated five components: capital adequacy, asset quality, management and administration, earnings, and liquidity.

Over the years, the UFIRS has proven to be an effective internal supervisory tool for uniformly evaluating the soundness of financial institutions and for identifying those institutions requiring special attention or concern. Recently, the UFIRS was revised and updated to address changes in the financial services industry and in supervisory policies and procedures. The revisions include the addition of a sixth component addressing sensitivity to market risks, explicit reference to the quality of risk-management processes in the management component, and identification of risk elements within the composite and component rating descriptions.

The revisions to UFIRS are not intended to add to the regulatory burden of institutions nor require additional policies or processes. Instead, they are intended to promote and complement efficient examination processes. The revisions have been made to update the rating system, while retaining the basic framework of the original system.

The UFIRS considers certain financial, managerial, and compliance factors that are common to all institutions. Under this system, the supervisory agencies endeavor to ensure that all financial institutions are evaluated comprehensively and uniformly and that supervisory attention is appropriately focused on the financial institutions exhibiting financial and operational weaknesses or adverse trends.

The UFIRS is a useful vehicle for identifying problem or deteriorating financial institutions, as well as for categorizing institutions with deficiencies in particular component areas. Further, the rating system helps Congress follow safety-and-soundness trends and assess the aggregate strength and soundness of the financial industry, which helps the federal banking agencies in fulfilling their collective mission of maintaining stability and public confidence in the nation’s financial system.

COMPOSITE RATINGS

Under the UFIRS, each financial institution is assigned a composite rating based on an evaluation and rating of six essential components of its financial condition and operations. These component factors address the adequacy of capital, quality of assets, capability of management, quality and level of earnings, adequacy of liquidity, and sensitivity to market risk. Evaluations of the components take into consideration the institution’s size and sophistication, the nature and complexity of its activities, and its risk profile.

Composite and component ratings are assigned based on a 1-to-5 numerical scale. A “1” is the highest rating, indicating the strongest performance and risk-management practices and the least degree of supervisory concern. A “5” is the lowest rating, indicating the weakest performance, inadequate risk-management practices, and the highest degree of supervisory concern.

The composite rating generally bears a close relationship to the component ratings assigned. However, the composite rating is not derived by computing an arithmetic average of the component ratings. Each component rating is based on a qualitative analysis of the factors that make up that component and its interrelationship with the other components. When assigning a composite rating, some components may be given more weight than others depending on the situation at the institution. In general, assignment of a composite rating may incorporate any factor that bears significantly on the overall condition and soundness of the financial institution. Assigned composite and component ratings are disclosed to the institution’s board of directors and senior management.

The ability of management to respond to changing circumstances and address the risks that may arise from changing business conditions or the initiation of new activities or products is an important factor in evaluating a financial institution’s overall risk profile, as well as the level of supervisory attention warranted. For this reason, the management component is given special consideration when assigning a composite rating.

Futhermore, the ability of management to identify, measure, monitor, and control the risks of its operations is taken into account when assigning each component rating. Examiners should recognize, however, that appropriate management practices vary considerably among financial institutions, depending on their size, complexity, and risk profile. For less complex institutions engaged solely in traditional banking activities and whose directors and senior managers, in their respective roles, are actively involved in the oversight and management of day-to-day operations, relatively basic management systems and controls may be adequate. At more complex institutions, detailed and formal management systems and controls are needed to address their broader range of financial activities and to provide senior managers and directors, in their respective roles, with the information they need to monitor and direct day-to-day activities. All institutions are expected to properly manage their risks. For less complex institutions engaging in less sophisticated risk-taking activities, detailed or highly formalized management systems and controls are not required to receive strong or satisfactory component or composite ratings.

Examiners consider foreign branch and specialty examination findings and the ratings assigned to those areas, as appropriate, when assigning component and composite ratings under UFIRS. The specialty examination areas include Compliance, Community Reinvestment, Government Security Dealers, Information Systems, Municipal Security Dealers, Transfer Agent, and Trust.

