Office of Thrift Supervision **September 18, 1998**

Department of the Treasury

Regulatory Bulletin

RB 32-8

Handbook: **Thrift Activities**

Subject: **Various Sections**

Thrift Activities Regulatory Handbook Update

Summary: This bulletin provides the second in a series of updates to the Thrift Activities Regulatory Handbook. Enclosed are seven sections: 040, EDS/ROE; 050, Regulatory Plan; 240, Troubled Debt Restructurings; 360, Fraud and Insider Abuse; 410, Financial Records and Reports; 430, Operations Analysis; and 560, Deposits and Borrowed Funds. Please replace the existing handbook sections with the enclosed revised sections. A summary of changes for each section is provided below.

For Further Information Contact: Your Office of Thrift Supervision (OTS) Regional Office or the Supervision Policy Division of the OTS, Washington, DC. You may access this bulletin at our web site: www.ots.treas.gov. If you wish to purchase a handbook and a subscription to the updates, please contact the OTS Order Department at (301) 645-6264.

Regulatory Bulletin 32-8

SUMMARY OF CHANGES

Changes to the enclosed Thrift Activities Handbook Sections are summarized below. Change bars in the margins of the handbook section indicate revisions.

040 EDS/ROE

Introduction: Deletes historical references and references to discontinued Output Reporting System (ORS). Introduces Thrift Information Management (TIM) system as the source of EDS reports. Deletes Figure 1 flow chart as confusing and unneeded. Uniformly labels dates using interagency terminology. Edits to improve readability.

EDS Part I: Abbreviates. Includes text on types of examinations and types of examination packages.

EDS Part II: Clarifies that the completion date indicates the completion of "on-site" examination work.

EDS Part III: Simplifies discussion, includes reference to Net Portfolio Value (NPV) exposure limits. Improves description of Examination Ratings and Asset Quality and NPV

Exposure Limits sections of EDS Part III. Changes CAMEL to CAMELS. Eliminates references to subfactor ratings no longer recorded in EDS. Includes EDS edit restrictions on as of date. Edits to improve readability.

EDS Part IV: Deletes references to supervisory letter, as there is no longer a provision for a supervisory letter in EDS.

States that upon transmittal of the report in EDS, concurrent with the mailing of the report to the institution, the examination is closed.

States that the rating sent to an institution should always be the most current. Any significant events occurring after the examination is closed should be addressed in a subsequent supplemental examination and in the Regulatory Plan. Previously a supervisory letter was advised; EDS no longer accepts supervisory letters.

Includes boilerplate text to enter into EDS when a state ROE cannot be uploaded into EDS.

Table 2: Removes as redundant to ROE instructions.

Interim Reports: Deletes; no longer available.

The Output Report System: Deletes; discontinued.

Types of Examinations Table: Reduces table to a list of the nine types of safety and soundness examinations.

050 Regulatory Plan

This section is rewritten to address concerns brought up in discussions and comments received from regional and Washington staff. The section emphasizes the need for current, relevant, and brief comments with the understanding that if comments are brief and relevant, then keeping the plan current should be less demanding and more likely to occur. Changes the approach of the section from directive to descriptive. Specific directions for those staff making entries in the regulatory plan system are contained in the user guide.

Introduction: Includes Washington supervision staff as part of the primary audience for regulatory plans.

Overview: Emphasizes that regulatory plans should be brief.

Content of the Regulatory Plan: Provides clarifying descriptions of the contents of the plan narratives. Revises the description of the Regulatory Plan System (RPS) following implementation of the Thrift Information Management (TIM) system.

Access: Describes TIM access to RPS contents and lists TIM reports replacing former Regulatory Plan Reports.

240 Troubled Debt Restructurings

Introduction: Minor edits to improve readability.

Definition: Incorporates Thrift Bulletin 63 regarding OTS policy on refinancing and renegotiating loans where market interest rates have declined, including loans secured by real estate collateral that has declined in value.

Accounting: References OTS policy found in Section 260 regarding collateral-dependent loans. Includes SFAS 121 language on costs to sell. Adds OTS policy for measuring impairment. Inserts definition of cost to sell as set forth in SFAS 121.

Effective Date and Transition: Minor edits to improve readability. Omits the last paragraph.

Timing: Clarifies that SFAS 15 applies under GAAP (amendments to 15 are listed in the reference section). Omits last paragraph as superfluous.

Repossession in Substance: Includes SFAS 121 language. Deletes discussion regarding recognition of losses prior to adoption of SFAS 114 as no longer relevant. Deletes reference to regional director requiring fair value.

Disclosure: Discusses provisions of SFAS 118. Deletes reference to notification by regional accountant regarding misstatements as examination procedures section directs examiners to discuss TDR disclosure issues with the regional accountant.

Returning Nonaccrual loans to Accrual Status: This is a new subsection with two sub-subsections (TDR Multiple Note Structure and Past Due Loans) to incorporate interagency guidance on returning nonaccrual loans to an accrual status.

Loans to One Borrower: Adds sentence clarifying institution's efforts to make a loan conforming. Clarifies that renewal should not be done with the purpose of evading the lending limits.

Classification: Reiterates OTS policy cited in Thrift Bulletin 63 regarding loans renegotiated to a current market interest rate when the pledged collateral has declined in value.

Examination Procedures: Moves first sentence of procedure No. 5 to the first sentence of procedure No. 3 as a list of TDRs is necessary to determine whether they are being reported correctly.

References: Revises section numbers due to changes made in a final rule in September 1996.

Adds SFAS 118 which amends SFAS 114. Adds the AICPA's SOP 92-3 which addresses accounting for foreclosed assets. Also adds two interagency policy statements addressing in-substance foreclosure reporting and the return of nonaccrual loans to an accrual status. Notes that 92-3 has certain sections effectively superseded by SFAS 121. Adds SFAS 121. Specifies amendments for each statement.

360 Fraud/Insider Abuse

Introduction: Deletes some outdated items in the listing of OTS's accomplishments in combating fraud and insider abuse.

Criminal Statutes: Deletes the listing of one statute (18 USC 1828).

Suspicious Activity Reports (SAR): Adds this section, which explains the requirements of new OTS regulation § 563.180(d); deletes the section concerning the filing requirements of rescinded OTS Criminal Referral Form 366.

Confidential Individual Information System: Adds this section, which explains OTS's Confidential Individual Information System.

Regional Fraud and Insider Abuse Program: Revises the section to remove reference to Appendix B, "Model Regional Fraud and Insider Abuse Program;" deletes the requirement that regions base their programs on the model; and incorporates a condensed version of the required model procedures (formerly Appendix B) into the section.

Examination Objectives and Examination Procedures: Changes the references from the OTS Criminal Referral Form 366 to the Suspicious Activity Report (SAR).

Appendix B: Deletes.

410 Financial Records and Reports

Thrift Financial Reports: Discusses June 1996 TFR changes which require consolidated reporting. Discusses January 1997 changes pursuant to the final Subsidiary and Equity Investment Rule. Adds that TFRs now must be filed with the Financial Reporting Division (FRD) in Dallas. Discusses the appropriateness of examiner adjustments and institution amendments to the TFR.

Books and Records: Revises to reduce requirements on establishing and maintaining specific documentation.

Procedures: Combines Nos. 6 and 7. Omits No. 8 but moves the parenthetical to Section 430, No. 18.

References: Updates regulatory cites pursuant to the Lending and Investment regulation.

Appendix A: Moves to Section 430, Appendix C.

430 Operations Analysis

Information Sources: Eliminates language pertaining to the National Financial Monitoring System (NFMS). Rather than referring to certain reports within a system, such reports are now referred to as "National Financial Monitoring Reports." Adds a reference to the "Thrift Monitoring System (TMS)."

National Financial Monitoring Reports: Reflects new subsection title. Adds language pertaining to the Uniform Thrift Performance Report (UTPR); eliminates references to the Quarterly Compliance Monitoring Report and Quarterly Financial Summary Report; and adds language detailing TMS and its functions.

Components of Earnings: Adds a subsection titled "Provision for Loan Losses" as an earnings component.

Analytical Techniques: Updates the Comparative Analysis subsection to reflect the new TFR consolidated reporting requirements effective with the June 1996 TFR, and the effect that reporting changes might have on certain UTPR items compared with prior quarter UTPRs.

References: Removes the "NFMS User's Manual" from the list of Office of Thrift Supervision Publications; changes the name of the "Methodologies for Estimating Economic Values in the OTS Net Portfolio Value Model" to "The OTS Net Portfolio Value Model Manual." Updates the "UTPR Reports" listing to reflect the changes made to the UTPR for the June 1996 quarter.

Appendix C: Transfers from Section 410, Appendix A. Revises the discussion of the reconciliation of investments and capital accounts to include the consolidated and equity methods of reporting. Also includes the cost method of reporting under the reconciliation of intercompany payables and receivables.

560 Deposits/Borrowed Funds

Introduction: Adds a new paragraph describing the reinvention of the deposit rules.

Deposits: Adds a new paragraph regarding Bank Investment Contracts (BIC).

Brokered Deposit Restrictions: Adds a new paragraph relating to deposit development and brokered deposit retention policies. Adds discussions concerning large deposits, demand deposits, and sweep accounts.

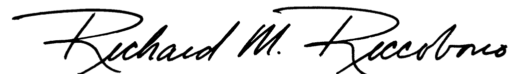
Borrowed Funds: Mentions criticism of borrowed funds if precipitated by poorly planned funds management practices.

Other Sources of Borrowed Funds: Adds a new sentence and additions to "common sources of thrift borrowed funds."

Examination Procedures: Adds a new bullet, "Liquidity," under No. 6. Adds procedure regarding deposit concentrations in new No.11. Moves present Nos. 13-17 in Level II to new Nos. 14-18 in Level I. Deletes Level III and reclassifies as Level II.

References: Revises reference from RB 3a-1 (rescinded) to RB 3b, Policy Statement on Growth for Savings Associations. Deletes section entitled: Comment-Rulings with description of FHFB Resolution No. 92-277.1. Incorporates changes to deposit rules published in the Federal Register October 22, 1997.

Deposits/Borrowed Funds Questionnaire: Adds new 4.a. and 4.b. regarding brokered deposits and money desk deposits. Revises No.12 to reconcile trial balance to general ledger weekly rather than monthly.



—Richard M. Riccobono
Deputy Director

Introduction

EDS refers to the Examination Data System (EDS) which captures basic data from an institution's examination and maintains it on a central data base in Washington. The ROE or Report of Examination system stores the ROE as a text file in the EDS data base.

Information from both EDS/ROE can be easily accessed in the Thrift Information Management (TIM) system. TIM allows ready access to standard reports for individual institutions or groups of institutions grouped by docket file, specific caseload, state, subregion, region, or all regions.

The Examination Data System

The EDS is composed of four parts (I, II, III, and IV) which are accessed throughout the examination process.

EDS Part I: Examination Commencement Data

The official examination start date is recorded in EDS I anytime from when an examination is scheduled until the day the on-site examination work begins. For on-site examinations, the start date is always the day that examiners begin on-site work. On-site work includes examination procedures performed by examiners while on the subject institution's premises, courthouse, building site, real estate office, or other location outside of an OTS office.

For off-site examinations, the start date is always the day that examiners begin off-site work. Off-site work includes examination procedures performed by examiners while in an OTS office. For off-site examinations, EDS Part I is entered the day office work begins. The system allows future dates to be entered as examinations are scheduled and planned. Upon data entry, EDS I is transmitted to Washington and the data is available in TIM reports. EDS I also records the examination type.

Types of Examinations

Following is a list of the nine types of thrift safety and soundness examinations:

Code	Type
10	Federal Regular
11	State
20	On-site Supplemental
21	Off-site Supplemental*
22	Off-site Monitoring
23	Year 2000 (Y2K)
30	Eligibility
40	Special Limited
50	Field Visit

* Off-site and supplemental Y2K beginning 1997

All examination types, except state examinations, may be joint examinations with other regulators. Special limited examinations include all Capital, Assets, Management, Earnings, Liquidity, and Sensitivity to Market Risk (CAMELS) pages, but may have "no comment, not examined" entered instead of a comment. There are various ROE packages for the various examination types.

Types of Examination Packages

The ROE document is created from a personal computer (PC) client-server application designed specifically for the examination process. The examiners identify the pages pertinent to the examination and the application assembles the latest version of the ROE documents, populates the financial data, and downloads the assembled document to the examiner's PC. The ROE document can be uploaded with additional pages throughout the examination process. Two types of safety and soundness ROE shells are available. They are the full ROE and the memo-style ROE. There is also a year 2000 ROE.

Full ROE

The full ROE is required for all thrift regular, eligibility, and special limited examinations. The ROE consists of mandatory and optional supplementary pages. The mandatory pages are generally based on the October 1, 1993 Common Core report of examination adopted by the four federal financial institution regulatory agencies.

The CAMELS pages contain analysis and comments. The optional pages contain various schedules, financial data, and statistical data used to support the analysis. The type and scope of an examination dictates which optional supplementary pages are required. Examiners are encouraged to use only ROE pages that are useful in presenting examination findings.

Memo-Style ROE

The memo-style ROE is just that, a memorandum, and is used for field visits, supplemental, and monitoring examinations. Any of the ROE pages can be attached to the memo-style report if needed. The memo-style ROE is commonly used for completing brief examination reports and for requesting replacement ROE core financial pages and ROE interest rate risk pages whenever a new Thrift Financial Report (TFR) cycle becomes available during the course of an examination.

Year 2000 ROE

The Year 2000 (Y2K) ROE is a special purpose report used only for the Year 2000 examinations.

EDS Part II: Examination Completion Data

EDS Part II records the official completion date of the on-site examination work. Examiners enter data elements into the system on the final day of the on-site examination. For off-site examinations, examiners enter the data on the day office work ends. Upon data entry, EDS II is transmitted to Washington and the data is available in TIM reports.

EDS Part III: Supplemental Data

EDS Part III records examination findings as data that can be retrieved and analyzed. This data is entered into EDS Part III during or soon after an examination is completed. EDS Part III is designed to supplement the ROE. At the completion of the examination, EDS PART III is forwarded along with the ROE to the regional office for review and concurrence. Once in final form, EDS Part III is transferred to the OTS Washington data base with the report of examination. It is used by the OTS as a data source for analysis and planning and for inclusion in the next ROE.

EDS Part III is completed during the course of the examination and consists of two sections labeled on the data input screen as "R Exam Ratings" and "A Asset Quality and NPV Exposure Limits."

Examination Ratings

The Examination Rating Section records the CAMELS composite and component ratings for the examination. All ratings must be entered as N, 1, 2, 3, 4, or 5 to be accepted by the system. Entry of an "N" (the default rating for the system) indicates that no rating was assigned.

At the conclusion of the examination, it is the responsibility of the examiner in charge (EIC) to assign ratings. If the scope for a particular examination is not sufficient to assign a rating to each individual component, the EIC should only assign a rating to those components that were reviewed and assign an "N" to those components that were not reviewed. Federal regular and eligibility examinations report all ratings, while other examination types provide ratings only if any are appropriate for the individual examination. Regional Directors have the authority to accept a State examination as a substitute for an OTS examination on an alternating basis. State examinations are recorded in EDS as type 11 state interim examinations.

Refer to the Thrift Activities Regulatory Handbook Section 071, CAMELS Ratings, for a description of the criteria regarding the CAMELS composite and component ratings. Additional guidance to assist regulatory staff in assigning ratings is pro-

vided in the "Safety and Soundness Report of Examination Instructions" manual.

Asset Quality

The asset classifications in EDS may be compared with the asset classifications reported in the TFR as of the same date. (Beginning in June 1996, the asset classifications in EDS and the TFR use the same accounting standards. Prior to this date, EDS classifications were net of specific valuation allowances (SVA) while the TFR reported classifications gross of SVA. The current standard is to report both net of SVA.)

Examination Date

The date of the quarterly TFR information used in an examination is stored in the field identified on the input screen as: TFR financial data as of date. This date allows future comparisons between the thrift's current financial condition as reported in the TFR and the thrift's financial condition as of this examination. The date must be entered in the TFR date format. The date should not be more than 180 days prior to the start date of the examination and no later than the completion date of the examination.

NPV Exposure Limits

The interest rate risk net portfolio value exposure limits set by the thrift are stored here. This record allows a comparison of the limits with actual performance as reported in the Consolidated Maturity and Rate report (CMR).

EDS Part IV: Report of Examination and Close Date

EDS Part IV is more commonly called the Report of Examination (ROE) and is the document used to report examination findings. During the course of the examination, the examination team completes a draft version of the ROE on a personal computer using the Microsoft WORD ROE shell that is pre-formatted and downloaded from Washington before each examination.

EDS Part IV also includes the date the examination is closed and the report is mailed to the institution and transmitted to Washington. This date is referred to as the close, transmittal, or mail date and is not to be confused with the completion (of on-site work) date in EDS II.

At the completion of the on-site work, the ROE (along with EDS Part III) is forwarded to the regional office for review and concurrence. Events that occur subsequent to examination completion, but before the examination is closed, such as the institution's agreeing to corrective action, should be incorporated into the ROE.

The EDS Parts III and IV data are not transferred immediately to Washington by the examination team. Instead, they are transferred by direction of supervisory staff at the regional offices after they have reviewed the information. The review of EDS Parts III and IV can occur at the examination site (field review), the regional office (either after or during the examination), or both, depending on the examination type, examination scope, available personnel, and other criteria.

Once the report is in final form, a copy is sent to the institution and the ROE is transmitted to Washington EDS, thus closing the examination. (A copy of the final ROE is sent to the thrift, except field visit ROEs with no rating; these ROEs may be sent to the thrift at the region's discretion.) Additional copies may be sent to other agencies, such as the FDIC or the state regulator. A transmittal letter that merely acts as a cover memo accompanying the ROE is discouraged. EDS does not accommodate transmittal letters.

Entry into EDS of the date the ROE was transmitted to the institution indicates final acceptance by the regional office, after which the ROE document cannot be altered. The EDS data correction facility (DCF) may be used to correct errors. The paper copy of the ROE stored by the region is the official document of record.

At the time of transmittal, the examination must be current, based on all available information. A ROE with an outdated rating should never be sent to an institution. Any significant events occurring after the examination is closed should be addressed in a subsequent supplemental examination and in the Regulatory Plan.

A state ROE written in a format other than WORD may be converted to WORD or the text may be copied into a WORD document to be uploaded into EDS.

If a state ROE cannot be uploaded into EDS (e.g., the ROE is a WordPerfect document) a message such as the following should be entered into a memo-style ROE and uploaded into EDS:

> "This is an intervening state examination in accordance with provisions set forth in the Federal Deposit Insurance Corporation Improvement Act of 1991. The official hard copy Report of Examination (ROE) is retained with the examination workpapers. These files are stored at the OTS Regional Office. To obtain a copy of this ROE, contact the Regional Office."

A similar message may be used for IS/EDP ROEs written in WordPerfect if they cannot be either converted to WORD or copied into a WORD document.

References

Office of Thrift Supervision

Thrift Safety and Soundness Report of Examination Instructions

Examination Data System, EDS User Guide

Introduction

The regulatory plan is a summary of a thrift's condition, regulatory concerns, and future plans. It is created and maintained by regional regulatory staff to aid in the supervision and examination of individual thrifts. The primary audience for the plans are the senior regional managers and Washington Supervision staff. These individuals rely heavily on regulatory plans for current and relevant information about thrifts.

The primary objective of each regulatory plan is to help ensure a thrift's safety and soundness and to minimize the degree of risk exposure presented to the banking system through effective monitoring and regulation of the thrift. Realization of this objective can be enhanced by proper planning. Regulatory plans are structured to support this objective. In addition, implementation of the plan assists regulators in identifying weaknesses or deficiencies within an institution and thereby aids in developing and applying corrective measures.

The plan further assists regulatory staff in performing their duties by ensuring greater consistency in regulatory actions. A regulatory plan serves to shorten the learning curve associated with case familiarization and the examination planning and scoping for a specific thrift.

Overview

Strategic planning in the form of a regulatory plan or a business plan is a meaningful tool to accomplish stated objectives, rather than an exercise to satisfy regulatory requirements or directives. The plan should meet all of these criteria:

- Be brief.
- Be current.
- Clearly identify material problems and concerns.
- Provide meaningful objectives and strategies.
- Include plans for corrective actions, including examination scoping and the planned date of the next examination.

Plans are periodically reviewed and updated when necessary so that they are always current documents. The regulatory plan is updated after each full examination cycle. The plan is also updated between examinations when new information outdates the contents of the plan. Additionally, each plan is reviewed quarterly (as part of off-site monitoring activities) to determine if revisions are necessary. The date of each review or update is inserted to document the timeliness of the plan for the benefit of the next reader.