Composite ratings are based on a careful evaluation of an institution's managerial, operational, financial, and compliance performance. The six key components used to assess an institution's financial condition and operations are capital adequacy, asset quality, management capability, earnings quantity and quality, the adequacy of liquidity, and sensitivity to market risk. The rating scale ranges from 1 to 5, with a rating of 1 indicating the strongest performance and risk-management practices, relative to the institution's size, complexity, and risk profile, and the level of least supervisory concern. A rating of 5 indicates the most critically deficient level of performance; inadequate risk-management practices relative to the institution's size, complexity, and risk profile; and the level of greatest supervisory concern. The composite ratings are defined below.

Composite 1

Financial institutions with a composite 1 rating are sound in every respect and generally have components rated 1 or 2. Any identified weaknesses are minor and can be handled routinely by the board of directors and management. These financial institutions are the most capable of withstanding fluctuating business conditions and are resistant to outside influences, such as economic instability in their trade area. These institutions are in substantial compliance with laws and regulations. As a result, they exhibit the strongest performance and risk-management practices relative to their size, complexity, and risk profile, and give no cause for supervisory concern.

Composite 2

Financial institutions with a composite 2 rating are fundamentally sound. For a financial institution to receive this rating, generally none of its component ratings should be more severe than 3. Only moderate weaknesses are present, and the board of directors and management are capable of and willing to correct them. These financial institutions are stable, can withstand business fluctuations, and are in substantial compliance with laws and regulations. Overall risk-management practices are satisfactory relative to the institution's size, complexity, and risk profile. There are no material supervisory concerns and, as a result, the supervisory response is informal and limited.

Composite 3

Financial institutions with a composite 3 rating exhibit some degree of supervisory concern in one or more of the component areas. These institutions have a combination of moderate to severe weaknesses; however, the magnitude of the deficiencies generally will not cause a component to be rated more severely than 4. Management may lack the ability or willingness to effectively address weaknesses within appropriate timeframes. Financial institutions in this group generally are less capable of withstanding business fluctuations and are more vulnerable to outside influences than those institutions rated a composite 1 or 2. Additionally, these financial institutions may be in significant noncompliance with laws and regulations. Risk-management practices may be less than satisfactory relative to the institution's size, complexity, and risk profile. These financial institutions require more than normal supervision, which may include formal or informal enforcement actions. Failure of the institution appears unlikely, however, given its overall strength and financial capacity.

Composite 4

Financial institutions with a composite 4 rating generally exhibit unsafe and unsound practices or conditions. They have serious financial or managerial deficiencies that result in unsatisfactory performance. The institution's problems range from severe to critically deficient, and weaknesses and problems are not being satisfactorily addressed or resolved by the board of directors and management. Financial institutions in this group generally are not capable of withstanding business fluctuations. There may be significant noncompliance with laws and regulations. Risk-management practices are generally unacceptable relative to the institution's size, complexity, and risk profile. Close supervisory attention is required, which means formal enforcement action is necessary in most cases to address the problems. Institutions in this group pose a risk to the deposit insurance fund. Failure of the institution is a distinct possibility if the problems and weaknesses are not satisfactorily addressed and resolved.

Composite 5

Financial institutions with a composite 5 rating exhibit extremely unsafe and unsound practices or conditions. Their performance is critically deficient and risk-management practices are inadequate relative to the institution's size, complexity, and risk profile. These institutions are of the greatest supervisory concern. The volume and severity of problems are beyond management's ability or willingness to control or correct. Immediate outside financial or other assistance is needed for the financial institution to be viable. Ongoing supervisory attention is necessary. Institutions in this group pose a significant risk to the deposit insurance fund and their failure is highly probable.

COMPONENT RATINGS

Each of the component rating descriptions below lists the principal evaluation factors that relate to that component and briefly describes each numerical rating for that component. Some of the evaluation factors appear under one or more of the other components to illustrate the interrelationship among the components. The evaluation factors for each component are not listed in any particular order.

Capital Adequacy

A financial institution is expected to maintain capital commensurate with its risks and the ability of management to identify, measure, monitor, and control these risks. The effect of credit, market, and other risks on the institution's financial condition should be considered when evaluating the adequacy of capital. The types and quantity of risk inherent in an institution's activities will determine the need to maintain capital at levels above required regulatory minimums to properly reflect the potentially adverse consequences of these risks on the institution's capital.

The capital adequacy of an institution is rated based on, but not limited to, an assessment of the following evaluation factors:

- the level and quality of capital and the overall financial condition of the institution
- the ability of management to address emerging needs for additional capital
- the nature, trend, and volume of problem assets, and the adequacy of allowances for loan and lease losses and other valuation reserves
- balance-sheet composition, including the nature and amount of intangible assets, market risk, concentration risk, and risks associated with nontraditional activities

- risk exposure represented by off-balance-sheet activities
- the quality and strength of earnings, and the reasonableness of dividends
- prospects and plans for growth, as well as past experience in managing growth
- access to capital markets and other sources of capital, including support provided by a parent holding company

Ratings

1—A rating of 1 indicates a strong capital level relative to the institution's risk profile.

2—A rating of 2 indicates a satisfactory capital level relative to the institution's risk profile.

3—A rating of 3 indicates a less than satisfactory level of capital that does not fully support the institution's risk profile. The rating indicates a need for improvement, even if the institution's capital level exceeds minimum regulatory and statutory requirements.

4—A rating of 4 indicates a deficient level of capital. In light of the institution's risk profile, viability of the institution may be threatened. Assistance from shareholders or other external sources of financial support may be required.

5—A rating of 5 indicates a critically deficient level of capital. The institution's viability is threatened, and immediate assistance from shareholders or other external sources of financial support is required.

Asset Quality

The asset-quality rating reflects the quantity of existing and potential credit risk associated with the loan and investment portfolios, other real estate owned, other assets, and off-balance-sheet transactions. The ability of management to identify, measure, monitor, and control credit risk is also reflected here. The evaluation of asset quality should consider the adequacy of the allowance for loan and lease losses and weigh the institution's exposure to counterparty, issuer, or borrower default under actual or implied contractual agreements. All other risks that may affect the value or marketability of an institution's assets, including but not limited to operating, market, reputation, strategic, or compliance risks, should be considered.

The asset quality of a financial institution is rated based on, but not limited to, an assessment of the following evaluation factors:

- the adequacy of underwriting standards, soundness of credit-administration practices, and appropriateness of risk-identification practices
- the level, distribution, severity, and trend of problem, classified, nonaccrual, restructured, delinquent, and nonperforming assets for both on- and off-balance-sheet transactions
- the adequacy of the allowance for loan and lease losses and other asset valuation reserves
- the credit risk arising from or reduced by off-balance-sheet transactions, such as unfunded commitments, credit derivatives, commercial and standby letters of credit, and lines of credit
- the diversification and quality of the loan and investment portfolios
- the extent of securities underwriting activities and exposure to counterparties in trading activities
- the existence of asset concentrations
- the adequacy of loan and investment policies, procedures, and practices
- the ability of management to properly administer its assets, including the timely identification and collection of problem assets
- the adequacy of internal controls and management information systems
- the volume and nature of credit-documentation exceptions

Ratings

1—A rating of 1 indicates strong asset-quality and credit-administration practices. Identified weaknesses are minor and risk exposure is modest in relation to capital protection and management's abilities. Asset quality is of minimal supervisory concern.

2—A rating of 2 indicates satisfactory asset-quality and credit-administration practices. The level and severity of classifications and other weaknesses warrant a limited level of supervisory attention. Risk exposure is commensurate with capital protection and management's abilities.