Drafting and updating regulatory plans is integrated with other regional functions such as examination scoping, examination report review, drafting supervisory correspondence, and periodic thrift monitoring. Periodic monitoring assists in allocating supervisory resources to those thrifts, and the areas within them, that pose the greatest risk.

In developing the initial regulatory plan and for subsequent updates, input is sought from all regulatory staff who are knowledgeable about the institution. In addition, various documents may be used as information sources:

- SEC reports.
- News clippings.
- Prior examination reports.
- Business and capital plans on file.
- Independent audit reports and management letters.
- Correspondence with the institution, including applications.

- Uniform Thrift Performance Reports and Thrift Monitoring System reports.

Content of the Regulatory Plan

In general, the plan is a brief summary individually customized to the institution and targeting risk and safety and soundness issues not discussed elsewhere. Each plan is directed toward the unique characteristics of the subject thrift, such as principal lines of business. If an institution poses minimal risk to the banking system, then only minimal documentation and comment is in the regulatory plan.

There are three Regulatory Plan Narrative Advisory text sections. With the narrative sections, the examination comments and conclusions page of the most recent full Report of Examination (ROE) is available in the Thrift Information Management (TIM) system.

The main sections of the regulatory plan are the:

Latest ROE Overview

This is composed of the Examination Conclusions and Comments and Matters Requiring Board Attention pages of the last full ROE as it is stored in the Examination Data System (EDS). The availability of these ROE pages eliminates any need to repeat ROE text in the other narrative texts.

Current Condition and Operating Environment

This narrative includes the major changes, concerns and conclusions from the most recent quarterly financial review. The current condition may also include a brief quarterly financial analysis, however, this is not required. If a review indicates no concerns, then only the date of the review is entered to document when the review was completed.

Supervisory Concerns, Objectives, and Strategies

The second narrative identifies and ranks significant problems and concerns in the order of importance, lists supervisory objectives, and details a planned response and strategy. This narrative includes a brief dated chronology of current relevant concerns and conclusions. When needed, this section includes historical information necessary to understand the current situation not appropriate for an examination report.

- — Supervisory concerns are any material concerns identified in the monitoring, planning, or examination process. Current concerns are briefly summarized to facilitate efforts being directed to important issues.
- — Objectives are presented as a statement of desired results formulated through clear identification of an institution's weaknesses. Objectives included in the plan are tailored to the individual thrift.
- — Strategies are described for monitoring, reducing, or eliminating concerns to meet objectives. Strategies may entail a broad description of the scope for future examinations to ensure close surveillance of a problem or possibly a recommendation for supervisory action if a specified condition surfaces.

Plan Activity Agenda

The third narrative lists planned actions such as the scope and tentative date of the next examination.

For a more detailed discussion concerning the format and content of a regulatory plan refer to the Regulatory Plan System Guidelines.

Access

The Regulatory Plan System (RPS) stores current data and comments that can be obtained through reports in the TIM system available on the OTS VAX common user interface menu. These regulatory plan narratives are accessed using the View Menu (VM) option.

The TIM VM options also provide a wide array of reports on a thrift. There is a corporate structure

overview, a four quarter financial summary, a supplemental corporate structure information, an exam history, a list of outstanding enforcement actions, an applications history, a holding company structure summary, a merger history, a history of corporate name changes, a branch office deposits report, a history of acquired assets and deposits, and a history of sold assets and deposits. All of the reports may be obtained by selecting VM option 6 All Sections.

The TIM Examination and Enforcement (EE) Regulatory Plan Tracking (RP) report provides a history of each time a regulatory plan is updated. It also counts and lists plans that are pending, due, or overdue for updating, as well as plans filed on time or filed late.

References

Office of Thrift Supervision

Regulatory Plan System Guidelines

Introduction

In order to assist borrowers who are unable to meet the original terms of their loans, and maximize recovery of loans to these borrowers, an institution may have to renegotiate those terms. Such renegotiation may result in the institution making modifications that result in loan terms it normally would not accept. These may include a lower interest rate or even no interest, a reduction in principal, a lengthier term to maturity, a transfer of assets from the borrower, the substitution or addition of a new borrower, or some combination of these modifications. This renegotiation, where concessions are granted to the debtor/borrower, is known as a troubled debt restructuring or TDR.

Troubled debt restructurings are compromises of indebtedness designed to improve collection or reduce losses on problem loans. Strict controls such as dual authorization requirements and monitoring by a senior committee should be required in policy and practice to prevent unneeded compromises from occurring.

Generally accepted accounting principles (GAAP) for TDRs are set forth in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards (SFAS) Nos. 15, 114, 118, and 121. Troubled debts also require an evaluation of the probable loss from collection, as defined by SFAS No. 5.

This Section of the Handbook describes troubled debt restructuring and offers guidelines to regulators in assessing an institution's related policies for recognizing TDRs and to understand related accounting problems that can result in material overstatement of asset carrying values, which, in turn, may understate losses and affect tangible capital, and earnings.

Definition

According to SFAS No. 15, a TDR occurs when an institution grants a concession it would not otherwise consider because of economic or legal reasons pertaining to the debtor's financial difficulties. A TDR may include, but is not limited to, the following or any combination of the following:

- The transfer of assets from the debtor to the creditor to satisfy all or part of the indebtedness when the fair value of the assets received is less than the recorded investment in the receivable. The assets transferred may be receivables from third parties, real estate, or other assets.
- Issuance of an equity interest by the debtor to the creditor to satisfy all or part of a debt, provided the interest was not granted pursuant to existing terms for converting debt to equity.
- Modification of the terms of debt such as a reduction of the interest rate for the remaining term, an extension of the maturity date with a stated interest rate lower than the current market rate for new debt with similar risk, a reduction in the outstanding principal amount due, or a reduction in the accrued interest due.
- Substitution or addition of debtor(s) when the substitute or additional debtor(s) control, are controlled by, or are under common control with the original debtor. (When substitute or additional debtor(s) have no relationship with the original debtor after the restructuring, the restructuring must be accounted for as a new loan in partial satisfaction of the original borrower's loan. In this situation, any losses resulting from the new financing are recognized on the basis of the fair value of the new loan.)

Not all concessions granted by the creditor constitute a TDR. For example, the following situations do not constitute a TDR:

- The assets received by the creditor for full satisfaction of the debt have a fair value equal to

or greater than the recorded investment in the receivable.

- The creditor reduces the interest rate on the debt to reflect a decrease in the market interest rate.

Periods of declining interest rates may make refinancing of loans appealing to borrowers whose current contractual interest rates are higher than market interest rates. However, the value of the pledged collateral may have declined. The Office of Thrift Supervision (OTS) encourages institutions to work constructively with creditworthy borrowers, including instances where the refinancing of real estate-related loans involves an adjustment of the existing loan rates to current market rates. The OTS will not criticize an institution solely for refinancing or renegotiating a loan to a current market rate, even if the pledged collateral has declined in value. Refinanced and renegotiated loans will be evaluated based on the borrower's creditworthiness and repayment capacity.

Accounting

GAAP for TDRs is prescribed principally by SFAS Nos. 5, 15, and 114. SFAS No. 114, "Accounting By Creditors for Impairment of a Loan," significantly changed GAAP for loss recognition in a TDR involving modification of terms. SFAS No. 114 became effective for fiscal years beginning after December 15, 1994.

A loan that has been subject to a TDR is typically considered "impaired" as defined in SFAS No. 114. A loan is impaired when, based on current information and events, it is probable that the institution will be unable to collect all amounts due according to the contractual terms of the original loan agreement. All amounts due according to the contractual terms means that both the contractual interest payments and the contractual principal payments of a loan will be collected as scheduled in the loan agreement. A loan is not impaired during a period of delay in payment if the creditor expects to collect all amounts, including interest at the contractual rate for the period of delay. Support for collection of all amounts due should be based upon the cash flow from the project and/or borrower, not the fair value estimate of the collateral.

SFAS No. 114 for impaired loans requires measurement of impairment based on the present value of expected future cash flows discounted at the loan's effective interest rate. However, as a practical expedient, impairment may also be measured based on the loan's observable market price, or the fair value of the collateral if the loan is collateral-dependent. A loan is collateral-dependent if the repayment of the loan is expected to be provided solely by the underlying collateral.

SFAS No. 114 and Thrift Activities Handbook Section 260 require that institutions shall measure impairment based on the fair value of the collateral less costs to sell when foreclosure is probable. In addition, Section 260 of the Thrift Activities Handbook require that the valuation and classification of troubled, collateral-dependent loans should be based on the fair value of the collateral, and not on the present value of the expected future cash flows or on the loan’s observable market price. Thus, OTS has restricted thrifts to a single option - - the fair value of the collateral (less costs to sell) - - for troubled, collateral-dependent loans. (See Thrift Activities Handbook Section 260 for OTS policy regarding Valuation and Classification of Troubled, Collateral-Dependent Loans.)

The effective interest rate for a loan is the rate of return implicit in the loan. A savings association should consider estimated costs to sell, on a discounted basis, in the measure of impairment if those costs are expected to reduce cash flows available to repay or otherwise satisfy the loan.

Cost to sell an asset to be disposed of generally includes the estimated incremental direct costs to transact the sale of the asset such as broker commissions, legal and title transfer fees, and closing costs. Generally, costs to sell exclude insurance, security services, and utility costs.

If the present value of expected future cash flows (or, alternatively, the observable market price of the loan or the fair value of the collateral) is less than the recorded investment in the loan (including accrued interest, net deferred loan fees or costs, and unamortized premium or discount), an institution shall recognize an impairment by creating a

valuation allowance with a corresponding charge to provision for loan losses or by adjusting an existing valuation allowance for the impaired loan with a corresponding charge or credit to provision for loan losses.

Loss recognition by institutions for TDRs involving a modification of terms is recorded in accordance with the provisions of SFAS No. 114. Therefore, the effective interest rate for a loan restructured in a TDR involving a modification of terms is based on the original contractual rate, not the rate specified in the restructuring agreement.

Effective Date and Transition

As stated previously, SFAS No. 114 became effective for fiscal years beginning after December 15, 1994. A TDR that was restructured before the effective date of SFAS No. 114 may continue to be accounted for and disclosed in accordance with SFAS No. 15 as long as the restructured loan is not impaired based on the terms specified in the pre-SFAS No. 114 restructuring agreement. If such a TDR fails to perform as agreed, or if it is again restructured, the effective interest rate reverts back to the contractual interest rate of the original loan.

The OTS policy regarding troubled, collateral-dependent loans (including collateral-dependent TDRs), which became effective on September 30, 1993, is similar in many respects to certain provisions of SFAS No. 114. Thrift Activities Handbook Section 260 and SFAS No. 114 may require recognition and measurement of impairment independent of any TDR.

Timing

A TDR may occur before, at, or after the stated maturity of the debt. Time may elapse between the restructuring agreement and the effective date of the new terms of the restructuring. For GAAP purposes, the date of consummation of the restructuring agreement is the recognition date for the restructuring, not necessarily the date the restructuring paperwork is completed.

The OTS views a TDR as existing as soon as there is an agreement between the thrift and the borrower consummating the restructuring. A TDR would be presumed to exist if the senior management of both the thrift and the borrower reach an oral agreement memorialized in written documentation, such as a memorandum to the files, setting forth the terms of the TDR.

An oral agreement may reflect the restructuring of a loan, but is not a long-term substitute for written agreement. The consummation of a TDR should be documented in writing within a reasonable time frame. Restructurings should normally be completed within six months. A claim that a loan has been restructured becomes dubious when negotiations continue for a long period without producing a final written agreement. The issue of timing is important when applying GAAP because it determines when and if a problem loan should be accounted for as a TDR under SFAS No. 15.

Receipt of Assets

Assets transferred in partial or total repayment of indebtedness, including an equity interest in the debtor, should be recorded at their fair value less cost to sell. Fair value is defined as the amount the debtor could reasonably expect to receive from a current sale between a willing buyer and a willing seller; that is, other than a forced or liquidation sale.

The fair value of an asset is measured by the market value if an active market exists. If no market exists for the assets transferred, a forecast of expected cash flows from the asset, discounted at a rate commensurate with the risk involved, may be used to arrive at the fair value.

Repossession in Substance

A creditor cannot avoid accounting for an asset at its fair value by simply avoiding a formal foreclosure. In accordance with SFAS No. 114, an impaired collateral-dependent real estate loan is treated as a repossession in substance (and reported as REO) once the lender has taken possession of the collateral -- even if the lender has not obtained legal title. (Examples of “taking possession” include managing the collateral, proceeding with the foreclosure process, and marketing the project for sale.) For other troubled collateral-dependent loans, loss recognition is based on the fair value of the collateral less costs

to sell if full payment of the amounts due is not expected. Such loans would remain in the loan category.

If a repossession in substance has occurred, the examiner should consider whether an independent reappraisal is necessary. Regulation 12 CFR § 563.170 empowers OTS officials to obtain independent reappraisals.

Disclosure

A loan modified and accounted for as a TDR must be disclosed in the institution's audited financial statements and on reports to the OTS. Audited financial reports should disclose the following information pertaining to all impaired loans including TDRs, as required in SFAS No. 15, 114, and 118, if material:

- The total recorded investment in the impaired loans at the end of each period, and (1) the amount of that recorded investment for which there is a related allowance for credit losses, and (2) the amount of that recorded investment for which there is no related allowance.
- The creditor's interest income recognition policy including how cash receipts are recorded.
- The activity in the allowance for credit losses account, including the balance in the allowance for credit losses account at the beginning and end of each period, additions charged to operations, direct write-downs charged against the allowance, and recoveries of amounts previously charged off.

An exception to these disclosure requirements states that a TDR involving a modification of terms need not be included in the disclosures in the years after the restructuring if:

- The restructuring agreement specifies an interest rate equal to or greater than the rate that the creditor was willing to accept at the time of restructuring for a new loan with comparable risk, and
- The loan is not impaired based on the terms specified by the restructuring agreement.

Returning Nonaccrual Loans to Accrual Status

TDR Multiple Note Structure

A typical example of a TDR multiple note structure is where the original troubled debt is restructured with the borrower and split into two notes. The first note, or the "A" note, represents the portion of the original loan principal amount that is expected to be collected in full, along with contractual interest. The second note, or the "B" note, represents the portion of the original loan that is charged off.

Under interagency guidance, the "A" note may be returned to accrual status provided all of the following conditions are met:

- The restructuring qualifies as a TDR, as defined by SFAS No. 15, and there is economic substance to the restructuring.
- The portion of the original loan represented by the "B" note must be charged-off before or at the time of the restructuring. The charge-off must be supported by a current, well-documented credit evaluation of the borrower's financial condition and prospects for repayment under the modified terms.
- The "A" note is reasonably assured of repayment and of performance in accordance with the modified terms.
- There is a sustained period of repayment performance (generally a minimum of six months), either immediately before or after restructuring, in accordance with the modified terms, involving payments of cash or cash equivalents.

The "A" note would initially be disclosed as a TDR. Such disclosure could be eliminated in the year following the restructuring, provided both of the following additional conditions are met:

- The "A" note yields a market rate of interest. To be considered a market rate of interest, the interest rate on the "A" note at the time of the restructuring must be equal to or greater than

the rate the institution is willing to accept for a new receivable with comparable risk.

- The "A" note performs in accordance with the modified terms.

(Please note that SEC staff are reviewing the disclosures that are required.)

Past Due Loans

Under interagency guidance, past due loans may be returned to accrual status, even though the loans have not been brought fully current, and any previous charge-offs have not been fully recovered, provided both of the following conditions are met:

- All principal and interest amounts contractually due (including amounts past due) are reasonably assured of repayment within a reasonable period.
- There is a sustained period of repayment performance (generally a minimum of six months) in accordance with the contractual terms, involving payments of cash or cash equivalents.

However, past due loans that meet the above conditions would continue to be disclosed as past due, until they have been brought fully current.

Loans to One Borrower

The restructuring of a troubled loan constitutes a renewal, but is not a new loan for purposes of the loans-to-one-borrower (LTOB) rule, 12 CFR § 560.93, provided that no additional funds are advanced to the borrower. In the case of a nonconforming loan, the institution should take reasonable efforts, consistent with safety and soundness, to make the loan conforming. In addition, the institution should document its efforts to bring the loan into conformance. If the efforts are unsuccessful, the institution may renew, restructure, or modify the nonconforming loan, provided that the renewal, restructuring, or modification is not done with the purpose of evading the lending limits, and that there is neither a substitution of borrowers nor an additional advance of funds.

Classification

As with all assets of institutions, TDRs are subject to the classification requirements of 12 CFR § 560.160*,* Asset Classification. Loans will not automatically be adversely classified merely because they have been restructured. Conversely, a loan accounted for as a TDR is not exempt from the classification process. When evaluating TDRs for possible classification, the examiner should use the same criteria as for all other loans. TDRs are probable candidates for adverse classification. As a practical matter, TDRs have demonstrated weakness and often require some loss recognition.

The OTS will not criticize an institution solely for refinancing or renegotiating a loan to a current market rate, even if the pledged collateral has declined in value. Refinanced and renegotiated loans will be evaluated based on the borrower's creditworthiness and repayment capacity.

References

Code of Federal Regulations (12 CFR)

§ 560.93	Lending Limitations
§ 560.160	Asset Classification
§ 560.172	Re-evaluation of Real Estate Owned
§ 563.170	Examinations and Audits; Appraisals, Establishment and Maintenance of Records
Part 564	Appraisals

Financial Accounting Standards Board, Statement of Financial Accounting Standards

No. 5	Accounting for Contingencies (as amended by No. 114)
No. 15	Accounting by Debtors and Creditors for Troubled Debt Restructurings (as amended by Nos. 114 and 121)
No. 114	Accounting by Creditors for Impairment of a Loan (as amended and superseded in part by No. 118, amends No. 5)
No. 118	Accounting by Creditors for Impairment of a Loan – Income Recognition and Disclosures

	(amends and supersedes, in part, No. 114)
No. 121	Accounting for Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of (amends No. 15)
EITF 96-22	Applicability of Disclosures Required By FASB Statement No. 114 When a Loan is Restructured in a Troubled Debt Restructuring Into Two (or More) Loans

Other References

American Institute of Certified Public Accountants, "AICPA Audit and Accounting Guide for Banks and Savings Institutions," (April 1, 1996).

American Institute of Certified Public Accountants, Statement of Position 92-3. Accounting for Foreclosed Assets (significant portions have been effectively superseded by SFAS No. 121).

SEC FRR 28: Interpretive Release No. 33-6679, Sections I and II only.

Interagency Guidance on Reporting of In-Substance Foreclosure (June 10, 1993)

Revised Interagency Guidance on Returning Non-accrual Loans to Accrual Status (June 10, 1993)

Troubled Debt Restructurings
Program

Examination Objectives

To assess the institution's policies, procedures, and controls on troubled debt restructurings and to determine whether the policies are adequate to ensure that TDRs benefit the thrift.

To determine if TDRs and repossessions in substance are reported in accordance with OTS policy and GAAP.

To assess the reasonableness of concessions granted to borrowers by management under TDR agreements.

To assess the risk that TDR policies and practices pose to the institution and ultimately to the insurance fund, its members, and the public.

Examination Procedures

Wkp.Ref.

Level I

1. Evaluate the adequacy of the institution's policies, procedures, and controls on troubled debt restructuring to ensure that TDRs are structured to the thrift's benefit.

2. Ascertain through review of minutes, audit reports, and other management reports whether TDRs are properly approved in accordance with institution policy and reported to the institution's board of directors.

3. Obtain from management a current list of TDRs. Determine whether TDRs are correctly reported in audited financial statements and in reports to the OTS. Discuss missing material disclosures with the regional accountant.

4. Review Level II procedures and perform those necessary to test, support, and present conclusions derived from performance of Level I procedures.

Exam Date:
Prepared By:
Reviewed By:
Docket #:

Troubled Debt Restructurings
Program

Level II **Wkp.Ref.**

5. If the effect of TDRs is material relative to regulatory capital or earnings, test TDRs for compliance with the institution's policies and procedures and for compliance with GAAP, relying on the thrift's work papers and internal and external audit work as appropriate.

6. Ensure that the *Objectives* of this Handbook Section have been met. State your findings and conclusions, as well as appropriate recommendations for any necessary corrective measures, on the appropriate work papers and report pages.

Exam Date:
Prepared By:
Reviewed By:
Docket #:

Introduction

Fraud and insider abuse significantly contributed to many thrift institution failures during the late 1980s and early 1990s, and caused substantial losses at many others. Because of this, in an effort to combat fraud and insider abuse at thrifts the Office of Thrift Supervision (OTS):

- Helped establish and has been active in an Interagency Bank Fraud Working Group composed of thrift and banking regulators, the Department of Justice (DOJ), and the FBI. Representatives from these government agencies work together to establish policies to improve interagency cooperation and to resolve criminal investigation and prosecution problems;
- Helped develop the uniform interagency "Suspicious Activity Report" (SAR) form that federally insured financial institutions use to report suspected violations of federal criminal law and suspicious transactions related to money laundering offenses and Bank Secrecy Act violations. In April 1996 this form replaced the criminal referral form (OTS Form 366) previously used to report suspected criminal activity;
- Promulgated regulations requiring insured institutions and service corporations to file SARs;
- Established, with the DOJ, the Significant Referral Tracking System, to which the OTS designates its most significant SARs and DOJ provides tracking of their progress in local U.S. Attorneys' Offices; and
- Designated a criminal referral coordinator staff member at each regional office whose function is to coordinate reports of suspected criminal activities and provide assistance to the FBI and DOJ in criminal investigations and prosecutions.

Fraud, Insider Abuse, and Criminal Misconduct

Fraud is the intentional misrepresentation of a material fact(s), or a deception, to secure unfair or unlawful gain at the expense of another. Financial institution fraud can be perpetrated by outsiders, insiders, or both.

Each year thrift institutions lose a significant amount of money due to insider abuse and criminal misconduct. The FBI had estimated that insiders of financial institutions steal eight times more money than is stolen through bank robberies and burglaries.

The term insider abuse refers to a wide range of activities by officers, directors, employees, major shareholders, agents, and other controlling persons in financial institutions that are intended to benefit the insiders or their related interests. They include:

- Unsound lending practices, such as inadequate collateral and poor loan documentation;
- Excessive concentrations of credit to certain industries or groups of borrowers;
- Unsound or excessive loans to insiders or their related interests or business associates;
- Violations of civil statutes or regulations, such as legal lending limits or loans to one borrower; and
- Violations of criminal statutes, such as fraud, misapplication of bank funds, or embezzlement.

In addition to criminal misconduct, insider abuse includes other actions or practices that may harm or weaken an institution, but that do not violate criminal statutes. While every criminal violation by an insider constitutes insider abuse, not all insider abuse constitutes criminal misconduct. In most problem institutions where insider abuse is detected, regulators find a variety of unsafe and

unsound banking practices and mismanagement that may involve criminal acts. While a thin line often separates a criminal act from an abusive act, the OTS has the responsibility and the authority to act against all insider abuse, whether criminal or not.

Many of the largest cases of financial institution fraud involved insiders. If the insider is in a key position, the amount of loss can be significant enough to cause the institution to fail. Often, these individuals perform criminal acts using subordinates who do not question their instructions. In some instances, however, the subordinates may be astute enough to know that what they were instructed to do is questionable or wrong and may freely discuss the situation if the regulators simply inquire.

During both formal and informal discussions with employees, regulators should listen carefully and be attuned to signals of possible illegal activity by others within the institution. Often, discovering fraud is a matter of talking with the right person who knows what is occurring. Because inside abusers often start off small, and engage in increasingly larger transactions as their confidence level rises, the early detection of insider abuse is an essential element in limiting risks to the insurance fund.

Conflicts of Interest

There remains a continuing need for regulatory personnel to scrutinize all conflict-of-interest transactions in the context of the OTS's Conflicts of Interest regulation § 563.200. Examiners should, accordingly, comment on and request appropriate corrective action on any actual or apparent conflict- of-interest situation that adversely affects the institution, even though a regulation may not specifically address the conflict. Examiners should also comment on and request appropriate corrective action whenever people involved in a conflict situation participate in, or by virtue of their position, exercise an undue influence over the approval of the transactions.

Criminal Statutes

The following principal criminal statutes apply to financial fraud:

18 USC § 215

Kickbacks and bribes: Makes it unlawful for any officer, director, employee, agent, or attorney to solicit, accept, or give anything of value with intent to corrupt, in connection with any transaction or business of any financial institution.

Significant Aspects:

- Intent to corrupt requires an intent to receive a personal financial benefit or to direct to another person such benefit;
- Applies to noncustomer transactions (e.g., suppliers);
- Applies where a payment is given after the fact to reward an individual for a prior act; and
- Can apply where the benefit is directed to a third party if the intent is to influence the insider.

18 USC § 657

Theft, embezzlement, or willful misapplication of an insured institution's funds by an officer, director, agent, or employee with intent to defraud the institution.

Significant Aspects:

- Applies to check kites, nominee borrowers, and in some cases unauthorized loans; and
- Violation of internal policies, violation of regulations, and personal benefit to the insider.

18 USC § 1001

General false statements: Knowingly and willfully falsifying or concealing a material fact or making a false statement or making or using false writing knowing it to be false.

18 USC § 1006

False entries and reports or statements, including material omissions, with intent to injure or defraud

an insured institution or deceive an OTS regulator; includes an officer's, agent's, or employee's receipt of any benefits from an institution transaction with intent to defraud.

Significant Aspects:

- Misstatement should be material; and
- Often used in conjunction with misapplication statutes such as 18 USC § 657.

18 USC § 1014

False statement, oral or written (e.g., loan applications), made knowingly for the purpose of influencing the OTS or any institution whose deposits are federally insured, on any application, purchase agreement, commitment, loan (or any change or extension of same), including willfully overvaluing land, property, or security.

Significant Aspects:

- Usually used against borrowers for submitting false financial statements; and
- Applies to all persons, not just insiders.

18 USC § 1344

Bank fraud: A scheme or artifice to defraud a federally insured institution or take money, funds, credit, assets, security, or other property by misrepresentation.

Significant Aspects:

- Applies to most activities that are violations under the statutes; and
- Generally must find deceit, trickery, deception, falsehood, or failure to provide information when there is an obligation to do so.

18 USC 1517

Obstructing an examination: makes it a crime to corruptly obstruct or attempt to obstruct an examination of a financial institution.

Significant Aspects:

- The examination must be one that an agency of the United States, with examination jurisdiction, is conducting; and
- Applies to whoever corruptly obstructs or attempts to obstruct.

Detecting Fraud and Insider Abuse

Because fraud is not always carefully planned and discreetly carried out, if regulators are alert to certain warning signs they may be able to detect it. It is essential, however, that regulators are knowledgeable of the warning signs and are alert to circumstances where fraud may exist, either by insiders or outsiders. Once fraud is suspected, regulators should thoroughly investigate the circumstances surrounding a suspected activity.

The primary problem that regulatory personnel face in detecting fraud is the limited time and resources available to conduct an examination. Certainly, if fraud is known and is material, regulatory staff would be expected to devote the time necessary to conduct a thorough investigation. However, when fraud is only mildly suspected, such as with a hunch, it is often difficult to justify expanding examination scope. The Fraud Risk Evaluation Form (Appendix A) and the "Red Flags of Fraud and Insider Abuse" listed below, are provided to assist regulatory personnel in assessing the risk of fraud at an institution. When the risk of fraud is considered high, examiners will be justified in looking further into certain areas.

Regulatory personnel must be alert to situations that may be conducive to fraud and insider abuse. If a situation exists such that an officer or employee is able to control a sizable transaction from beginning to completion, the institution's directorate should be notified and the situation should be immediately corrected. Examiners should not think of internal control weaknesses, poor loan documentation, improper internal audit reporting relationships, etc., only as technical violations, but also as potential opportunities for large frauds. Such weaknesses should receive appropriate treatment in the report of examination and should result in effective supervisory action.

Red Flags of Fraud and Insider Abuse

Experience has taught the OTS staff that certain common elements are often present in cases of insider abuse. The following are warning signs of possible fraud and insider abuse:

General

- Dominant officer with control over the institution or a critical operational area;
- Internal audit restrictions or unusual reporting relationships (the internal auditor not reporting directly to the board or audit committee);
- Lack of written or inadequately written policies;
- Written policies not followed;
- Unusual or lavish fixed assets (aircraft, art work, etc.);
- Management attempts to unduly influence examination or audit findings;
- Material internal control deficiencies;
- Frequent changes of auditors;
- High internal audit department turnover;
- Alteration of records;
- Withholding of records;
- Delaying tactics in providing documents or records;
- Large transactions with small out-of-town banks;
- Ownership or control vested in a small group;
- Inaccurate, inadequate, or incomplete board reports;
- Key internal reports discontinued; and
- No vacation taken by employee/officer.

Red Flags of Lending Abuse

- High concentrations of credit in an industry or to individuals;
- Poorly documented loans and appraisals;
- Lack of an acceptable past due or watch list;
- Lack of, or unsigned, borrower financial statements;
- Questionable loan disbursement transactions;
- Loan funds disbursed to a third party;
- Corporate loans with no endorsements or guarantors;
- Large pay-down of problem loans prior to an audit or examination;
- Large overdrafts;
- Refinancing of debt in a different department;
- Loan documents signed outside of institution;
- Loans secured by flipped collateral;
- Nominee loans;
- Loans of unusual size or with unusual interest rates or terms;
- Loans with unusual, questionable, or no collateral;
- Loan review restrictions;
- Out-of-territory loans;
- Evergreen loans (loans continuously extended or modified);
- A considerable number or amount of insider loans;
- Loan concentrations (e.g., one borrower, one area);
- Construction draws with no or inadequate inspection reports;
- Construction inspections conducted by unauthorized or inappropriate persons;
- Market study on proposed project not on file;

- Loan approvals granted to uncreditworthy employees;
- Lack of independence between the approval and disbursement functions;
- Frequent sales of collateral (land flips) indicating related party transactions; and
- Unusual relationship between appraiser/lender/borrower.

Red Flags of Appraisal Abuse

- No appraisal or property evaluation in file;
- One appraisal in file, but institution is billed for two or more;
- Unusual appraisal fees (high or low);
- No history of property or prior sales records;
- Market data located away from subject property;
- Unsupported or unrealistic assumptions relating to capitalization rates, zoning change, utility availability, absorption, or rent level;
- Valued for highest and best use, which is different from current use;
- Appraisal method using retail value of one unit in condo complex times number of units equals collateral value;
- Use of superlatives in appraisals;
- Made for borrower; and
- Appraisals performed or dated after loan.

Suspicious Activity Reports (SAR)

Filing Requirements

Paragraph (d)(3) of OTS regulation § 563.180, Suspicious Activity Reports and Other Reports and Statements, requires savings associations[1] and their service corporations to file a SAR with the appropriate federal law enforcement agencies and the Department of Treasury by sending the report to the Financial Crimes Enforcement Network (FinCEN) of the Department of the Treasury. The filing is required following the discovery of any known or suspected federal criminal violation that involves (i) any officer, director, employee, agent, or other institution-affiliated person; (ii) a transaction or transactions involving or aggregating $5,000 or more in funds or other assets, when there is a factual basis for identifying a suspect; (iii) transaction(s) aggregating $25,000 or more even though a suspect has not been identified; or (iv) transaction(s) aggregating $5,000 or more that involve potential money laundering, or violations of the Bank Secrecy Act.

Section 563.180(d)(5) requires savings associations and their service corporations to file a SAR no later than 30 calendar days after the date of initial detection of facts that may constitute a basis for filing a SAR, unless no suspect was identified on the date of detection, in which case a filing may be delayed up to an additional 30 days to identify a suspect. In situations involving violations requiring immediate attention, such as when a violation is ongoing, savings associations and their service corporations are to immediately notify, by telephone, an appropriate law enforcement authority and the OTS, in addition to filing a timely SAR.

In addition to these requirements, OTS regulation § 563.180(d) also:

- Encourages savings associations and their service corporations to file a copy of the SAR with state and local law enforcement agencies where appropriate;

[1] For Section 563.180(d) regulatory purposes, a savings association and its operating subsidiaries are consolidated and treated as a unit.

- Provides that a SAR need not be filed for robberies and burglaries that are reported to appropriate law enforcement authorities;
- Requires that copies of SARs, and any supporting documentation, be retained for a period of five years from the date the SAR was filed;
- Advises that failure to file a SAR in accordance with this section may subject the savings association, or service corporation, its officers, directors, employees, agents, or other institution-affiliated parties to supervisory action; and
- Advises that the law shields financial institutions and their employees from civil liability when they report suspicious activities.

The information reported in SARs is included in a FinCEN central database that is accessible only to federal and state financial institution regulators and law enforcement agencies. The usefulness of the database depends on the completeness and accuracy of the reported information. Accordingly, examiners should ensure that associations are accurately and fully completing SARs.

Examiner and Regional Reporting Requirements

While savings associations and their service corporations have the primary responsibility to file SARs, regulators must complete and file a SAR when the required filing institution has either failed to do so or has not properly completed or filed it. When necessary, examiners should seek filing guidance from their supervisors or regional legal or enforcement personnel, including guidance concerning Right to Financial Privacy Act issues.

Confidential Individual Information System

In addition to contributing to and using the FinCEN database, OTS utilizes its own automated system, the Confidential Individual Information System (CIIS), to record information on individuals concerning events such as enforcement actions, referrals to a professional organization for disciplinary reasons, liability suits, investigations as to unusual transactions, and certain application activity (such as, acquisition or change of control, and procurement of a charter). Other federal agencies and state authorities may access CIIS information, with the approval of the OTS national or a region's CIIS administrator.

Regional Fraud and Insider Abuse Program

Each region must maintain a written fraud and insider abuse program, and should designate a person on its staff to be a Criminal Referral Coordinator to administer the program. The coordinator should act as a contact person or liaison to develop and maintain both internal and external fraud and insider abuse operations and communications.

While the extent of a regional program will be dependent on the incidences of fraud and insider abuse within the region, at a minimum each region (operations or legal) is responsible to:

- Monitor and review regional SARs entered into the FinCEN system, particularly those that involve institution-affiliated persons or significant losses, and as appropriate communicate to the staff the reported suspicious activities;
- Ensure that institutions (and OTS staff, when necessary) complete and file accurate and timely SARs, including the providing of assistance and advice in such filings;
- Exchange information with and provide assistance to the FBI, Department of Justice, and other agencies, and ensure that timely follow-ups are made on important SARs;
- Participate with local interagency bank fraud working groups that meet within the region;
- Ensure compliance with the Right to Financial Privacy Act as it relates to providing information and documentation to law enforcement and other government agencies;
- Work with the OTS Regional Counsel office and OTS Enforcement Division in matters that relate to investigations for criminal prosecution or civil enforcement actions; and
- Be able to provide background information reports on regional fraud and insider abuse cases, including prosecutions in progress and

the outcome of important institution-affiliated person cases.

Regional directors are responsible to ensure that examiners are adequately trained to accomplish the examination objectives and procedures set forth in this handbook section.

References

United States Code (12 USC)

§ 3401 Right to Financial Privacy Act of 1978

United States Code (18 USC)

§ 215	Kickbacks and Bribes
§ 657	Theft, Embezzlement, or Willful Misapplications of Funds
§ 1001	General False Statements
§ 1006	False Entries or Reports
§ 1014	False Statements
§ 1344	Bank Fraud
§ 1517	Obstructing Examination of Financial Institution

Code of Federal Regulations (12 CFR)

Chapter V: Office of Thrift Supervision

Part 215	Regulation O, Loans to Executive Officers, Directors and Principal Shareholders of Member Banks
§ 561.14	Controlling Person
§ 561.18	Director
§ 561.24	Immediate Family
§ 561.35	Officer
§ 563.33	Directors, Officers, and Employees
§ 563.41	Loans and other Transactions with Affiliates and Subsidiaries
§ 563.43	Loans by Savings Associations to their Executive Officers, Directors and Principal Shareholders
§ 563.130	Prohibition on Loan Procurement Fees
§ 563.170(a)	Examinations and Audits
§ 563.180(d)	Suspicious Activity Reports
§ 563.200	Conflicts of Interest

Office of Thrift Supervision Bulletins

RB 20	Proper Investigation of Applicants and Increased Communication Between OTS and other Financial Institution Regulatory Agencies

American Institute of Certified Public Accountants

Statement of Auditing Standards, No. 53

Suspicious Activity Report Form

Fraud and Insider Abuse Program

Examination Objectives

To recognize warning signs of fraud and insider abuse and to take appropriate measures to follow-up on possible instances of such activity.

To determine if the institution's system of internal controls is applicable to officers and directors as well as other employees.

To determine the institution's risk exposure associated with each significant instance of fraud or abuse.

To identify weaknesses in the institution's internal controls through detection and analysis of any patterns of fraud or abuse.

To properly report suspected criminal misconduct uncovered during the examination to appropriate law enforcement authorities.

To determine if the institution is reporting suspected criminal acts as § 563.180(d) requires.

To determine if the institution is properly completing SARs.

To determine if the institution has an adequate program of follow-up with law enforcement authorities regarding SARs it has filed.

Examination Procedures

Wkp.Ref.

Level I

1. Review the adequacy of the institution's policies and procedures with respect to conflicts of interest. Determine whether directors, officers, and employees are required to sign a "Code of Ethics" statement.

2. Discuss the issue of fraud and insider abuse with the internal auditors (and external auditors, if necessary) to assess whether they have any concerns and if they have made reports on suspected fraud to the board or others.

3. Review the results of the procedural and general questionnaires to determine if adequate controls are in place to mitigate fraud. Assess the adequacy of controls that would prevent officers and directors from perpetrating fraud.

Exam Date: ______
Prepared By: ______
Reviewed By: ______
Docket #: ______

Wkp.Ref.

4. Review the results of the various examination programs to determine if problems exist that may be symptomatic of fraud. In cases where fraud may be likely, investigate such problems to determine the cause of the problem (e.g., poor staff training, errors, poor judgment).

5. Review the institution's policies and procedures on reporting suspected criminal activity to law enforcement agencies and its board of directors for compliance with § 563.180(d).

6. Review the institution's SARs, including those that the OTS has filed, to determine if any patterns of criminality exist:
   - Identify multiple SARs on individual suspects, location of violation (i.e., loan center, savings branch, etc.), or type of violation; and
   - Analyze any apparent pattern of fraud or abuse to determine if enhanced internal controls would deter any future abuse.

7. Review all significant SARs, other reports, and patterns to determine if the institution has properly identified and addressed all related financial, operational, and legal risks; e.g., valuation allowances established, internal controls strengthened, etc.

8. Assess the institution's risk of fraud by reviewing the "red flag" warning signals and conditions in the institution. This should be done in conjunction with performing other examination programs and procedures, completing the Fraud Risk Evaluation Form (Appendix A) and, if necessary, by other appropriate means. The EIC should notify his or her supervisor when any individual fraud risk score is rated 4 or 5, and the EIC believes that there is significant potential for insider abuse or fraud.

9. Consult with other examination crew members concerning the need to expand examination scope within certain areas based on an indication of a higher than acceptable risk of fraud within certain areas of the institution.

Exam Date: ____
Prepared By: ____
Reviewed By: ____
Docket #: ____

Wkp.Ref.

10. Notify the regional legal staff of any instances where an attempt was made, in possible violation of criminal statute 18 USC 1517, to obstruct the examination.

11. Obtain a list of deposit and loan accounts of directors, officers, and other affiliated persons. Test check these accounts for preferential rates and, for deposit accounts, appropriate board approval of any overdrafts.

12. Review Level II procedures and perform those necessary to test, support, and present conclusions derived from performance of Level I procedures.

Level II

13. Choose a sample of SARs that the institution has filed. Review each sample SAR to determine its accuracy, completeness, timeliness, and propriety.

14. Should any instance of suspected criminal misconduct be identified during the course of the examination, complete the following procedures:

- Immediately notify the EIC and field manager;
- Consult with appropriate regional office staff or counsel to determine a course of action, including preparation of a SAR; and
- Obtain input from regional office legal staff on Right to Financial Privacy Act issues during the preparation of every SAR.

The following elements are particularly important in preparing a successful SAR:

- A chronology of events;
- A summary of suspected violations;
- A list of key participants or affiliates;

Exam Date: ______
Prepared By: ______
Reviewed By: ______
Docket #: ______

Wkp.Ref.

- A list of potential helpful witnesses; and
- Any supporting documentation.

15. Review the institution's independent audit reports to determine if specific procedures exist to detect fraud, as the American Institute of Certified Public Accountants (AICPA) rules adopted effective January 1, 1989, require.

16. Review the institution's program of follow-up with law enforcement authorities to determine if timely and adequate follow-up is being conducted on significant SARs.

17. For institutions with composite ratings of 4 or 5, determine if, in possible violation of 12 USC 1828(k), the institution (a) has made, or has entered into an agreement to make, any golden parachute or indemnification payments; or (b) has prepaid any salary, or any liability or legal expense, in anticipation of insolvency and with a view towards preventing the proper use or purpose of assets. Notify the regional legal staff if such determination is made.

18. Ensure that the *Objectives* of this Handbook Section have been met. State your findings and conclusions, as well as appropriate recommendations for any necessary corrective measures, on the appropriate work papers and report pages.

Exam Date: ________
Prepared By: ________
Reviewed By: ________
Docket #: ________

Fraud Risk Evaluation Form

Institution Docket No.

Prepared by Date

Approved by Date

Instructions

This form documents the examiner's assessment of the overall level of fraud risk within the institution. Each risk factor should be rated from 1 to 5 with a 1 indicating the lowest level of risk or concern and a 5 indicating the highest level of risk or concern.