3—A rating of 3 is assigned when asset-quality or credit-administration practices are less than satisfactory. Trends may be stable or indicate deterioration in asset quality or an increase in risk exposure. The level and severity of classified assets, other weaknesses, and risks require an elevated level of supervisory concern. There is generally a need to improve credit-administration and risk-management practices.

4—A rating of 4 is assigned to financial institutions with deficient asset-quality or credit-administration practices. The levels of risk and problem assets are significant and inadequately controlled, and they subject the financial institution to potential losses that, if left unchecked, may threaten its viability.

5—A rating of 5 represents critically deficient asset-quality or credit-administration practices that present an imminent threat to the institution's viability.

Management

The capability of the board of directors and management, in their respective roles, to identify, measure, monitor, and control the risks of an institution's activities, and to ensure a financial institution's safe, sound, and efficient operation in compliance with applicable laws and regulations is reflected in this rating. Generally, directors need not be actively involved in day-to-day operations; however, they must provide clear guidance regarding acceptable risk-exposure levels and ensure that appropriate policies, procedures, and practices have been established. Senior management is responsible for developing and implementing policies, procedures, and practices that translate the board's goals, objectives, and risk limits into prudent operating standards.

Depending on the nature and scope of an institution's activities, management practices may need to address some or all of the following risks: credit, market, operating or transaction, reputation, strategic, compliance, legal, liquidity, and other risks. Sound management practices are demonstrated by active oversight by the board of directors and management; competent personnel; adequate policies, processes, and controls taking into consideration the size and sophistication of the institution; maintenance of an appropriate audit program and internal control environment; and effective risk-monitoring and management information systems. This rating should reflect the board's and management's ability in relation to all aspects of banking operations as well as other financial-service activities the institution is involved in.

The capability and performance of management and the board of directors is rated based on, but not limited to, an assessment of the following evaluation factors:

- the level and quality of oversight and support of all institution activities by the board of directors and management
- the ability of the board of directors and management, in their respective roles, to plan for and respond to risks that may arise from changing business conditions or the initiation of new activities or products
- the adequacy of and conformance with appropriate internal policies and controls addressing the operations and risks of significant activities
- the accuracy, timeliness, and effectiveness of management information and risk-monitoring systems appropriate for the institution's size, complexity, and risk profile
- the adequacy of audits and internal controls to promote effective operations and reliable financial and regulatory reporting; safeguard assets; and ensure compliance with laws, regulations, and internal policies
- compliance with laws and regulations
- responsiveness to recommendations from auditors and supervisory authorities
- management depth and succession
- the extent that the board of directors and management are affected by or susceptible to dominant influence or concentration of authority
- reasonableness of compensation policies and avoidance of self-dealing
- demonstrated willingness to serve the legitimate banking needs of the community
- the overall performance of the institution and its risk profile

Ratings

1—A rating of 1 indicates strong performance by management and the board of directors and strong risk-management practices relative to the institution's size, complexity, and risk profile. All significant risks are consistently and effectively identified, measured, monitored, and controlled. Management and the board have demonstrated the ability to promptly and successfully address existing and potential problems and risks.

2—A rating of 2 indicates satisfactory management and board performance and risk-management practices relative to the institution's size, complexity, and risk profile. Minor weaknesses may exist, but they are not material to the safety and soundness of the institution and are being addressed. In general, significant risks and problems are effectively identified, measured, monitored, and controlled.

3—A rating of 3 indicates management and board performance that needs improvement or risk-management practices that are less than satisfactory given the nature of the institution's activities. The capabilities of management or the board of directors may be insufficient for the type, size, or condition of the institution. Problems and significant risks may be inadequately identified, measured, monitored, or controlled.

4—A rating of 4 indicates deficient management and board performance or risk-management practices that are inadequate considering the nature of an institution's activities. The level of problems and risk exposure is excessive. Problems and significant risks are inadequately identified, measured, monitored, or controlled and require immediate action by the board and management to preserve the soundness of the institution. Replacing or strengthening management or the board may be necessary.