An individual factor rated 4 or 5 indicates that the institution is vulnerable to fraud. If fraud conditions or circumstances other than the factors listed below indicate a higher risk than normal, describe them on a separate sheet and attach it to this form. At the end of this form, after all relevant factors are considered, the regulator should make an overall assessment of fraud risk and indicate its effect, if any, on the scope of the examination.

General Factors	Indicator: Lower	Indicator: Higher	Comment or Description *	Risk Factor
Top management operating style	Effective board oversight	Domination of decisions by single person		
Financial reporting	Conservative; accurate	Liberal; questionable; inaccurate		
Management turnover, including senior accounting personnel	Nominal	High		
Emphasis on meeting earnings projections	Little	Very high		
Profitability relative to industry	Adequate and consistent	Inadequate or inconsistent		
Growth within last 3 years	Stable	Rapid		
Financial Condition	Healthy	Distressed		
Oversight of branches and subsidiaries	Centralized/strong oversight	Decentralized/weak oversight		
Indicators of going-concern problems	No serious indications of failure	Failure a distinct possibility		
Disagreements with Auditors/Examiners	None	Many		
Difficult-to-audit transactions or balances	Few	Many		
Misstatements detected in prior audits or examinations	Few and immaterial	Significant or material misstatements		
Examiner relationship with management	Cordial/constructive	Confrontational		
Response to supervision	Very responsive	Unresponsive		
Disclosures of Directors/officers outside interests	Fully disclosed	Not disclosed		
Background checks made on new directors/officers/employees	Checked and verified	Not checked		
Internal auditor restrictions	None: Auditor performs full scope reviews	Auditor works with restriction, or on limited projects		

*Required if factor is rated 4 or 5.

Fraud Risk Evaluation Form
Page Two

General Factor	Indicator: Lower	Indicator: Higher	Comment or Description *	Risk Factor
Internal auditor reporting	Reports to board or audit committee	Reports to management		
Internal audit department turnover	None or minimal	High		
Policies and procedures	Well developed for all areas of operations	None or poorly developed		
	Applied equally to employees and management	Not followed or circumvented by management or key employees		
Unusual/lavish fixed assets	None	Boats, aircraft, artwork, condos, etc.		
Internal controls	Sound system of controls	Material control deficiencies (or controls do not apply to top management)		
Response of management in providing documents to examiners	Documents provided quickly	Long delays in getting documents		
Transactions with other financial institutions	Appropriate for business activities	Large transactions with small out of state banks		
Board reports	Accurate and complete	Inaccurate, inadequate, or incomplete		

Lending Factors	Lower	Higher	Comment or Description *	Risk Factor
Concentrations of credit	No concentrations	High concentrations to individuals or firms		
Loan documentation	Well documented loans and credit quality	Poorly documented loans		
Loan performance tracking	Close review of problem credits by management and board	No (or erroneous) past due or watch list reports		
Borrower financial statements	Borrowers' financial position well documented	No (or unsigned) financial statements		
Loan disbursements	Well documented; approved by independent officer	Questionable ; approved by loan officer		
Corporate loans	Proper endorsements and guarantees	No (or inadequate) endorsements/guarantees		
Resolution of problem loans	Well documented and reasonable	Questionable pay-downs prior to examination or audit		
Overdrafts	Properly approved/ reasonable amounts	Large questionable overdrafts		
Refinancing	Well documented–properly approved	Poorly documented–refinanced by different department		
Document signing	Documents signed in institution or notarized	Documents signed outside of institution		

*Required if factor is rated 4 or 5.

Fraud Risk Evaluation Form
Page Three

Lending Factors	Indicator: Lower	Indicator: Higher	Comment or Description *	Risk Factor
Nominee loans	No nominee loans	Nominee loans made		
Loan terms	Loan size, rates, and maturities appropriate	Loans of unusual size, rates, and maturities		
Evergreen/nonamortizing loans	No evergreen/ nonamortizing loans	Several large evergreen/nonamortizing loans		
Real property sales history	Well documented history of sales/ownership	No history of sales or ownership		
Out of territory loans	No out of territory loans	Many out of territory loans		
Brokered loans	No brokered loans	Loans from brokers		
Adequacy of collateral	Loans adequately collateralized when appropriate	Large loans with unusual/ questionable or no collateral		
Collateral sales history	Collateral sales history is reasonable	Frequent sales/ flipped collateral		
Loans to directors, officers, and employees	Properly underwritten and reported to board	Loans to uncreditworthy directors, officers, or employees		
Lending authority	Large approval limits are vested in board or its committee	Large approval limits given to individuals or to inexperienced/ inappropriate employees		
Third party disbursements	Disbursements made to borrowers	Disbursements made to third parties		
Construction disbursements	Property inspected by independent institution officer prior to disbursement	No (or poorly documented) inspections; no rotation of inspectors		
Asset performance	Very low percentage of delinquent/nonperforming/ classified assets	High percentage of delinquent/ nonperforming/classified assets		
Independent loan review function	Effective, independent loan review function	No (or ineffective) loan review		
Speculative, high-risk lending activities	Institution has conservative lending practices	Institution engaged in high-risk lending activities		

*Required if factor is rated 4 or 5.

Consideration of the risk factors identified above has caused the following modifications of the examination scope in the following areas:

Introduction

Complete and accurate records and reports are essential for a savings association's board of directors and officers in making informed decisions and in clearly understanding and supporting transactions. The savings association must also have policies, procedures, and controls to ensure that financial reports and records are properly maintained. Inaccurate, incomplete, or unreliable information jeopardizes the safety and soundness of the savings association in that unidentified or undisclosed problems could prevent or delay corrective action and undermine the viability of the savings association.

The Office of Thrift Supervision (OTS) must have reliable data so it can assess and monitor a savings association's financial condition and activities. Review of a savings association's books and records, internal reports, and reports to the regional office is necessary if OTS is to rely on the savings association's records for information throughout the examination, supervision, and monitoring processes.

The focus of a regulator's review should be directed at assessing the accuracy and adequacy of records and reports. Accuracy is essential so that the savings association's financial condition can be properly evaluated and monitored. This involves obtaining satisfactory explanations of all material variances, trends, or other items and assessing the reasonableness of financial records. In addition, the savings association's policies and procedures must be evaluated for relevance and sufficiency.

Institution records from which data may be gathered include, but are not limited to, the general ledger, subsidiary ledgers, journals, vouchers, and schedules. An inordinate amount of time should not be spent verifying a minor account if the small balance does not consist of large, offsetting transactions. Minor errors or omissions that are discovered should be reported to management. Some reports useful in the review process are the variety of internal reports submitted to management and the board of directors, the Thrift Financial Report (TFR), independent and internal audit reports, and, when applicable, holding company annual reports and Securities and Exchange Commission (SEC) 10Q and 10K filings.

Additional information about the savings association's records and reports is also generated from regional office monitoring activities and the review of work performed by independent and internal auditors who attest to the integrity of the savings association's books and records.

Savings associations should maintain internal systems and procedures to ensure that reporting is done according to appropriate regulatory requirements. Clear, concise, orderly records should support the compilation of various data. Proper documentation provides not only a logical tie between financial report data and the savings association's records, but also facilitates accurate reporting and verification.

Books and Records

The savings association should have a chart of accounts describing the nature and general content of each general ledger account, or should be encouraged to develop one. The chart of accounts will not only aid in the regulator's review, but will also encourage consistency and continuity in the savings association's accounting department.

The regulator should obtain the general ledger and any appropriate subordinate organization (e.g., service corporation, operating subsidiary or lower-tier entity as defined in Part 559) ledgers and review the individual asset, liability, capital, income, and expense accounts. These accounts should be reviewed for their history, recent activity, balance, and propriety. Any extraordinary items or items that are not self-explanatory

should be investigated. Catch-all accounts (i.e., other assets, other liabilities, miscellaneous, or suspense accounts) should be reviewed and reconciled. If errors or omissions are disclosed, it should be determined whether they result from inadequate policies, deficient procedures, or practices not in accordance with the savings association's policies and procedures.

During the review of the general ledger and subsidiary ledgers, it may be appropriate to determine that account contents are accurately reflected by the account title. A title describing an account may not always represent its content. The determination that an account contains the proper items and has a true balance helps to ensure that all line items are being recorded properly on the TFR. If reclassifications are necessary, management should be advised, and the regulator must follow up to see that the re-classifications are done correctly.

Thrift Financial Reports

Each insured savings association is required to file a TFR with the Financial Reporting Division (FRD) office in Dallas on the 30th day following the end of each calendar quarter. Schedule CMR (Consolidated Maturity/Rate) is due 45 days following the end of each calendar quarter. "Clean" data are typically available within 45 days following the filing of the reports.

OTS uses the TFR to collect detailed financial information in a consistent format on all regulated savings associations, to collect uniform information on industry activities, and to facilitate supervision by OTS. The TFR discloses the savings association's financial condition, the results of its operations, and other supplemental data. Information from this report is used as the basis for OTS' Thrift Time Series that, in turn, produces reports such as the Uniform Thrift Performance Report (UTPR) and the Thrift Monitoring System (TMS), as well as the Report of Examination (ROE) financial pages. Regulators may access the Time Series reports through the Thrift Information Management (TIMS) System.

As of June 1996, savings associations must report the detailed financial sections of the TFR on a consolidated basis. Examiners should review the TFRs to ensure that all consolidations are being performed properly, and that the savings associations are following revised TFR instructions in completing their reports.

In addition, various changes to data field captions reflect new terminology and definitions effected by the final Subsidiaries and Equity Investment Rule, effective January 1, 1997. Other changes reflect the expiration of grandfathering provisions for certain “nonincludable” equity and subsidiary investments.

To collect detailed information relating to an institution's interest rate risk, OTS uses the Consolidated Maturity and Rate Information on Schedule CMR. A savings association must file Schedule CMR if it meets one of the following criteria:

- Total assets are in excess of $300 million.
- The risk-based capital ratio is less than 12 percent.
- The OTS Regional Director directs the institution to file Schedule CMR.

Additionally, many savings associations that are not required to file Schedule CMR do so voluntarily. Savings associations that file Schedule CMR voluntarily are expected to conform to the same filing deadlines and requirements for accuracy as those associations that are required to file.

The Competitive Equality Banking Act of 1987 (CEBA) requires savings associations to file financial reports on the basis of generally accepted accounting principles (GAAP).

All insured savings associations are required to file the TFR electronically with the FRD. Most savings associations use personal computer software programs to file the TFR electronically, while a few savings associations prepare the TFR, then rely on a third party to file it electronically. The electronic filing software may interface with the general ledger to create an electronic relationship between the general ledger and the TFR line items. This interface automates the preparation and filing of the TFR and shortens the learning curve when there is a change in the institution's

report preparer. The software also contains an editing function that helps reduce reporting errors. It is important to note that the regulators must thoroughly review the institution's books and records and should not rely on the interface reporting capability.

The regulator should review the content of the most recent quarterly TFRs for accuracy. Line items shown on the reports should be reconciled to the general ledger, the subsidiary ledgers, and other appropriate sources, such as loan registers. The TFR Instruction Manual provides instructions on the content of TFR line items. The TFR Instruction Manual explains, line by line and category by category, what information is allowable for placement in specific TFR line numbers. Revisions to the TFR Instruction Manual are made quarterly and the form is revised annually. Both industry and regulatory personnel must have up-to-date instructions for accurate classifications and reconciliations.

If any errors or omissions are discovered during the TFR review, the regulator should determine whether they are caused by policies, procedures, or practices that are deficient or inadequate. Significant adjustments (and their causal factors) should be explained and documented in the ROE. A significant adjustment includes any one of the following:

- Failure of a capital requirement.
- Change in the institution's prompt corrective action (PCA) category.
- Change in a component rating.
- Significant for regulatory reporting purposes.

Generally, examiners should not require that the institution amend a prior period TFR unless the adjustment is significant. If the adjustments are not significant, the examiner should direct the institution to show the adjustments on the next TFR scheduled to be filed.

Errors or omissions in one schedule usually have repercussions within other schedules. As a result, when an error in one schedule is discovered and corrected, other schedules affected by the error must also be amended. For example, if a credit in Schedule SC, Statement of Condition, is initially classified as a mortgage loan and is subsequently reclassified as a commercial loan, then the appropriate changes in Schedule CMR, Consolidated Maturity and Rate, must be made. Errors discovered in the TFRs are to be disclosed on the proper page(s) in the ROE, including financial report pages, where necessary.

The accuracy of the TFRs is extremely important, because information contained in the reports is used to monitor savings associations between examinations. If inaccurate data are submitted, changing patterns of behavior or deteriorating trends may not be detected in an individual savings association. If compounded, a distorted picture of the industry condition can result.

Internal Reports to the Board of Directors

Boards of directors have extensive fiduciary responsibilities in guiding the activities of their savings associations. Creditors, including depositors, have the right to expect that a savings association's officers and board of directors use safe, sound, and ethical practices.

The regulator should ascertain whether any reports are presented to the board of directors in addition to the required reports such as the TFR. The content of any additional reports should also be reviewed for accuracy and adequacy. Regulators should also determine whether the submission of inaccurate or inadequate reports is the result of an intentional act on the part of management. Reports to the board of directors should include, at a minimum, a significant financial activity summary and documentation detailing loans granted, delinquencies, the status of ongoing projects (loans) previously approved, the status of any real estate workouts, liquidity reports, profit and loss statements with yearly and year-to-date comparisons, foreclosure status reports, classified asset summaries, and other salient trial balance data.

If any material errors or omissions are discovered in these reports, the regulator should determine and explain the causal factors.

Monitoring Reports

Monitoring is performed by the regional offices on an ongoing basis. Depending on regional office policy, reports that are generated from information gleaned during the surveillance process may be sent to the field for the regulator's use. If monitoring reports are sent to an examination, they should be reviewed for incipient adverse trends noted, material deviations from one period to another, extraordinary developments, or other matters of concern.

The regulator should follow up on all items deemed worthy of further investigation and obtain a satisfactory response from management, explaining specific questionable matters.

Books and Records

Section 563.170 requires that savings associations establish and maintain an accurate and complete record of all business it transacts. The savings association must establish and maintain such other records as required by applicable statutes or regulations. The documents, files, and other material or property comprising these records must be available for examination and audit.

If books and records are so incomplete that the examination is made impossible, or if they do not provide complete and accurate details on all business transactions, supervisory directives for correction should be issued immediately. The caseload manager (or equivalent) should promptly meet with the savings association's board of directors, discuss the problem, and require expeditious corrective action via a formal supervisory agreement. If correction of the deficiency is not made, the matter should be referred by the caseload manager (or equivalent) to the OTS division of Chief Counsel for the initiation of cease-and-desist proceedings.

Regulators should be particularly alert to violations of § 563.170, as the presence of incomplete and inaccurate records historically shows evidence of severely deficient operating standards and a resultantly deteriorating financial condition.

References

Code of Federal Regulations (12 CFR)

§ 552.11	Books and Records
§ 560.160	Asset Classification
§ 560.172	Re-evaluation of Real Estate Owned
§ 562	Regulatory Reporting Standards
§ 563.170	Examinations and Audits; Appraisals; Establishment and Maintenance of Records
§ 563.173	Forward Commitments
§ 563.174	Futures Transactions
§ 563.175	Financial Options Transactions

Other References

Office of Thrift Supervision, *Thrift Financial Report Instruction Manual*

U.S. League of Savings Institutions, *Standard Accounting Manual*

Financial Records and Reports
Program

Examination Objectives

To determine and evaluate the savings association's policies, procedures, and controls for maintaining adequate and accurate reports and records as considered appropriate by standard accounting guidelines and as required by applicable regulations.

To determine the accuracy of the quarterly TFRs filed with OTS and to ascertain whether or not the savings association is required to file any amended reports.

To determine the accuracy and adequacy of the savings association's internal financial records and reports.

Examination Procedures

Wkp.Ref.

Level I

1. Review the previous examination report, any off-site monitoring reports, management letter, and Preliminary Examination Response Kit (PERK) information, specifically the internal control questionnaire and the applicable financial data.

2. Review and discuss with management the savings association's policies, procedures, and controls relating to the maintenance of financial records and reports. Include in your discussion the training and support given to the report preparer(s) of the TFR.

3. Review the most recent quarterly TFRs for accuracy by ensuring that the reports are prepared in accordance with TFR instructions. Explain any material reporting errors identified in the examination work papers and in the ROE and discuss them with management. (Determine, based on the guidance in the general instructions section of the TFR Instructions, whether an amended report is necessary.)

4. Review internal reports provided to management and the board of directors and compare with the TFRs. Identify and explain material variances. Coordinate this review process with the regulator involved in the review of management. If appropriate, determine the frequency and adequacy of the internal reports in relation to the complexity and level of the savings association's operations.

Exam Date:
Prepared By:
Reviewed By:
Docket #:

Wkp.Ref.

5. Review Level II procedures and perform those necessary to test, support, and present conclusions derived from performance of Level I procedures.

Level II

6. Review and reconcile TFR line items to the general ledger, appropriate subsidiary ledger, and any other financial records of the savings association. Identify unusual or unexplained activity and material variances. Specifically review non-descriptive accounts such as "other assets" or "other expenses."

7. Ensure that the *Objectives* of this Handbook Section have been met. State your findings and conclusions, as well as appropriate recommendations for any necessary corrective measures, on the appropriate work papers and report pages.

Exam Date: ________
Prepared By: ________
Reviewed By: ________
Docket #: ________

Introduction

All phases of the regulatory process, from off-site monitoring between examinations to the preparation of the Report of Examination (ROE), involve some form of operational analysis. Operational analysis is the interpretation of financial data through careful and questioning study. An analysis of operations should result in a comprehensive review and evaluation of the savings association's past, current, and prospective earnings.

Earnings are essential to the savings association's continued viability. A savings association's earnings determine its ability to absorb losses, ensure capital adequacy, and generate a reasonable return. The savings association's operations should be evaluated for stability, trend, and level of earnings. Additional factors such as credit risk and interest rate risk must also be analyzed to thoroughly evaluate the savings association's operational structure. To maintain the savings association's viability and to minimize the risks to the Savings Association Insurance Fund (SAIF), it is essential that problems or potential problems be recognized and reported and that corrective action be taken. This Handbook Section provides guidelines for reviewing and evaluating the financial operations of a savings association.

The review of the savings association's operations and financial condition is a continuing process. The pre-examination analysis and scoping process identifies existing or potential problem areas requiring attention. A comprehensive on-site analysis substantiates and assesses current and prospective earnings. A well-performed analysis not only provides an understanding of the savings association's operations, but also identifies matters of existing or potential concern. Thus, the analysis can be used to facilitate corrective action that may avert problems or prevent existing problems from worsening.

The regulator should maintain a sense of balance when analyzing financial statements, avoiding undue precision or spending excessive time on immaterial amounts. Most importantly, the regulator should constantly maintain a sense of the examination objectives. Since earnings reflect the savings association's overall financial condition, when examining a savings association, the regulator must also be aware of the extent of existing or potential problem areas outside the purview of operations analysis. As such, the regulator must maintain a constant flow of communication with individuals working on other examination areas in order to effect a cohesive and comprehensive review.

Finally, reporting errors, incomplete information, and deficient accounting procedures may hinder or prevent an accurate evaluation of the savings association's operations. A thorough analysis depends on accurate, reliable information and is an extension of reviews of the savings association's financial records and reports (Handbook Section 410) and accounting standards.

Information presented in this Section will enable examiners to do the following:

- Establish the scope of the financial analysis aspect of the examination. Specific guidance on establishing the scope of the examination is provided in Section 060, Examination Strategy, Scoping, and Management.
- Identify practices that are potentially unsafe and unsound and formulate a regulatory response.
- Assess the institution’s operations and strategies.
- Identify problem areas disclosed by the financial records.
- Obtain satisfactory explanations for all material variances of financial data from prior periods and budgeted amounts.

Information Sources

The basic sources of information for performing an analysis of the operations of a savings association include all of the following items:

- Thrift Financial Reports (TFRs) filed quarterly with the Office of Thrift Supervision (OTS).
- Financial pages of the previous and current ROE.
- National Financial Monitoring Reports including:
  - — Uniform Thrift Performance Report (UTPR),
  - — Interest Rate Risk Exposure Report (IRRER); and
  - — Thrift Monitoring System (TMS).
- Additional monitoring reports developed at the regional office, if any.
- Independent and internal audit reports.
- Other internal reports to the board of directors, including budget, business plan, earnings reports such as yield/cost analysis, and investment committee reports.
- For publicly traded stock savings associations, 10Q and 10K reports filed quarterly and annually.
- Board minutes.

National Financial Monitoring Reports

The OTS makes available to its staff a variety of reports accessible through its data base systems that serve as the basis for its financial monitoring and analysis of savings associations. These reports are available for individual associations or, in some cases, groups of associations, and provide uniformity in the presentation of financial data for monitoring and analytical purposes. The following is a brief summary of the primary national monitoring reports available to OTS staff:

Uniform Thrift Performance Report. The UTPR is an analytical tool created for monitoring the financial condition of savings associations. The UTPR is produced every quarter, based on quarterly TFR financial data submitted to the OTS by each regulated association. Savings associations are grouped into seven peer groups based on asset size, and peer median data and the association's percentile ranking within the peer group is provided in the UTPR on virtually all items reported on the TFR. The format of the UTPR was influenced by the analytical tool of the banking regulators, the Uniform Bank Performance Report. The UTPR sections are listed in the "References" section at the end of this Handbook Section, providing a comprehensive financial overview of virtually all major areas of each association's financial condition, as well as the association's relative standing of key financial performance factors measured against peer median levels.

The UTPR presents income information for the current quarter, the prior quarter, the year-to-date, and the two previous years. The UTPR is also available in a format that details the previous five quarters. This provides the opportunity to review the historical condition of the savings association and to analyze the more recent quarterly trends in performance. The OTS provides one copy of the report to each regulated association quarterly.

Interest Rate Risk Exposure Report. The IRRER lists OTS's estimates of the associations' Net Portfolio Value (NPV) in nine interest rate scenarios and provides ratios that examiners use to assess an institution's interest rate risk and compare it to that of other institutions. The NPV is derived from OTS's Interest Rate Risk Model, using information derived from quarterly filings of Schedule CMR of the TFR. The model uses certain assumptions, and generates the present values for a savings association's asset, liabilities, and off-balance sheet items. See Thrift Activities Handbook Section 410, Financial Records and Reports, and Thrift Activities Handbook Section 650, Interest Rate Risk Management, for additional information.

Thrift Monitoring System. The TMS was developed to provide staff at various levels throughout OTS with the capability of readily viewing selected examination and financial information on savings associations, either on an individual or group ba-

sis. A primary attribute of TMS is the flexibility the system provides the user in creating customized analytical reports on groups of associations. The source of the financial information for TMS is the UTPR. TMS presently contains three distinct functions - individual association reports, group query reports and fixed reports.

The TMS individual association report function allows the user to access a summary report on a single association, which contains four quarters of financial information relating to capital adequacy, asset quality, valuation allowances, earnings and interest rate risk, as well as selected examination rating information. In addition to such summary information, the report contains a second page which presents a condensed four-quarter balance sheet and operating statement, shown both on a dollar volume and percentage of assets basis. The individual association report is a convenient briefing tool for quickly assessing an association's overall financial condition, as well as for identifying developing financial trends.

The TMS group query report function allows the user to select many examination and financial information items for inclusion in customized reports, and to sort selected information using any selected item as a sort criteria. This function is one of the most powerful aspects of TMS, allowing for a virtually limitless combination of options for creating customized reports to analyze examination and financial information on groups of associations.

The TMS fixed report function allows the user to establish customized threshold tests for analyzing growth and concentrations of assets in non-traditional asset categories among groups of associations in order to identify associations exceeding growth and/or concentration threshold levels in such categories. This function is particularly useful in providing early identification of associations that are rapidly expanding in high-risk areas, thereby allowing supervisory staff to respond in a timely fashion to potential adverse trends within a particular association or group of associations.

The aforementioned TMS reports are incorporated within the "Financial: Reports and Query" section of the Thrift Information Management (TIM) interface on the OTS Main Menu. A task force, comprised of regional and Washington Office representatives, regularly reviews existing TMS reports to assess the need for possible updates and works to develop new TMS reports as needed. The regulator should be familiar with the instructions regarding the correlation of line items on the aforementioned reports with the line items on the TFR. For additional information and instructions refer to the Thrift Financial Report Instruction Manual, the OTS Net Portfolio Model Manual and TMS online help screens, or contact your regional TMS representative.

Off-Site Monitoring

Monitoring of savings associations with high-risk profiles will be more extensive and more frequent than that of non-high-risk associations. High-risk associations include those that fail the minimum capital requirements and those that have a higher overall risk profile based on such factors as asset size, asset quality, asset composition, operating results, interest rate risk, and others. For non-high-risk associations, it may be sufficient to limit the review to compliance and summary monitoring reports on a quarterly basis.

Each regional office has an individual or department to coordinate the financial monitoring effort for the region. This department undertakes a quarterly review of the performance of each association. This includes a review of the Quarterly Compliance Monitoring Report and any additional monitoring reports necessary to assess changes in the institution's financial condition. Problems or risks identified through monitoring should be sent to other regional staff as appropriate, including senior management. The department must maintain written documentation of the results of off-site monitoring. Corrective action should be initiated when appropriate, and may range from a telephone call or letter to the association, a meeting with management, recommendation for an examination, or, in the case of serious problems, formal enforcement action.

Regulators should incorporate in the associations' regulatory plans, as necessary, a discussion of the monitoring findings and any corrective action recommended or taken as a result. Significant actions, including the identification of material concerns and recommendations for action, should be documented in the Regulatory Plan. The documentation should provide an understanding of the savings

association's operations and performance and should identify matters of existing or potential concern. When appropriate, reference should be made to all violations of law, regulation, policy or supervisory directives.

Off-Site Monitoring Scope

In order to identify weaknesses or deficiencies within associations and to detect all material financial developments at the earliest possible time, periodic monitoring and analysis should focus on the following items:

- Capital adequacy
- Asset quality and composition
- Loan and investment portfolio yields
- Liability mix and rates
- Earnings trend, composition, and stability
- Net interest margin
- Provision for loss on interest-bearing assets
- Operating expenses
- Net operating income
- Noninterest income and expense components
- Net income
- Change in retained earnings
- Adequacy of valuation allowances
- Activity of significant subsidiaries
- Regulatory compliance
- Performance relative to adopted business plans
- Accuracy of reports to OTS

Components of Earnings

In order to obtain a complete and accurate understanding of a savings association's operations, it is essential to know the operating strategy of the institution. The operating strategy is identified in the regulatory plan or can be identified by determining revenue and funding sources. Earnings components include such items as interest income and expense, noninterest income and expense, and core income. Each of these components are described in greater detail below:

Interest Income: Interest income consists of interest earned on loans, investment securities, deposits, and mortgage pool securities. Interest income is the most important income component of core income for non-mortgage bankers. Mortgage loan servicing fees and other fees and charges are the most important income component of core income for institutions that emphasize mortgage banking.

Interest Expense: Interest expense is the interest that the savings association pays on deposits, subordinated debt, collateralized securities, FHLBank advances, and other borrowed money.

Net Interest Income: Interest margin is interest income minus interest expense. The interest margin is the primary source of income for a savings institution and a key indicator of earnings for institutions that do not engage in mortgage banking. However, its usefulness is limited because it makes no adjustment for assets that earn no interest or liabilities that bear no explicit interest cost, i.e., an institution's net interest position, described below.

Net Interest Margin: Net interest income is called the net interest margin (NIM) when expressed as an annualized percent of average total assets. An institution can maximize its net interest margin by effectively allocating resources among earning and nonearning assets, maintaining low levels of nonperforming assets, providing adequate funding through the lowest-cost mix of funds, and maintaining a strong capital position. In a volatile interest rate environment, large changes in NIM are frequently associated with high interest rate risk.

Interest-Earning Assets: Interest-earning assets (IEAs) consist of investment securities, deposits in other institutions, mortgage-backed securities, mortgage loans, and nonmortgage loans less non-IEA components. Non-IEA components include intangible assets such as goodwill, as well as nonaccrual loans, real estate owned and real estate for investment.

Interest-Costing Liabilities: Interest-costing liabilities (ICLs) consist of deposits, FHLBank advances, subordinated debentures, mortgage collateralized securities, other borrowings, any non-ICL components deducted from these categories, and the combined total. The level of ICL is influenced by the level of equity capital. High capital levels will lower ICL as a percentage of total assets.

Net Interest Position: A net IEA position, IEAs less ICLs, is called a net interest position (NIP). A shrinking NIP indicates a weakening balance sheet, and a greater reliance on margins on products and investments for continued profitability. A NIP that is negative is considered a more serious weakness since it indicates that interest-costing liabilities are financing non-interest-earning assets.

Net Interest Spread: Net interest spread is the weighted interest yield on average earning assets less the weighted interest rate paid on average interest paying liabilities.

Noninterest Income: Included in noninterest income are loan origination fees, loan servicing fees, late fees, hedging gains and service corporation profits. This item may also contain non- recurring sources of income such as gains on the sale of assets, income from REO operations and other income sources of earnings that are generally unpredictable and unstable.

Noninterest Expense: The major component of noninterest expense is salaries and compensation. Also included in this category are rent, depreciation, utilities, marketing, assessments, professional fees and amortization of goodwill. Controlling costs is a critical management function. A reduction in non-interest expenses will increase core earnings, net income and market value.

Provision for Loan Losses: Weak or deteriorating credit quality can result in the need for higher provision expenses, which can adversely effect the institution's earnings. See Thrift Activities Handbook Section 261, Adequacy of Valuation Allowances, for examination procedures on evaluating the adequacy of the institution's valuation allowances.

Core Income: Core income is limited to spread income and other sources of income that may be considered recurring and reasonably predictable. Core income is defined as net interest margin plus fees earned from loan servicing and other sources, minus general and administrative expenses and goodwill amortization. While serving as a useful analytical tool, it is important to realize that even core income can be misleading. For example, if spread income stems from an interest rate risk gamble, or if fee income is derived from non-recurring sources, core income will not be sustainable. Therefore, it is important to know what percentage of core income is made up of interest income.

Operating Income: For financial institutions, operating income is net income before taxes and extraordinary income. Operating income is adjusted to add back the amount of goodwill and other "disallowed" intangible assets that are amortized during the period. For nonfinancial institutions, operating income is also called earnings before interest expense and taxes. For financial institutions, however, interest expense is an integral part of normal operations, not just the financing of normal operations.

Return on Assets and Equity

Return on Assets: Return on assets is net income divided by average assets. Traditionally, return on assets is the primary measure of an institution's profitability. Regulators should review the level, trend, and peer comparison of this ratio since it is a critical determinant of long-term viability.

Return on Equity: Return on equity is net income divided by average equity. The return on equity ratio is used by investors and capital markets to determine investment options. Average equity refers to the average of total equity capital: perpetual preferred, common stock, paid in excess of par, retained earnings, and unrealized marketable securities losses.

See Appendix A for the derivation of the return on assets and return on equity ratios.

Evaluation of Earnings

To make a thorough analysis of earnings, an aggregate evaluation of the components should be

performed in relation to three key aspects of earnings—stability, trend, and level:

Stability: The quality, composition, and constancy of income and expense flows relative to internal factors such as credit risks, interest rate risks, or accounting practices, and external factors such as general economic or competitive forces.

A savings association's income stability depends on proper management of its sources of income and expense and the influence of internal and external factors on those sources. Recurring income sources, such as net interest on loans or investment portfolios are usually preferable to nonrecurring income sources, such as income derived from the sale of assets. A savings association's future viability could be severely affected if it relies too heavily on nonrecurring sources of income.

Trend: The general direction of the savings association's earnings relative to previous time periods.

Evaluating previous time periods should encourage the regulator to identify and investigate both adverse and positive trends within the savings association's earnings.

Level of Earnings: The measure of earnings relative to internal factors such as capital position, credit risk, and interest rate risk.

A comparison to peer groups should be performed to determine material variances. The standard peer groups based solely on asset size or the more refined peer groups based on operational and geographical characteristics as well as asset size may be used.

Additional areas must be reviewed to ensure a comprehensive analysis, since other risks may materially affect earnings. Therefore, the regulator should review the findings relating to risk analysis that are covered under the Asset Quality and Sensitivity to Market Risk sections of the Thrift Activities Handbook.

Analytical Techniques

Operations analysis involves a review of financial data on a period-to-period basis in an effort to substantiate the reasonableness of financial performance without requiring a systematic review of transactions. (This does not preclude a review of transactions, if appropriate.) Through understanding the components of operations analysis the examiner is able to apply various analytical techniques to assess the financial condition of the institution. Savings association and peer group ratios are also used to identify discrepancies.

Examiners must be aware of the weaknesses inherent in the approaches employed in the operations analysis. First, apparent variances can be caused by more than one component of the financial data being analyzed. Second, operations analysis is historical in that it is performed on financial data that describe the institution at a prior point in time. Finally, operations analysis may not answer all questions, but it can raise additional ones.

For example, a common ratio used to evaluate the efficiency of an institution's operations is the level of operating expenses expressed as a percentage of operating income. An examiner, using this ratio, may conclude that operating expenses are higher than the peer group and that they have been increasing during the periods under review. The real concern, however, is not that a variance exists, but why.

Operations analysis requires an awareness of the interrelationships of the data used in the ratio. An increase in the operating expense to operating income ratio may be due to an increase in actual operating expenses. The variance may also be caused by a decline in revenues that were the result of shrinking assets without a corresponding decline in the fixed operating expenses of the company or by many other reasons. Examination procedures that investigate operating expenses would not explain why the variance occurred if the ratio increased due to a decline in revenues. By understanding the interrelationships of the data, the examiner is able to focus the examination to answer the questions raised by the variance.

All financial analytical techniques are combinations or adaptations of four basic approaches used to evaluate the savings association's operations: structural, trend, ratio, and comparative analyses. The following discussion describes the fundamental considerations of each approach.

Structural Analysis

Structural analysis is a static analysis, where the components of a financial statement are viewed in relation to their whole as of a specific date. This technique can provide insight regarding the relative size of a particular line item in comparison to the other components of the financial statement. Structural analysis can also be used to determine whether a particular line item is increasing or decreasing in relation to the other components. For example, total assets on a statement of condition and gross revenues on a statement of operations are designated as the base figures representing 100 percent. Each line item within a statement is expressed as a percentage of these base figures. An example of a structural analysis of a statement of condition follows:

Statement of Condition
12/31/XX

Assets			
Cash	$	12,500	0.66%
Marketable Securities		210,000	11.16%
Mortgage Loans		1,275,000	67.75%
Fixed Assets		325,000	17.27%
Prepaid Expenses		50,000	2.66%
Other Assets		9,500	0.50%
Total Assets	$	1,882,000	100.00%
Liabilities			
Accounts Payable		25,500	1.35%
Notes Payable		500,000	26.57%
Deposits		1,100,000	58.45%
Other Liabilities		74,500	3.96%
Total Liabilities		1,700,000	90.33%
Stockholders Equity			
Capital Stock		100,000	5.31%
Retained Earnings		82,000	4.36%
Total Stockholders' Equity		182,000	9.67%
Total Liabilities and Stockholders' Equity		1,882,000	100.00%

As shown, each line item of the statement of condition is expressed as a percentage of total assets.

Trend Analysis

Trend analysis is the technique of comparing ratios or a financial statement line item to itself over several periods of time. The comparison should be made using both the dollar variance and the percentage variance methods. The dollar variance method involves calculating the dollar difference in the line item between the various periods. The percentage variance method is based on the percentage change in the line item for the periods.

It is important to use both methods. The percentage variance may not readily disclose large dollar changes in line items if the base is also large. The dollar variance method may not disclose large percentage changes in line items. For example, a line item variance could be under 5 percent but still require investigation if the amount of the change is $5 million. Conversely, a $20,000 change in a line item may not seem to be material. If it represents a 35 percent change from a prior period, however, it may also warrant investigation.

There are three primary components to performing a good trend analysis:

- Three or more accounting periods for analysis.
- Sound judgment in determining the materiality of variances.
- Volume-to-rate variance analysis.

The use of three or more accounting periods provides an understanding of what will likely be normal changes in the data. By comparing variances in the data over several accounting periods, patterns of change emerge that can be used to identify any unusual changes in current periods. Another benefit is that a regulator can identify a change that may warrant investigation.

The accounting periods reviewed may include annual, quarterly or monthly data depending on the purpose of the review. Quarterly or annual data in some instances can mask any month-to-month cash flow problems that an institution is experiencing. Association records must be used to review monthly figures as OTS no longer requires associations to file a monthly report.

The use of sound judgment in assessing the materiality of a variance in the data cannot be overstressed. Regulators must use professional skepticism when evaluating the change, but must also remember that business is dynamic and change is inevitable. Only those variances that are

not reasonable or are of sufficient magnitude to justify additional examination procedures should be pursued. Such variances must be evaluated in relation to the overall financial position of the institution. A number of factors may account for variances including cyclical and seasonal factors, changes in accounting practices, and changes in operating strategies. Positive or adverse trends should be identified and explained, so that the findings support the overall evaluation.

Volume-to-rate variance analysis identifies how much of a change in an income statement line item is due to a change in volume and how much is due to a change in rate. This analysis is especially beneficial in evaluating changes in revenues and expenses associated with interest-bearing assets and costing liabilities. Further, this technique allows examiners to identify offsetting variances that may otherwise go undetected. For example, a large increase in volume may be offset by a substantial decline in rate that results in little change in the financial statement line item, although significant changes are occurring. Through this analysis, the scope of the examination can be narrowed to focus on the cause of the change in the data. Table 1 below illustrates the technique and its benefits.

Numerous ratios can be used in a trend analysis. Typical balance sheet ratios include real estate owned to total assets, equity capital to total liabilities, delinquent mortgage loans to net mortgage loans, and subordinate organization investment to total assets. (See Appendix B for a discussion of the latter.) Typical operating ratios include gross income to average assets, operating expense to average assets, net income to average assets, and net interest margin to average earning assets or average costing liabilities.

Ratio Analysis

Ratio analysis is the method of comparing a figure or group of figures in a set of financial statements to another figure or group of figures within the same financial statements. It is predicated on the assumption that there are meaningful relationships between different asset, liability, net worth, income, and expense accounts.

Table 1

Volume-to-Rate Variance Analysis

	19X1	19X2	Variances
Yield from Mortgage Loans	$400,000	$450,000	$50,000
Average Yield	10.0%	9.0%	
Average Amount of Mortgage Loans Outstanding	$4,000,000	$5,000,000	

Volume Variance = variance in base times the first year rate
= ($5,000,000-4,000,000) x 10%
= $1,000,000 x.10
= $100,000

Rate Variance = variance in rate times second year base
= (9.0%-10.0%x$5,000,000)
= -1.0% x $5,000,000
= .01 x $5,000,000
= -$50,000

Volume = $100,000
Rate Variance = -50,000
Net Change in Yield = $50,000

Numerous standardized ratios have been developed for analyzing financial statements. Although it is beyond the scope of this Handbook to provide a listing of all the ratios that may be used to analyze financial statements, the more commonly used ratios include:

- Current Assets divided by Current Liabilities (Current Ratio)
- Net Income divided by Average Assets
- Operating Expenses divided by Average Assets

These ratios can be found in nearly all intermediate accounting or financial analysis texts. In addition, there are several ratios that have been developed specifically to analyze financial institutions.

Most traditional lending institutions strive to maintain a relatively stable spread between asset yields and liability costs. Net interest income is a function of interest-earning asset (IEA) yields, interest-costing liability (ICL) costs, and the IEA/ICL relationship.

When IEA/ICL exceeds 100 percent, net interest income is bolstered by the excess of earning assets,

and the effect of interest rate volatility on earnings is also somewhat mitigated. As the IEA/ICL ratio falls below 100 percent net interest income is obviously impaired. As the ratio falls below 100 percent, net interest income becomes less and less likely to cover operating expenses.

In general, the NIM will be greater than the spread if IEA exceeds ICL and less than the spread if ICL exceeds IEA. The difference between the yield on earning assets and the cost of funds provides the net interest spread.

Ratios should be compared against historical (trend analysis) and peer group standards (comparative analysis) to identify unusual items.

Comparative Analysis

Comparative analysis is the method of comparing the components of a financial statement with those of a savings association of a similar size or other similar characteristics. Ratio analysis may also be used to compare ratios from one firm with that of industry standards or peer group ratios.

The UTPR provides the savings association's own ratio, the median value of that ratio for the savings association's peer group, and the percentile ranking of the savings association's ratio value within the peer group. This enables measurement of the relative performance of an institution to a peer group of savings associations, as well as measurement of the relative performance of the savings association and its peer group over time.

The UTPR constructs seven peer groups for comparative purposes. The first six groups are based on asset size. The seventh group contains institutions whose consolidated equity capital is less than zero or are in conservatorship.

Group 1	Assets less than $50 million
Group 2	Assets between $50 million and $100 million
Group 3	Assets between $100 million and $300 million
Group 4	Assets between $300 million and $1 billion
Group 5	Assets between $1 billion and $5 billion
Group 6	Assets over $5 billion

All peer groups are defined on a regional geographic basis, with the exception of Group 6. This peer group of the largest institutions is calculated on a national basis to allow for a larger sample size than would be available in any one region.