5—A rating of 5 indicates critically deficient management and board performance or risk-management practices. Management and the board of directors have not demonstrated the ability to correct problems and implement appropriate risk-management practices. Problems and significant risks are inadequately identified, measured, monitored, or controlled and now threaten the continued viability of the institution. Replacing or strengthening management or the board of directors is necessary.

Earnings

The earnings rating reflects not only the quantity and trend of earnings, but also factors that may affect the sustainability or quality of earnings. The quantity as well as the quality of earnings can be affected by excessive or inadequately managed credit risk that may result in loan losses and require additions to the allowance for loan and lease losses. High levels of market risk may unduly expose the institution's earnings to volatility in interest rates. The quality of earnings may also be diminished by undue reliance on extraordinary gains, nonrecurring events, or favorable tax effects. Future earnings may be adversely affected by an inability to forecast or control funding and operating expenses, improperly executed or ill-advised business strategies, or poorly managed or uncontrolled exposure to other risks.

The rating of an institution's earnings is based on, but not limited to, an assessment of the following evaluation factors:

- the level of earnings, including trends and stability
- the ability to provide for adequate capital through retained earnings
- the quality and sources of earnings
- the level of expenses in relation to operations
- the adequacy of the budgeting systems, forecasting processes, and management information systems in general
- the adequacy of provisions to maintain the allowance for loan and lease losses and other valuation allowance accounts
- the exposure of earnings to market risk such as interest-rate, foreign-exchange, and price risks

Ratings

1—A rating of 1 indicates earnings that are strong. Earnings are more than sufficient to support operations and maintain adequate capital and allowance levels after consideration is given to asset quality, growth, and other factors affecting the quality, quantity, and trend of earnings.

2—A rating of 2 indicates earnings that are satisfactory. Earnings are sufficient to support operations and maintain adequate capital and allowance levels after consideration is given to asset quality, growth, and other factors affecting the quality, quantity, and trend of earnings. Earnings that are relatively static, or even experiencing a slight decline, may receive a 2 rating provided the institution's level of earnings is adequate in view of the assessment factors listed above.

3—A rating of 3 indicates earnings that need to be improved. Earnings may not fully support operations and provide for the accretion of capital and allowance levels in relation to the institution's overall condition, growth, and other factors affecting the quality, quantity, and trend of earnings.

4—A rating of 4 indicates earnings that are deficient. Earnings are insufficient to support operations and maintain appropriate capital and allowance levels. These institutions may be characterized by erratic fluctuations in net income or net interest margin, the development of significant negative trends, nominal or unsustainable earnings, intermittent losses, or a substantive drop in earnings from the previous years.

5—A rating of 5 indicates earnings that are critically deficient. A financial institution with earnings rated 5 is experiencing losses that represent a distinct threat to its viability through the erosion of capital.

Liquidity

In evaluating the adequacy of a financial institution's liquidity position, consideration should be given to the current level and prospective sources of liquidity compared to funding needs, as well as to the adequacy of funds-management practices relative to the institution's size, complexity, and risk profile. In general, funds-management practices should ensure that an institution is able to maintain a level of liquidity sufficient to meet its financial obligations in a timely manner and to fulfill the legitimate banking needs of its community. Practices should reflect the ability of the institution to manage unplanned changes in funding sources, as well as react to changes in market conditions that affect the ability to quickly liquidate assets with minimal loss. In addition, funds-management practices should ensure that liquidity is not maintained at a high cost or through undue reliance on funding sources that may not be available in times of financial stress or adverse changes in market conditions.