Beginning with the June 1996 quarter, the UTPR is presented on a consolidated basis. For periods prior to the June 1996 quarter, most of the detailed financial data presented in the UTPR is on an unconsolidated basis unless otherwise noted. Regulators using the UTPR for monitoring and analytical purposes should be aware of this issue and its potential effect on certain financial ratios within the UTPR.

Comparative analysis typically uses ratios such as net income to average assets, operating expense to average assets, or cost of funds to average costing liabilities.

Future Operating Results

Once historic trends of the primary revenues are reviewed and the stability of operating results identified, an evaluation of the probable future operating results can be made.

A key tool in making this evaluation is the budget prepared by management. The examiner should obtain a copy of the budget including projected revenues, expenses, and underlying assumptions. An evaluation of the budget would include all of the following comparisons:

- Projections with prior period results.
- Projections with actual results for the same period.
- Projected return on assets and return on equity with prior period results.
- Projected yields for major earning assets with prior period yields.
- Projected operating expenses as a percentage of assets and revenues with prior period data.

- Projected goals and assumptions with trends in market conditions.

Although comparing the operating budget with prior period data is necessary, the key to evaluating the budget is to understand the validity of the underlying assumptions and the probability of projected goals. Prior data does not provide meaningful information if the entire focus of the association is changing. For example, if a portfolio lender begins mortgage banking operations, the crucial evaluation of the budget would not come from comparison with prior period data.

Instead, the focus would be on the reasonableness of projected loan originations and sales compared with current market conditions.

Controlling business risks is one of the primary responsibilities of management. The types of risk assumed by the associations, and how well management controls those risks, is reflected in the association's balance sheet and operating statement. By analyzing the balance sheet and operating results, and identifying trends in the financial data, a determination can be made as to whether management's policies benefit or adversely impact the association.

Profitability Assessment

An institution may assess its own profitability in many ways and at different levels. A thrift may evaluate the profitability of the institution as a whole; the particular profitability of branches, products, or types of customers. However the association assesses its profitability, accurate information is the basis for good decisions.

An association's information requirements depend largely on its size and complexity of its operations. While examiners should encourage management to develop improved systems and information, they must be reasonable in their expectations.

Consolidated Financial Statements

Consolidated financial statements are used to summarize the financial position and results of operations for two or more affiliated companies. Such statements are prepared and presented without regard to the separate legal status of each company. The purpose of consolidated financial statements is to present a parent company and its subsidiaries as if they were a single company. Such statements do not include gain or loss on transactions among the companies in the group. Further, consolidation is usually necessary for a fair presentation when one of the companies in the group directly or indirectly has a controlling financial interest in the other companies.

Consolidated financial statements should be prepared for all GAAP-consolidated subsidiaries in which the association has a controlling financial interest through direct or indirect ownership of a majority voting interest. As a general rule, direct or indirect ownership by one company of over 50 percent of the outstanding voting shares of another company is a condition that suggests consolidation.

In order for the parent and its subsidiaries to be presented as one entity, the separate trial balances of the parent and subsidiaries must be consolidated into one trial balance, and intercompany balances and transactions must be eliminated. Eliminating entries are recorded on the consolidating worksheets but are never entered in the general ledgers of either the parent or the subsidiaries.

Examiners should review the consolidating entries of intercompany accounts. Typical elimination entries include the following:

- Intercompany payables should be eliminated against intercompany receivables.
- Intercompany profit/loss on sales of assets that have not been subsequently resold to third parties should be eliminated.
- Investment accounts of the first-tier subordinate organizations should be eliminated against the capital accounts of the lower-tier subsidiaries.
- Intercompany revenues that should be eliminated against intercompany expenses.

See Appendix C, Reconciliation of Intercompany Accounts.

Materiality

Materiality is defined as an assessment of relative size and importance. The materiality of intercompany transactions can be analyzed by:

- Identifying intercompany transactions that frequently occur. Such transactions include:
  - Parent's investment in capital of the subordinate organization;
  - Long-term loans from the parent to the subordinate organization; and
  - Short-term accounts receivable (payable) between the parent and the subordinate organization pertaining to normal operations.
- Assessing activity in intercompany accounts. This involves reviewing general ledger account histories of selected accounts for:
  - Numerous transactions;
  - Correcting entries (original entries were posted to the wrong accounts); and
  - Entries involving large dollar amounts whose purposes are not clearly explained by descriptions provided in the account histories.
- Identifying source documents that can be reviewed if analysis of specific transactions is deemed necessary. Such documents include:
  - Cash receipts records (cash receipts journals and bank deposit slips);
  - Cash disbursements records (cash disbursement journals and checks issued); and
  - Journal vouchers for non-cash transactions.

References

Code of Federal Regulations (12 CFR)

Part 562 Regulatory Reporting Standards

Office of Thrift Supervision Publications

Thrift Financial Report Instruction Manual

Thrift Time Series User's Guide

The OTS Net Portfolio Value Model Manual

UTPR Reports

Section A	Summary Statement
Section B	Detailed Income Statement
Section C	Analysis of Net Interest Income
Section D	Detailed Balance Sheet
Section E	Asset Quality
Section F	Allowances
Section G	Capital Accounts and Requirements
Section H	Changes in Financial Condition
Section I	Lending, Investment, Foreclosure and Restructuring Activity
Section J	Questions, Strategies, New Deposit Yields
Section K	Composition of CMR Portfolio
Section L	Interest Rate Risk Information
Section M	Examiner Support Software Ratios

Operations Analysis Program

Examination Objectives

To evaluate the association's operating environment and business strategy.

To identify, evaluate and explain positive and negative income and expense trends.

To assess the prospective effect on earnings as a result of any changes in the activities or strategies of the association.

To evaluate the association's financial performance to determine whether the association's strategies result in sufficient profitability.

Examination Procedures

Wkp.Ref.

Level I

1. Review the prior regular examination report and any other subsequent examination reports, audit reports, monitoring reports, and any off-site analysis to ascertain strengths and weaknesses in the association's operations.

2. Review the findings in examination Program 410, Financial Records and Reports, to ascertain any significant concerns such as reporting errors, unusual variances, or accounting deficiencies that may affect the review of operations.

3. Review the UTPR financial schedules. Identify and explain trends, material variances, and other factors affecting earnings. Note any material reporting errors and make notations on the UTPR schedules to ensure appropriate analysis. Include copies in the work papers.

4. Compare the association's financial data to available peer group data and explain material variances.

Exam Date:

Prepared By:

Reviewed By:

Docket #:

Wkp.Ref.

5. Review the core financial pages in the ROE. Identify and explain trends, material variances, and other matters, as appropriate.

6. Review the findings of the asset quality review to determine the effect on earnings. For example, consider severity and level of classifications, the need for provisions to ensure the adequacy of allowances for loan and lease losses (ALLL), and loss of interest earnings due to poor quality assets. Consider the cost of carrying nonperforming assets and the effect on earnings stability over the long term.

7. Review the findings of the sensitivity to market risk review, particularly the interest rate risk management review. Evaluate the composition of earnings between recurring net interest margin and net noninterest income vs. net interest income. Consider the effect on future earnings potential.

8. Evaluate the adequacy of the association's net interest margin. Use peer group comparisons as a guide. Identify the sources of changes in net interest margin and attribute trends to rate (net interest spread), volume (net interest position; interest-earning assets minus interest-costing liabilities), or restructuring factors. Consider the long term effect on earnings potential as a result of any material factors.

9. Review the association's financial statements and evaluate trends for return on assets, return on equity, net interest margin and the mix and growth of asset/liability structure. Compare these results with the results in procedure No. 3.

10. Review the association's business plan. Compare the business plan to the association's actual operating results and explain any material differences. Determine if the business plan was developed by the savings association (as opposed to an outside consultant) and tailored to the association's operating strategies.

Exam Date: ________
Prepared By: ________
Reviewed By: ________
Docket #: ________

Wkp.Ref.

11. Review the management findings to ascertain whether new activities, strategies, or major changes are being planned or have been initiated that could materially affect operations.

12. Obtain and review the association's current budget. Determine if the budget is reasonable and supported. Compare the budget to current operations; identify and explain material variances.

13. Review Level II procedures and perform those necessary to test, support, and present conclusions derived from performance of Level I procedures.

Level II

14. Review and evaluate the savings association's sources and uses of funds since the last examination. This analysis will give insight into the savings association's business operation and the potential risks involved.

15. Analyze the current cost of interest-costing liabilities and the yield on interest-earning assets and compare with the previous year. Note: The yields on mortgage loans and mortgage-backed securities are dependent on prepayment rates.

16. Review and evaluate the savings association's yield spread and compare with the previous year. Noninterest income and noninterest expense should be estimated based on normal levels.

17. If applicable, review TFR Schedule CSS, Subordinate Organization Schedule, to determine the extent of the parent association's dependence on the subordinate organization and the adequacy of the parent association's return on the investment in the entity. See Appendix B.

Exam Date: ________
Prepared By: ________
Reviewed By: ________
Docket #: ________

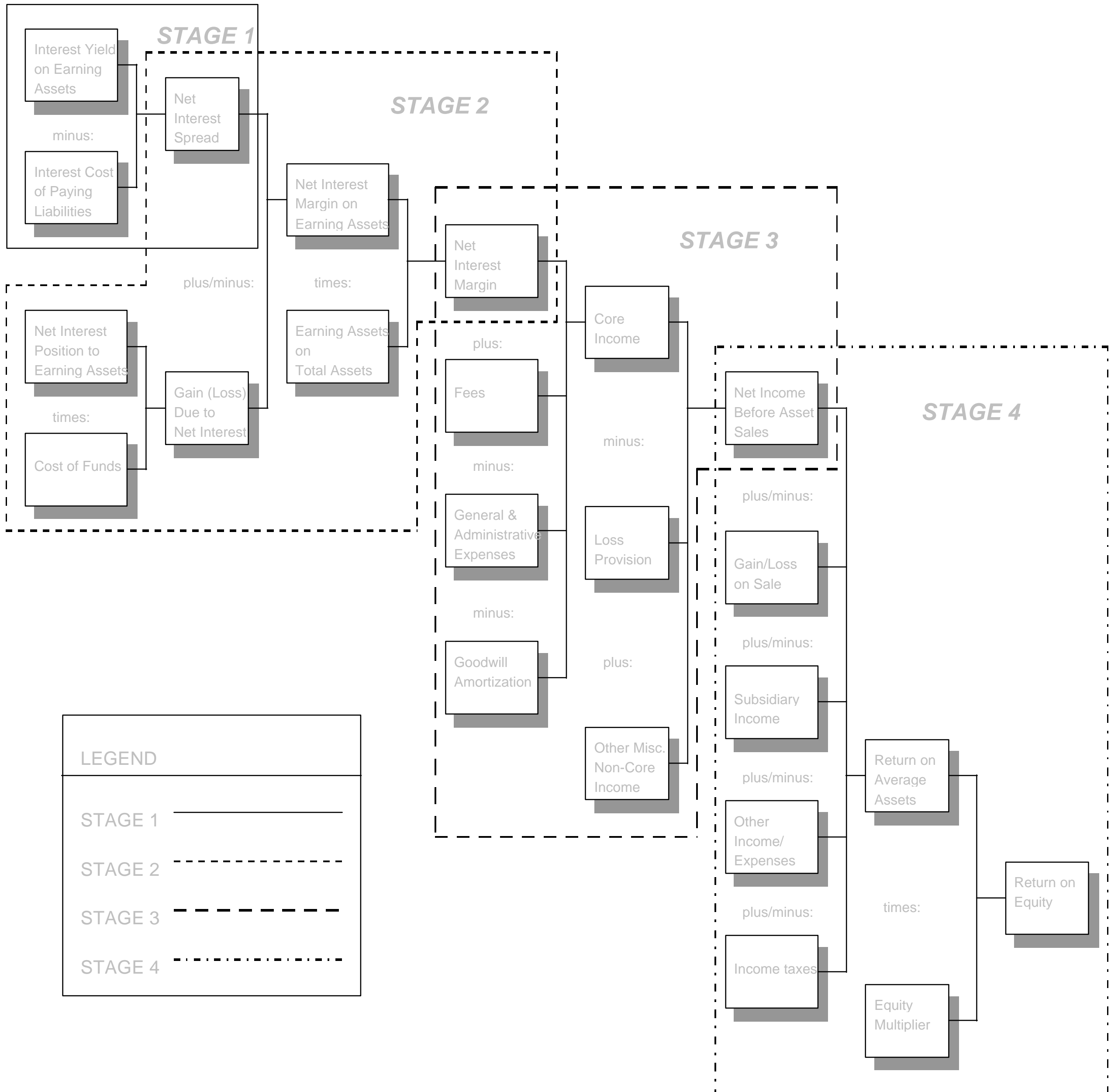
Wkp.Ref.

18. Reconcile and determine the materiality of the parent institution and subsidiary intercompany accounts. (For further information, refer to Appendix C, Reconciliation of Intercompany Accounts.)

19. Ensure that the *Objectives* of this Handbook Section have been met. State your findings and conclusions, as well as appropriate recommendations for any necessary corrective measures, on the appropriate work papers and report pages.

Exam Date:
Prepared By:
Reviewed By:
Docket #:

Derivation of Return on Assets and Return on Equity



Adequacy of Return on Investment

One of the primary objectives for investing in subordinate organizations (operating subsidiaries, service corporations, and their lower-tier entities) is to generate earnings. Since the parent savings association operates on a relatively small interest margin, the need to maximize returns on assets is important. The larger the investment in subordinate organizations, the greater the need for an adequate return on that investment.

In choosing alternative investments, investors are influenced by many factors. The most significant of these factors are the cost of the funds used to make the investment and the desire to maximize yield and minimize risks. In evaluating the adequacy of the return on the investment in a subordinate organization(s), a regulator must determine whether the:

- Return provides a reasonable margin in excess of the parent institution's cost of funds.
- Yield is reasonable for the risks assumed.

Return Versus Cost of Funds

In evaluating the savings association's return on the investment in a subordinate organization, regulators must determine the amount by which the return differs from the cost of funds. The Uniform Thrift Performance Report (UTPR) provides historical data that can be used to facilitate the analysis.

The following procedures provide a systematic approach for analyzing the margin generated by the investment in subordinate organizations:

- Determine whether a positive or negative margin is being generated by the investment in the subordinate organization. (See step 1 of the following example.)
- Calculate the dollar effect based on the margin ratio and the investment in the subordinate organization. (See step 2 of following example.)
- Identify or calculate the parent's net income before taxes and nonoperating items as a percentage of average assets. (See step 3 of following example.)
- Calculate earnings of the parent without the contribution/detriment of the subordinate organization investment. (See step 4 of following example.)
- Determine how investment in the subordinate organization affects the parent's net income before taxes and nonoperating items. (See step 5 of following example.)

Regulators must be guided by the materiality of the subordinate organization investment in applying any or all of these procedures. If the investment in the subordinate organization provides an adequate return with minimal risks, then use of these procedures would not be warranted.

For example, Association A has a nominal investment in a subordinate organization. The subordinate organization operates an electronic data processing center that services several clients. The yield on the institution's investment averages approximately 15 percent while the average cost of funds is 7 percent. In this example, the use of the above procedures would not be warranted.

Association A
(000's Omitted)

	12/31/XX	9/30/XX	6/30/XX	3/31/XX
Total Assets[1]	$987,535	$946,916	$1,019,578	$937,562
Net Income Before Taxes and Nonoperating Items[1]	3,073	2,475	2,842	4,647
Investment in Subordinate Organization	25,484	25,485	23,359	23,446
Income from Subordinate Organization	1.95%	3.82%	0.26%	47.84%
Cost of Funds1 (As a % of Average Total Assets Annualized)	7.78%	7.57%	7.57%	8.35%

[1] Obtained from UTPR.

1. Calculate the margin between yield on investment in the subordinate organization and the cost of funds.

Return on Subordinate Organization	1.95%	3.82%	0.26%	47.84%
Cost of Funds	7.78%	7.57%	7.57%	8.35%
Margin	- 5.83%	- 3.75%	- 7.31%	39.49%

2. Calculate the dollar effect of margin.

Beginning Investment Subordinate Organization	$25,485	$23,359	$23,446	$23,378
Ending Investment Subordinate Organization	+25,484	+25,485	+23,359	+23,446
Total	$50,969	$48,844	$46,805	$46,824
Average Investment Subordinate Organization	$25,485	$24,422	$23,403	$23,412
(Average investment equals the sum of beginning and ending investments divided by 2)				
Margin	-5.83%	-3.75%	-7.31%	39.49%
Annual Effect of Margin (Margin times average investment)	- $1,486	- $ 916	- $1,711	$ 9,245
Quarterly Effect of Margin (Annual margin divided by 4)	$ -372	$ -229	$ -428	$ 2,311

3. Calculate parent ratio of net income before taxes and nonoperating items (NOI) to average assets.

Beginning Assets	$ 946,916	$1,019,578	$ 937,562	$928,567
Ending Assets	987,535	946,916	1,019,578	937,562
Total	$1,934,451	$1,966,494	$1,957,140	$1,866,129
Average Assets	$ 967,226	$ 983,247	$ 978,570	$ 933,065
(Average assets equal the sum of beginning and endingassets divided by 2)				
NOI	$ 3,073	$ 2,475	$ 2,842	$ 4,647
NOI/Average Assets	1.27%	1.01%	1.16%	1.99%
(NOI divided by average assets times 4)				

4. Calculate parent ratio of net income before taxes and nonoperating items (NOI) and exclude effect of the subordinate organization margin above/below cost of funds to average assets.

NOI	$3,073	$2,475	$2,842	$4,647
Quarterly Effect of Investment	(-372)	(-229)	(-428)	(2,311)
NOI Excluding Effect of Investment	$3,445	$2,704	$3,270	$2,336
Net Income Before Taxes, Nonoperating Items & Effect of Investment/Average Assets	1.42%	1.10%	1.34%	0.93%
(Ratio was annualized by multiplying by 4)				

5. Determine how investment in the subordinate organization affects the parent's net income before taxes and nonoperating items.

Investment's Dollar Effect	-$1,486	- $916	- $1,711	$9,245
Percent of Average Assets	-0.15%	-0.09%	-0.18%	0.99%
Net Income Before Taxes, Nonoperating Items & Effect of Investment/Average Assets	1.42%	1.10%	1.34%	0.93%
Percentage Effect of Investment on NOI	-10.56%	-8.18%	-13.43%	106.45%

(Dollar effect of subordinate organization investment stated as a percentage of average assets/parent institution's net income before taxes, nonoperating items, and the effect of investment stated as a percentage of average assets, i.e., -0.15%/1.42% = -0.1056 or -10.56%)

Regulators also should compare data from period to period to identify any trends. Quarterly data can be compared for all quarters of the review period. Further, annual data can be compared for the three previous years to identify the cause(s) of any negative trends.

Although historical data provides useful information for evaluating the return on investment, consideration must also be given to management's projected return. Using the preceding example, if an analysis of the return on the investment had been done as of March 31 of that year, the conclusion might have been that the subordinate organization was extremely profitable. Although this may have been true at that time, a realistic operating budget would have tempered the assessment of profitability based on the return for the remainder of the year. A comprehensive analysis of the adequacy of the return on the investment should include:

- Determining the projected return on investments in subordinate organizations by reviewing management's operating budget(s).
- Comparing the projected return with historical data and investigating differences from historical patterns by interviewing management and reviewing the budget(s) assumptions for reasonableness.
- Comparing the most recent cost of funds ratio for the parent savings association with the projected yield on the investment in subordinate organizations.
- Determining the significance of any projected negative margins, by comparing the dollar amount of the negative margin to the capital and projected net income of the parent institution.

It is equally important to determine the reasons for changes in the return on investment and whether the changes are a safety and soundness concern. The regulator must determine whether a change is the result of sale of assets, accounting changes, market collapse, etc.

Risk Versus Return

Once the margin has been determined, the level of risk assumed to generate the margin must be evaluated. In general, the higher the return, the higher the risk. Subordinate organizations, like all other businesses, assume certain types of business risk in the process of generating earnings. By determining the types of risk associated with the subordinate organization's activities and comparing the return on investment with the yield on other earning assets, a foundation for evaluating the risk and reward position of the subordinate organization(s) can be established.

A return on investments that is significantly higher than yields on other earning assets may indicate that the subordinate organization(s) has assumed an excessive level of risk. A return that is lower than other earning assets may indicate an inefficient use of investment funds. By understanding the characteristics of all earning assets, regulators can establish a subjective correlation between yields and risks. This subjective correlation can then be used to evaluate the level of risk assumed or to evaluate the adequacy of the yield earned. For example, an investment in a mortgage banking subordinate organization would be expected to yield more than the parent's investment in short term investment securities. This higher expected yield is due to the higher level of business risk assumed. On the other hand, if a subordinate organization activity yields more than the parent's investment in commercial loans, that activity is likely to be more risky than commercial lending.

The yield from the investment in a subordinate organization(s) can be compared with the parent's return on its:

- Mortgage loan portfolio
- Other loan portfolio
- Investment portfolio.

The risk reward correlation can be distorted by tax considerations. If consolidated returns are not filed, there is an incentive to record income for the parent (which has a lower tax rate) instead of the subordinate organization. For example, the

subordinate organization may pay an above market rate on a loan from the parent. To avoid a distorted analysis, the comparisons should be made over several periods. As a guide, the comparison should be made for each quarter of the examination review period. The analysis can be further enhanced by comparing returns over the two previous years. In addition to making the comparison with a weighted return for the other assets, a regulator should be alert to current yields on new investments in these assets. This data can be used to evaluate new investments in subordinate organizations. Further assistance in identifying and evaluating the risk assumed by the subordinate organizations is provided in Thrift Activities Handbook Section 650, Interest Rate Risk Management.

Regulators must exercise sound judgment in evaluating the risk and reward position of the subordinate organization(s) since many variables may be involved. For instance, ancillary business obtained by the parent as the result of the subordinate organization's activities may be a valuable source of business to the parent. Even though the return on a subordinate organization of this nature may be lower than other assets, the overall benefit to the parent may be significantly greater due to this ancillary business.

Reconciliation of Intercompany Accounts

Overview

One of the most basic steps in evaluating the propriety of the parent savings association's accounting for its investment in subordinate organizations is to reconcile certain reciprocal accounts (e.g., the loans receivable and Investment accounts of the parent to the loans payable and capital accounts of the subordinate organizations). The reconciliation of reciprocal accounts verifies that adjustments in the carrying value of the investment have been properly reflected on the accounting records of the parent savings association. Also, the reconciliation process is an important step in ascertaining if the accounting for the subordinate organizations is in accordance with generally accepted accounting principles (GAAP).

The various tiers of subordinate organizations should be reflected on the parent's books in accordance with the appropriate GAAP method, which is largely determined by the parent's percentage ownership interest. As discussed in more detail below, a parent may record an investment in a subordinate organization under either the: (1) consolidated; (2) equity; or (3) cost methods of accounting, consistent with GAAP.

The term subordinate organization is defined in 12 CFR § 559.2 and includes a federal thrift's operating subsidiaries, service corporations, and their lower-tier entities (i.e., entities owned directly or indirectly by a first-tier subordinate organization). A subordinate organization does not include entities in which the savings association's ownership interest has been designated as a pass-through investment authorized under § 560.32. (Refer to Handbook Section 730 for a detailed discussion of subordinate organization examinations, or Section 230 for an overview of thrifts' pass-through investment authority.)

In a multi-tier organizational structure, the reconciliation of intercompany accounts should reflect the operations of all subordinate organizations having a material effect on the parent savings association's financial condition. It would be of little benefit to reconcile the accounts of the parent savings association and a first-tier subordinate organization if the subordinate organization had not recognized a $1 million loss sustained by its lower-tier real estate joint venture. Through the reconciliation process, investments in lower-tier entities that have a material effect on the parent savings association should be reconciled with the accounts of the investing organization up through the subordinate organization corporate structure, prior to reconciliation of the parent savings association's records to the first-tier subordinate organization.

Consequently, the reconciliation process should begin with an identification of all subordinate organizations and their relationship to each other. Data necessary to accomplish this identification is available in the TFR Schedule CSS (Subordinate Organization Schedule), and in the Preliminary Examination Response Kit (PERK).

Before addressing the actual reconciliation process, some of the causes of differences between the parent's general ledger accounts and the subordinate organization's accounts will be presented. Differences in account balances can result from many circumstances. The more common reasons for differences include:

- Delays by the parent savings association in recognizing its proportionate share of the subordinate organization's net income or loss;
- Posting errors;
- Inadequate or improper accounting procedures; and
- Differences in methods of accounting for payables and receivables.

The example that follows illustrates differences that result from delays in recognizing income or losses.

Example:

A common problem encountered in the accounting for investment in subordinate organizations is the timeliness of recording the results of the operations of subordinate organizations in the parent savings association's investment account. By delaying recognition of a subordinate organization's losses at year-end, the parent savings association may try

to shift the losses into the next accounting period. However, it is important that the results of a subordinate organization's operations be recognized in the appropriate accounting period to allow for a proper evaluation of the financial trends of the parent. In any case, the results of the subordinate organization's operations should be recorded at least quarterly to provide complete and accurate reports to the regulatory agencies. (Monthly posting of the subordinate organization's operations is preferable to quarterly.)

A one-month delay in accounting for the investment in a subordinate organization is a common practice. Generally, financial data for the subordinate organization will not be available until several days past the end of a month. As a result, the necessary financial data are not known by the parent at the time the posting is made. If the recognition of the results of the subordinate organization's operations are consistently posted one month late and there are no material changes in the unposted month, no exception should be taken. Regulators should be aware, however, that if monthly net incomes or losses are material to the financial condition of the parent savings association, an accrual, based on an estimate of the most recent month's operations should be made at month's end for financial statement presentation.

Only after verifying that the financial effect of the subordinate organization has been properly recognized and recorded in a timely manner can the assessment of the financial condition be considered complete. However, regulators must use judgment in evaluating the importance of a variance in account balances. The key factor to consider is whether or not the variance misrepresents the financial condition of the parent savings association. Another factor to consider is the cause of the account variance. Was the cause human error, inappropriate accounting procedures, or intentional misrepresentation? Any account variances should be brought to the attention of management for resolution. However, only those variances that misrepresent the financial condition of the parent savings association or appear to result from inappropriate procedures or intentional misrepresentation should be pursued for examination purposes.

Overview of Reconciliation Process

Initially, the regulator should determine if a reconciliation of accounts has already been made by the internal accounting staff. Any such reconciliation obtained from the accounting staff should be tested for accuracy. Generally, two basic categories of accounts are involved in the reconciliation process—the investment and reciprocal capital accounts, and intercompany payables and receivables. In many instances, the reconciliation of these accounts are part of the internal or administrative control procedures for the subordinate organization or savings association.

The actual reconciliation process is relatively mechanical. The first step is to identify all capital accounts on the working trial balance for the subsidiary. These accounts generally include:

- Common and preferred stock
- Paid-in-capital
- Undistributed current earnings
- Retained earnings/deficit

The investment accounts used by the parent are also identified from the working trial balance for the parent. Examples of names for investment accounts include:

- Common stock of subsidiary
- Investment in subsidiary
- Investment in service corporation
- Investment in joint venture
- Investment in operating subsidiary (entities designated finance subsidiaries should be redesignated "operating subsidiaries" to reflect revisions to subsidiary regulations under the final Subsidiaries and Equity Investment Rule, January 1, 1997)

Next, total all of the investment accounts and the related capital accounts and compare the totals.

Any material differences should be investigated to determine the reason for the variance.

The following examples illustrate the reconciliation process under the consolidated and equity methods of reporting. A discussion of the cost method is also provided, although this method does not involve the reconciliation of intercompany accounts other than to ensure that dividends from the subordinate organization are reflected as income on the parent's books.

Reconciliation of Investments and Capital Accounts

Consolidation. When a savings association owns more than 50 percent of a subordinate organization's outstanding common stock, the entity's assets are generally consolidated on the savings association's financial reports under GAAP. In a consolidation, the savings association's financial reports reflect the financial position, operating results, and cash flows of both the parent and subordinate organization as if they were a single business entity, although they maintain their separate corporate identities. In preparing consolidated reports, the reconciliation process involves the elimination of intercompany accounts. For example, an intercompany loan from the parent to a subordinate organization is eliminated from consolidated financial statements by crediting the parent's note receivable from subordinate organization on the parent's books and by debiting the note payable to parent company on the organization's books. From a consolidated entity viewpoint, an intercompany loan transaction simply results in the transfer of cash from one part of the entity to another and does not give rise to a receivable or payable.

Because consolidations are usually complex, a worksheet is generally prepared to consolidate the assets, liabilities, and income items, and includes certain elimination and adjustment entries. Typical intercompany elimination entries pertain to intercompany stock ownership, intercompany debt, and intercompany revenue and expenses. This includes open account balances, security holdings, sales and purchases, interest, dividends, gain or loss on transactions among companies in the consolidated group, and intercompany profit/loss on assets remaining within the group.

When a subordinate organization is majority-owned, but not wholly owned by the parent, a minority interest by shareholders owning less than 50 percent of the organization's outstanding voting common stock is reported separately. The minority shareholders have an interest in the entity's net assets and in earnings/losses.

Accounting Principles Board Opinion (APB) No. 16, "Business Combinations," should be consulted when there are complex consolidation matters, such as intercompany profits in assets, goodwill, and income taxes on undistributed earnings.

The following example illustrates the consolidation of a parent company and its subordinate organization, ABC company. Assume the parent company owns 60 percent of ABC Company. By owning more than 50 percent of ABC's outstanding voting common stock, 100 percent of ABC's assets and liabilities are combined with the parent company's assets and liabilities. However, an entry to eliminate the parent's investment in ABC is necessary in order to keep from double counting the investment.

Assuming that common stock, paid in capital, and retained earnings total $2,000,000 ($1,500,000 + $500,000), the investment account in ABC of $1,200,000 and ABC's stockholders' equity accounts are eliminated on the combined parent company and subsidiary working trial balance sheet, and minority interests are recorded as follows:

(000's omitted)

	debit (credit)
Common Stock and Paid-in Capital - ABC Company	$1,500
Retained Earnings and Undistributed Income - ABC Company	500
Investment in ABC Company	($1,200)
Minority Interests	(800)

The $800,000 represents the remaining 40 percent interest that is not owned by the parent company. Technically, minority interests are not liabilities since there is no payment obligation to anyone. However, in practice, minority interests may be shown as liabilities in the parent's consolidated balance sheets, but the usual practice is to show

minority interests between liabilities and stockholders' equity.

The parent company's stockholders' equity accounts do not change. For example, as shown in the following summary format, the parent company's stockholders' equity and retained earnings accounts total $4,400,000 before and immediately after the consolidation. Thus, these accounts balances are unaffected by the consolidation.

After the subordinate organization's investment accounts are eliminated, and other eliminating entries are made for intercompany debt and receivables, the remaining assets and liabilities of the parent company and the subsidiary are combined along with the parent's stockholders' equity account, including the minority interests, for the consolidated financial statements, as shown below in summary format.

(000's omitted)

	Parent	Subsidiary	Eliminating Entries	Consolidated
Assets	$ 51,100	15,100	($ 1,200)	$ 65,000
Liabilities	(46,700)	(13,100)	--	(59,800)
Minority Interests	--	--	(800)	(800)
Stockholders' Equity	(4,400)	(2,000)	2,000	(4,400)

Equity Method. When a parent thrift owns between 20 and 50% of a subordinate organization's outstanding voting common stock, the investment should generally be reflected on the parent's books under the equity method. The parent initially records its investment in the entity at cost. Subsequent adjustments to the carrying value are made to reflect the parent's share of the organization's earnings or losses in the period that operating results are reported by the subordinate organization. Also, the investment is adjusted to reflect dividends received from a subordinate organization. Under the equity method, a subordinate organization's dividends are not considered income to the parent, but rather as cash dividends that reduce the subordinate organization's net assets (and, stockholders' equity). Accordingly, the parent should record a proportionate decrease in its investment account for dividends received from the subordinate organization.

Other adjustments may be required to the investment account, similar to those made in preparing consolidated statements. These include eliminating intercompany gains and losses and to account for any differences among the parent or the subordinate organization in the measurement of the subordinate organization's expenses (e.g., depreciation).

In the following illustration of the equity method, assume that a review of the subordinate organization's records establishes that the savings association owns 40 percent of ABC. Accordingly, the savings association's investment should reflect 40 percent of the net book value of ABC. However, after examining the working trial balance for the parent savings association shown below, the investment account for ABC is $10,000 short ($2,000,000 x .40 = $800,000 and $800,000 - 790,000 = $10,000). It is apparent that the investment accounts on the parent general ledger do not balance with the capital accounts of the subordinate organization.

(000's omitted)

Capital Stock of ABC	$ 700
Share of ABC Income	90
Total	$ 790

The working trial balance for ABC Corporation contains the following capital accounts:

(000's omitted)

Common Stock (500 Shares, $1,000 Par)	$ 500
Paid-in Capital	1,000
Undistributed Current Earnings	200
Retained Earnings	300
Total	$ 2,000

The regulator must determine the cause of the difference to complete the reconciliation. One common cause of such a variance is a delay in the posting of the monthly income of the subordinate organization to the parent's investment account. By reviewing the previous month's financial statement for ABC, it is determined that net undistributed income was $175,000 for the prior month. This indicates that the net income of ABC for the most recent month was $25,000 ($175,000 + 25,000 =

$200,000, the amount of ABC's undistributed current earnings). The parent savings association's share of the net income was $10,000 ($25,000 x .40). The reconciliation should appear as follows:

(000's omitted)

Parent's Total Investment	$ 790
Plus: Parent's Share of Current Month Income Recognized After Month's End	10
Parent's Proportionate Share of ABC's Total Capital	$ 800

APB No. 18, "The Equity Method of Accounting for Investments in Common Stock," may be consulted for more detail on the equity method.

Reconciliation of Intercompany Payables and Receivables For Consolidated Financial Statements

The regulator should identify all intercompany payables and receivables that must be reconciled. Such intercompany transactions should be reconciled prior to elimination of accounting on consolidated financials. Examples of intercompany payables and receivables include:

- Loans and advances
- Income tax payables and receivables
- Accounts payable and receivable.

Generally, only those accounts that are material in relation to the financial position of the subordinate organization or the parent thrift are reconciled. Routine accounts payable and receivable may be included but may not warrant reconciliation due to their small amounts.

Intercompany payables and receivables can be identified by reviewing the working trial balances for the subordinate organization and the parent. In cases where the general ledger account name is inconclusive, the accounting staff should be interviewed. Also, in some instances it may be necessary to use general ledger subordinate organization records to identify the accounts that must be reconciled. For example, a mortgage loan to a subordinate organization will not, in most instances, be segregated on the general ledger of the parent savings association. In those cases, the mortgage loan trial balance of the savings association must be used in the reconciliation process.

Once the accounts have been identified, the regulator must total each of the intercompany payables and receivables accounts and compare the related totals. Any material differences should be investigated to determine the reason for the variance. An example of a common reconciliation of intercompany payables and receivables follows:

ABC Corporation has two loans shown as payable to its parent savings association on its general ledger trial balance as follows:

(000's omitted)

Note Payable Parent	$540
Mortgage Loan Payable	927

A review of the general ledger trial balance for the parent savings association reveals an account entitled Unsecured Note Receivable ABC for $540,000. However, the mortgage loan is not segregated on the parent's general ledger trial balance. The mortgage loan trial balance must, therefore, be obtained to reconcile the mortgage loan and payable. Once the loan number is obtained from subordinate organization personnel, the loan on the parent savings association's mortgage loan trial balance can be identified. However, the balance of the loan is listed at $1,200,000.

To quickly and efficiently reconcile this difference, the regulator must be aware of the types of activities conducted by the subordinate organization. If the entity is involved in construction activities, there needs to be a review of the loans-in-process balance. Information about loans-in-process may be part of the mortgage loan trial balance or a completely different report. The loans-in-process balance for this particular loan was $245,000, which gives a net loan balance of $955,000 or $28,000 more than reported by ABC. A common cause for this type of variance is a timing difference in recording disbursements between the parent thrift and the subordinate organization. To identify timing differences, the regulator would review the loans-in-process transaction history and the subordinate

organization's mortgage loan payable general ledger account history near the end of the month for which the accounts are being reconciled.

Regulators should look for disbursements that were not reflected in the mortgage loan payable account or repayments by the subordinate organization that were not reflected within the loans-in-process account until after the end of the month. In this instance, a disbursement of $47,000 was made on the day preceding the end of the month, but was not posted to the mortgage loan payable account until the first of the next month by the subordinate organization. Also, the subordinate organization closed a sale of a developed residential building lot on the last day of the month and issued a check for $19,000 to the parent savings association that was to replenish the loans-in-process account. This check was posted by ABC to the mortgage loan payable account on the last day of the month but not until the second day of the next month by the parent. The reconciliation of the mortgage loan payable should be reflected as follows:

(000's omitted)

Mortgage Loan Receivable Per Parent Trial Balance	$ 1,200
Adjustments:	
Less: Loans-in-Process	(245)
Less: Disbursements Posted After Month's End	(47)
Correct Total For Parent Trial Balance	$ 908
Mortgage Loan Payable Per ABC's Trial Balance	$ 927
Adjustments:	
Less: Repayments Posted After Month's End	(19)
Correct Total For ABC's Trial Balance	$ 908

Cost Method of Reporting. Under the cost method, the parent records its investment at cost, and recognizes as income subsequent dividends received that are distributed from net accumulated earnings of the organization. However, dividends received in excess of earnings subsequent to the date of investment are considered a return of investment and are reflected on the parent's books as a decrease in the cost of the investment (i.e., if the subordinate organization pays dividends to the parent in excess of the parent's share of earnings). In determining whether a dividend payment is a "liquidating" dividend or an ordinary dividend, the regulator can compare cumulative earnings and dividends.

Reporting Examination Findings

As previously noted, only those variances that are material in relation to the parent savings association or the subordinate organization should be investigated. Comparison of the variance with the capital and net income of the parent entity will provide a basis for determining the materiality of the variances for the individual subordinate organizations. Any material differences should be documented within the examination work papers with an explanation for the cause of the discrepancy. Also, the appropriate treatment or necessary adjustment should be identified within the same work papers. If necessary, initiate refilings of the appropriate regulatory financial reports by the subordinate organization and parent savings association.

Introduction

Deposits/borrowed funds, liquidity management, and funds management are integrally related. It is recommended that Handbook Sections 530, Cash Flow and Liquidity Management, and 510, Funds Management, be reviewed in conjunction with this Section.

The OTS reinvented its deposit rules October 22, 1997. This regulatory reinvention streamlined the regulations by eliminating outdated provisions as well as provisions that duplicated or overlapped other applicable requirements such as the Truth in Savings Act, and Federal Reserve Board Regulations D (Reserve Requirements) and DD (Truth in Savings), which apply to savings associations as well as banks. Additionally, OTS codified its long-standing position on federal preemption of state laws affecting deposit-related activities. OTS also consolidated all deposit-related regulations, except definitions, in a new Part 557.

Deposits

Deposits typically represent the largest source of a thrift's funds. Therefore, it is important that the thrift implement policies and procedures to generate and retain its deposit base as well as to monitor its overall deposit structure. An effective deposit management program should include all of the following elements:

- A clearly defined marketing strategy within the business plan that identifies the desired market share in terms of growth or shrinkage, market niche, and present and potential competition.
- Identification of core and volatile deposits and analysis of the cost of core and volatile deposits, including operating costs to maintain the various deposit products and deposit branches, and targeted spreads between deposit costs and earnings on assets funded by deposits.
- Periodic analysis of present and anticipated funding and liquidity needs, and comparative analysis of costs of deposits versus alternative sources of funds to meet those needs.
- Frequent review of deposit pricing, volume, sources, volatility, and trends in relation to overall funds management goals, interest rate risk exposure, spread, net interest margin, and profitability.

Core deposits are important in evaluating the stability of funding sources and costs, and in measuring liquidity risk. Core deposits may include regular and passbook savings, certificates of deposit (CDs), and various types of retirement and special savings. Typically, core accounts carry high average operating expenses and low deposit balances. Although, by definition, a stable source of funds, some core deposits will be lost over time if interest rates paid become noncompetitive.

Types of Deposit Accounts

The regulator's efforts to analyze the character of the overall deposit structure should be directed to types of deposit accounts shown by experience to be significant in presenting problems to management. The following paragraphs discuss common types of deposit accounts and practices that, under certain circumstances, can become problems.

- *Brokered and Money Desk-Originated Deposits*: Brokered deposits are usually obtained through a broker acting as an intermediary between the thrift and the depositor. Money desk operations are usually staffed by in-house personnel. Brokered and money desk-solicited deposits are a volatile and usually high-cost source of deposits. The cost is usually high because of higher interest rates needed to attract volume. Operating costs such as the fees paid to brokers and salaries or commissions paid to money desk personnel also contribute to the cost of these deposits. The depositors have no loyalty to the thrift.

Brokered and money desk deposits are highly susceptible to withdrawal if interest rates paid become noncompetitive or the solvency of the thrift is threatened.

A high volume of high interest rate, short-term brokered or money desk-originated deposits usually indicates excessive risk. Active solicitation of such deposits without the benefit of a well-designed risk management program is unsafe and unsound.