Liquidity is rated based on, but not limited to, an assessment of the following evaluation factors:

- the adequacy of liquidity sources compared with present and future needs and the ability of the institution to meet liquidity needs without adversely affecting its operations or condition
- the availability of assets readily convertible to cash without undue loss
- access to money markets and other sources of funding
- the level of diversification of funding sources, both on- and off-balance-sheet
- the degree of reliance on short-term, volatile sources of funds, including borrowings and brokered deposits, to fund longer-term assets
- the trend and stability of deposits
- the ability to securitize and sell certain pools of assets
- the capability of management to properly identify, measure, monitor, and control the institution's liquidity position, including the effectiveness of funds-management strategies, liquidity policies, management information systems, and contingency funding plans

Ratings

1—A rating of 1 indicates strong liquidity levels and well-developed funds-management practices. The institution has reliable access to sufficient sources of funds on favorable terms to meet present and anticipated liquidity needs.

2—A rating of 2 indicates satisfactory liquidity levels and funds-management practices. The institution has access to sufficient sources of funds on acceptable terms to meet present and anticipated liquidity needs. Modest weaknesses may be evident in funds-management practices.

3—A rating of 3 indicates liquidity levels or funds-management practices in need of improvement. Institutions rated 3 may lack ready access to funds on reasonable terms or may show significant weaknesses in funds-management practices.

4—A rating of 4 indicates deficient liquidity levels or inadequate funds-management practices. Institutions rated 4 may not have or be able to obtain a sufficient volume of funds on reasonable terms to meet liquidity needs.

5—A rating of 5 indicates liquidity levels or funds-management practices so critically deficient that the continued viability of the institution is threatened. Institutions rated 5 require immediate external financial assistance to meet maturing obligations or other liquidity needs.

Sensitivity to Market Risk

The sensitivity to market risk component reflects the degree to which changes in interest rates, foreign-exchange rates, commodity prices, or equity prices can adversely affect a financial institution's earnings or economic capital. When evaluating this component, consideration should be given to management's ability to identify, measure, monitor, and control market risk; the institution's size; the nature and complexity of its activities; and the adequacy of its capital and earnings in relation to the level of market-risk exposure.

For many institutions, the primary source of market risk arises from nontrading positions and their sensitivity to changes in interest rates. In some larger institutions, foreign operations can be a significant source of market risk. For other institutions, trading activities are a major source of market risk.

Market risk is rated based on, but not limited to, an assessment of the following evaluation factors:

- the sensitivity of the financial institution's earnings or the economic value of its capital to adverse changes in interest rates, foreign-exchange rates, commodity prices, or equity prices
- the ability of management to identify, measure, monitor, and control exposure to market risk given the institution's size, complexity, and risk profile
- the nature and complexity of interest-rate risk exposure arising from nontrading positions
- where appropriate, the nature and complexity of market-risk exposure arising from trading and foreign operations

Ratings

1—A rating of 1 indicates that market-risk sensitivity is well controlled and that there is minimal potential that the earnings performance or capital position will be adversely affected. Risk-management practices are strong for the size, sophistication, and market risk accepted by the institution. The level of earnings and capital provide substantial support for the degree of market risk taken by the institution.

2—A rating of 2 indicates that market-risk sensitivity is adequately controlled and that there is only moderate potential that the earnings performance or capital position will be adversely affected. Risk-management practices are satisfactory for the size, sophistication, and market risk accepted by the institution. The level of earnings and capital provide adequate support for the degree of market risk taken by the institution.

3—A rating of 3 indicates that control of market-risk sensitivity needs improvement or that there is significant potential that the earnings performance or capital position will be adversely affected. Risk-management practices need to be improved given the size, sophistication, and level of market risk accepted by the institution. The level of earnings and capital may not adequately support the degree of market risk taken by the institution.

4—A rating of 4 indicates that control of market-risk sensitivity is unacceptable or that there is high potential that the earnings performance or capital position will be adversely affected. Risk-management practices are deficient for the size, sophistication, and level of market risk accepted by the institution. The level of earnings and capital provide inadequate support for the degree of market risk taken by the institution.

5—A rating of 5 indicates that control of market-risk sensitivity is unacceptable or that the level of market risk taken by the institution is an imminent threat to its viability. Risk-management practices are wholly inadequate for the size, sophistication, and level of market risk accepted by the institution.

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