- *Bank Investment Contracts* (BIC): BICs are a deposit contract between a financial institution and its customer that permits the customer to deposit funds over a period of time and obligates the "bank" to repay the amounts deposited plus interest at a guaranteed rate to the end of the contract. A BIC is the counterpart of the insurance industry's Guaranteed Investment Contract (GIC). The customers for BICs and GICs are, in most cases, sponsors of employee benefit plans such as pension plans or deferred compensation plans that qualify under section 401(k) of the Internal Revenue Code (commonly referred to as "401(k) Plans").

Brokered Deposit Restrictions

Section 301 of the Federal Deposit Insurance Improvement Act (FDICIA) of 1991 mandated that the Federal Deposit Insurance Corporation (FDIC) place limitations on brokered deposits and deposit solicitations. Section 337.6 of the FDIC regulations applies to all thrifts and restricts the use of brokered deposits on the basis of capital adequacy. Under the regulation, institutions are divided into categories of well-capitalized, adequately capitalized, and undercapitalized condition. Only well-capitalized institutions may continue to accept brokered deposits without restrictions. Adequately capitalized institutions must now obtain a waiver from the FDIC in order to continue accepting brokered deposits. Undercapitalized institutions are prohibited from accepting brokered deposits.

Well-capitalized institutions are defined in the regulation based on § 38 of the Federal Deposit Insurance Act dealing with prompt corrective action.

A well-capitalized institution has:

- 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 the Office of Thrift Supervision (OTS) that it is in troubled condition.

An adequately capitalized institution is defined as neither well-capitalized nor undercapitalized.

An undercapitalized institution fails to meet minimum OTS regulatory capital requirements.

Adequately capitalized institutions must now obtain an FDIC waiver in order to accept, renew, or roll over brokered deposits. An adequately capitalized institution that needs a waiver should contact the appropriate OTS regional office to coordinate filing the waiver application with the FDIC. A copy of the waiver application should be submitted to the OTS regional office.

Adequately capitalized institutions are restricted as to the interest they may pay on brokered deposits. Any adequately capitalized institution that has been granted a waiver to accept, renew, or roll over a brokered deposit may not pay an effective yield on the deposits that exceeds the following yield by 75 basis points: (1) the effective yield paid on deposits of comparable size and maturity in such institution's normal market area for deposits accepted from within its normal market area or (2) the national rate paid on deposits of comparable size and maturity for deposits accepted outside the institution's normal market area. The FDIC has established that the national rate shall be 120 percent of the current yield on similar U.S. Treasury obligations; or in the case of any deposit that is at least half uninsured, 130 percent of such yield.

A deposit broker may not solicit or place any deposit with an insured depository institution unless it provides a notice to the FDIC that it is acting as a deposit broker.

OTS staff should refer to definitions and provisions of § 337 of the FDIC regulations to determine compliance with the brokered deposits provisions.

Deposit development and brokered deposit retention policies should recognize the following issues:

- Restriction on accepting, renewing or rolling over brokered deposits.
- Limits imposed by prudent competition.
- The risks of over-reliance on brokered deposits as a funding source.

Regulators should monitor their caseload of undercapitalized thrifts to identify violations of the prohibition on brokered deposits. If a thrift is in violation of the prohibition, staff should communicate this fact to the FDIC, request progress reports from the thrift regarding its disposition of brokered deposits, and initiate corrective action to ensure that the thrift ceases its violation.

- *Out-of-Area Accounts*: A high volume of deposits from customers who reside or conduct their business outside of the normal market area should be monitored by the thrift and reviewed by the regulator regarding their volatility and pricing. Such deposits may be the product of personal relationships or good customer service. However, large out-of-area deposits sometimes are related to liberal credit accommodations or have been attracted by paying significantly higher rates of interest than offered by competitors. Such deposits might prove costly in terms of excessive credit risks taken to generate sufficient revenue to pay for volatile, overpriced deposits.

  Only well-capitalized institutions may accept, renew, or roll over such deposits without restriction. Adequately capitalized institutions are subject to the interest rate caps described above.

- *Public Funds*: Public funds deposits should be reviewed because of their size and potential volatility. Public funds normally fluctuate on a seasonal cycle following the timing differences between tax collections and expenditures. Government officials controlling public deposits have a responsibility to ensure that such deposits are placed with a financial institution that can provide or arrange the best service at the least cost, and often place deposits with the highest bidder. Frequently, state laws require financial institutions to pledge collateral against public funds deposits. Public funds deposits acquired through political influence should always be regarded as volatile.

- *Stock Market-Indexed Certificates of Deposit*: Certificates of deposit with interest rates tied to a stock market index where a deposit brokerage firm covers the risk of increasing index values still entail certain risks. The movements of such indexes are subject to fluctuations that are unpredictable and, compared with the usual indexes used for variable-rate certificates of deposit, extraordinary. Pursuant to safety and soundness concerns, a savings association issuing such accounts must take precautionary measures. Accordingly, savings associations that offer variable-rate certificates of deposit tied to a stock market index must:

— Have the skills required to effectively analyze the potential interest expenses of the account.

— Take precautionary measures to ensure that it will not be subject to the payment of unrestrained interest expenses.

— Analyze the creditworthiness and financial strength of the brokerage firm, including the broker's specific plans to cover its interest rate risk exposure due to both upward or downward movements in the index.

— Have on file a record (for example, a broker's periodic status report) sufficient to disclose the broker's ongoing interest rate risk exposure from the date the association paid its "fixed fees" for receipt of the savings to the date of such a report.

— Ensure that the brokerage firm is contractually obligated to appropriately reimburse it in the event of an early withdrawal in view of an association's initial payment of a "fixed fee," representing prepaid interest costs paid on the assumption that the certificates will be held to maturity.

— Comply with the safety and soundness requirements of § 563.174 and § 563.175 of the OTS regulations and TB 13 if engaged in the interest rate futures or financial options transactions to cover interest rate risk exposure resulting from the issuance of these market-indexed accounts.

— Document the board of directors' approval of the form of account. The form must comply with the requirements of applicable law and regulations and the association's charter and bylaws; the minutes must include a detailed explanation as to how the interest rate risk exposure is to be covered. Otherwise comply with the requirements in §563.7.

— Comply with all other potentially applicable laws or regulations, such as those that the Securities and Exchange Commission and the Commodity Futures Trading Commission enforce. In light of this requirement, savings associations must consult with those agencies regarding the issuances of stock market-indexed certificates of deposit, or obtain for the file a legal opinion stating that the market-indexed CDs comply with all applicable law.

- *Large Deposits*: Large deposits are defined as those concentrations of funds under one control, or payable to one entity, that aggregate two percent or more of the institution's total deposits.
- *Demand Deposits*: Both bank and savings associations are prohibited from paying interest on demand deposits. The banking agencies (FDIC and FRB) have issued interpretations that permit premiums to be paid and describe when premiums will not be considered to be interest. Institutions may pay any premium that is not, directly or indirectly, related to or dependent on the balance in a demand deposit account and the duration of the account balance. OTS agrees that such premiums are not interest and generally follows the banking agencies interpretations on this point.
- *Sweep Accounts*: These are cash managed services that permit customers to earn interest on otherwise idle cash balances. Many institutions, particularly large, commercial banks and some savings associations, now offer these services to retail commercial and trust companies. Sweep accounts automatically "sweep" cash balances out of a checking or non-interest bearing deposit account into short term, typically overnight, investments outside the depository institution. A widely used vehicle by depository institutions is to "sweep" funds out of checking accounts into money market mutual funds that operate independently of the bank/savings association. Funds are swept from checking accounts into a money market mutual fund as frequently as every day after the close of business at the depository institution. The "sweep" is triggered by the amount of cash in the deposit account, which can be set by the depositor. The "sweep" also may be reversed so that shares in the money market mutual fund are redeemed and cash is deposited into the checking or non-interest bearing account at certain times or when certain dollar limits are reached. Depository institutions receive a fee for the "sweep" service.

The impetus for "sweep" accounts results from the statutory and regulatory prohibition on the payment of interest on demand accounts. Commercial checking accounts are non-interest bearing demand deposits owned by commercial entities, and against which checks may be written. Negotiable order of withdrawal (NOW) accounts are available only to individuals, including sole proprietorships or an unincorporated business owned by a husband and wife; non-profit organizations and for the deposit of public funds. While not technically demand deposits, NOW accounts permit the payment of interest on accounts which are subject to check writing but only for entities that qualify to use them. Because individuals and certain other non-corporate entities may hold NOW accounts which function as checking accounts, "sweep" arrangements for non-corporate entities do not necessarily raise legal questions. Since interest may be paid on NOW accounts held by individuals and certain non-corporate entities, "sweep" accounts are geared heavily toward corporations. It is essential that depository institutions have systems in place to ensure that "sweep" accounts comply with regulatory requirements.

Federal savings associations, unlike national banks, do not have the authority to directly invest customers' funds in mutual funds. Federal savings associations may, however, accomplish the same result for their customers through service corporations or with third-party broker-dealers. The service corporation or third party, pursuant to an agreement with the customer/ depositor, could in turn buy mutual fund shares for the customer and sell those same investments the next day. Upon sale, the sale proceeds belong to the depositor, who may deposit the proceeds back into the checking account at the federal savings association. "Sweeps" using mutual funds may involve more steps for federal savings associations than for national banks, but are permissible under applicable law.

Federal savings associations that wish to offer mutual fund "sweeps" through a service corporation have two options. Either the service corporation never holds mutual fund shares in its own name, so the type of mutual fund investments are unrestricted. Or, the service corporation holds the mutual funds in its own name and restricts the investments to those that savings associations can make. Savings associations may invest only in investment grade corporate debt securities.

An alternative method to structure a "sweep" is to invest excess cash of a checking account into repurchase agreements ("repos"). Such arrangements must comply with the Government Securities Act of 1986, as amended. See Thrift Activities Handbook, Section 563, Government Securities Act. Although permissible, this method is somewhat cumbersome because it requires substantial disclosures and a perfected security interest under state law for each sale subject to repurchase.

The simplest and most practical "sweep" arrangement is the so-called linked account "sweep" using two accounts at the same depository institution, one a checking account and the other some type of interest-bearing, non-checking account, such as a savings account or money market deposit account. However, the federal banking agencies have not allowed linked account "sweep" arrangements, either because these "sweeps" appear to evade the prohibition on paying interest on commercial checking accounts or, in the Federal Reserve Board's ("FRB's") case, because they interfere with the "FRB's" monetary policy.

Borrowed Funds

Borrowings provide thrifts with a complementary and often attractive alternative to deposits as a source of funds. Generally, thrifts pursuing a strategy of moderate growth find borrowing an attractive funding alternative to retail deposits. However, rapid growth based on short-term borrowed funds, without well-established risk management controls, has also contributed to the failure of several financial institutions.

The thrift's present and anticipated use of borrowed funds should be integrated into the overall goals and objectives of the business plan and its funds management strategy. Borrowing is subject to criticism if precipitated by poorly planned funds management practices. Prudent management of borrowed funds should include:

- The clear identification of the purpose of the borrowing;
- Analysis of present and anticipated funding and liquidity needs;
- Analysis of the cost of the borrowing (including the desired spreads between the cost of the borrowing and the earnings from the assets funded, and, if issuing securities, the cost of issuance);
- Analysis of the availability of collateral;
- Comparative analysis of the costs of various alternative types of borrowings and deposits; and
- Frequent monitoring of the borrowing activity to ensure that it remains appropriate to the thrift's overall goals of interest rate risk management, liquidity management, funds management, and near-term and longer-term profitability.

Many thrifts have become active solicitors of funds in the financial markets through transactions such as reverse repurchase agreements and various debt security issuances. Access to the financial markets and the cost of such borrowings is related to the thrift's credit reputation, which is primarily based

upon the thrift's financial condition and adequacy of capital.

Although borrowings in the financial markets can be an attractive alternative to deposits, they have certain costs and risks that must be considered. Borrowings through debt issuance have operating costs that should be considered such as issuance expenses and investment banker fees. A more important consideration is that thrift borrowings typically are collateralized. The amount that a thrift can borrow is related to the market value of the collateral. When interest rates increase, the market value of most financial collateral declines. Consequently, rising interest rates often require a thrift to pledge additional collateral or repay some debt. Such rising-rate scenarios can place a considerable strain on the thrift's liquidity. In a rising-interest rate environment, the thrift's financial condition will also be negatively affected if it has a significant mismatch of short-term borrowings financing long-term assets that are required to be held as collateral for borrowings.

Securities that are collateralized by direct obligations of or are fully guaranteed as to principal and interest by the United States or any agency thereof should not be "sold" in repurchase agreements under $100,000 with maturities of 90 days or more unless they meet the requirements under § 563.84 of the OTS regulations. In addition, the OTS considers the following to be "agencies" for the purposes of government repurchase agreements:

1. Federal Home Loan Bank(s) (FHLB) (including time deposits and overnight deposits). Note: FHLB overnight deposits are eligible collateral for retail repos only if a security interest may be perfected in such account as required in § 563.84(b)(3).
2. Federal National Mortgage Association
3. Government National Mortgage Association
4. Bank(s) for Cooperatives, including the Central Bank of Cooperatives*
5. Federal Land Bank(s)*
6. Federal Intermediate Credit Bank(s)*
7. Tennessee Valley Authority
8. Export-Import Bank of the United States
9. Commodity Credit Corporation
10. Federal Financing Bank
11. Federal Home Loan Mortgage Corporation
12. Student Loan Marketing Association

* Federal Farm Credit Banks

Major Sources of Borrowed Funds

Federal Home Loan Bank Advances

A traditional source of borrowing has been FHLB advances. The FHLB policies determine the types of advances, terms available, and any commitment fees. FHLB advances may be short- or long-term and may be secured or unsecured. An institution may use mortgages or other assets including notes secured by loans, funds on deposit with the FHLB, and obligations issued, insured, or guaranteed by the U.S. Government as security for an advance. Whether an advance is otherwise unsecured or secured, the institution's FHLB stock is pledged against all advances.

The Federal Housing Finance Board (FHFB) also determines the availability of FHLB advances to member institutions. An FHLB will not make new advances available to a tangibly insolvent member without advance request to the FHLB and notification of the FHFB. Such advances may be renewed for up to 30 days at the discretion of the FHLB. Requests from the OTS or FDIC that an FHLB not renew advances will be honored and must be submitted through the FHFB. For an institution that fails one or more capital requirements, an FHLB may make new advances as long as the institution is tangibly solvent. Such a member institution's access to advances may be limited or eliminated by an FHLB at the written request of the OTS or FDIC through the FHFB.

Reverse Repurchase Agreement

Reverse repurchase agreements (reverse repos) with investment broker/dealers are commonly used by thrifts as a short-term source of funds. Reverse repos are collateralized borrowings wherein the thrift

"sells" securities to a broker, agreeing to repurchase the same securities at a specified price and date.

Any repurchase agreement program should be authorized by a savings association's board of directors only after consideration of the association's financial plan, operational system, and risk controls. An association must create and maintain a system of appropriate internal control procedures similar to those instituted for other debt securities issuances and structured financings. Associations must comply with the federal securities laws, as well as with other regulatory and fiduciary requirements. Board minutes relating to the initial approval and subsequent review of such programs should also reflect compliance with all applicable OTS and Securities and Exchange Commission (SEC) requirements. As a result, any repurchase program authorization should document the board of directors' consideration of these matters and the conclusions should be recorded in the board's minutes. An association's repurchase agreement program must also be monitored closely by association management with appropriate expertise and experience in managing repurchase agreement programs.

As with any securities offering, the thrift should follow the regulatory requirements found in 12 CFR §§ 563.76, 563.80, 563.84 and Part 563g of the OTS regulations.

In order to satisfy the requirements of §563.84(b)(3) that the interest of a repurchase agreement purchaser in the security or securities underlying the repurchase agreement constitutes a perfected security interest under applicable state law, an issuing institution must structure its repurchase agreement program as a secured lending transaction. Repurchase agreement programs structured as a sale by the institution of undivided fractional interests in a government security or a pool of government securities, subject to the institution's obligation to repurchase those interests, do not satisfy the requirements of § 563.84(b)(3).

The issuance of repurchase agreements constitutes securities offerings and are subject to the requirements of the federal securities laws. These requirements include registration under the Securities Act of 1933, the Securities Exchange Act of 1934, and the Investment Company Act of 1940, unless exempted or the association's program is operating within the parameters of a "no action" position. Thrifts must comply with the OTS requirements related to securities offerings set forth in 12 CFR Part 563g, which applies the Securities Act and Securities Exchange Act specifically to thrifts under OTS jurisdiction.

The anti-fraud provisions of the federal securities laws also are applicable to repurchase agreement programs and may result in the imposition of severe sanctions against an association's directors and managers, including civil and criminal liability. These anti-fraud provisions prohibit fraudulent conduct, including making false or misleading representations in offering materials, advertisements, or otherwise if related to repurchase agreements.

If similar but not identical securities are sold and repurchased, they are referred to as dollar reverse repurchase agreements (dollar reverse repos) or dollar rolls. Reverse repos, wherein identical securities are exchanged, are accounted for as financing transactions. Depending on the terms of the agreement, dollar reverse repos are accounted for either as financings or as purchase and sales. For accounting purposes, dollar reverse repos can be considered financings if the securities returned at the repurchase date are "substantially the same" as the securities "sold" at the origination date. If the returned securities are not substantially the same, the transaction becomes a sale for accounting purposes.

Substantially the Same. Securities are considered substantially the same when they have similar characteristics and similar yields. The issuer, coupon interest rate, maturity, and anticipated prepayments of the underlying loans must all be consistent to be considered substantially the same. The issuer of the security (e.g., GNMA or FHLMC) is important because differences exist in relative creditworthiness. Loans packaged into a pool security must yield the same composite interest rate and have similar maturities. For example, GNMA issues two general types of securities: GNMA I's (characterized by loans with little deviation in individual interest rates with 30-year terms and from a similar geographic area) and GNMA II's (characterized by loans with a wider spread in their individual interest rates with 15- or 30-year terms and with more geographic diversity). Therefore,

because of differing characteristics, a GNMA I generally cannot be exchanged for a GNMA II and fulfill the substantially same criteria. Exchanges of GNMA I's for GNMA II's must be reviewed individually to determine that the securities have similar yields and maturities in order to be considered substantially the same.

Over-Collateralization. One of the primary sources of risk in reverse repos is required over-collaterization. Excessive over-collateralization of reverse repos is an unsafe and unsound practice that poses a serious risk to the earnings and assets of the institution. Should the purchaser be unable for any reason to redeliver the securities upon maturity of the repurchase agreement, large losses would result. The term of the agreement, the type of collateral transferred, and the likelihood of market value fluctuations in the value of the collateral are the primary determinants of the collateralization level necessary for reverse repos. The percentage of collateralization is based on the market value, not the face value, of the securities at the time of the transaction.

Typical collateralization levels required by reputable broker-dealers approximate the following:

Type of Security/ Term of Agreement	
U.S. agency securities/	
less than 1 month	2%
1 month	3-4%
2 month	4-5%
3 month	5-6%
U.S. government notes/	
1 month	1/4%
2 month	1/2%
3 month	3/4%
U.S. government bonds/	
1 month	1/2%
2 month	1%
3 month	1-1/2%
Collateralized mortgage obligations*	
1 month	5-7%
2 month	6-8%
3 month	7-9%

* For institutions with capital (excluding goodwill) exceeding $16 million. Smaller institutions would require a minimum of 20 percent, and often much more, to effect these transactions.

Riskier securities, such as stripped mortgage-backed securities, planned amortization class, targeted amortization class, and collateralized mortgage obligation residuals, have substantially higher and wider-ranging collateralization requirements.

Collateralization levels in excess of these for U.S. agency or government securities should necessitate further review and comment by the regulator and the board of directors' awareness and involvement in the transaction. For all such transactions, thrifts should attempt to minimize the necessary collateralization requirements by contacting several reputable brokers to obtain quotes. These quotes should be documented.

Counter-Party Risk. Excessive over-collateralization is not the sole risk factor affecting reverse repurchase agreements. The strength of the counter-party is also critical to minimizing risks to the thrift. Thrifts should routinely monitor the creditworthiness of counter-parties. At a minimum, this should include determining whether the counter-party is a primary dealer and length of time in business, reviewing counter-party reports filed with the SEC, reviewing financial statements of the counter-party with respect to capital levels, evaluating previous experience with the dealer, and researching the reputation of the counter-party with the SEC and the National Association of Securities Dealers.

Regulators should also review provisions for the assignment of collateral, rights to rehypothecate, and collateral maintenance practices for reverse repurchase agreements.

To satisfy the requirements of § 563.84(b)(3) -- that the interest of a repurchase agreement purchaser in the security or securities underlying the repurchase agreement constitutes a perfected security interest under applicable state law -- an issuing institution must structure its repurchase agreement program as a secured lending transaction. Repurchase agreement programs structured as a sale by the institution of undivided fractional interests in a government security or a pool of government secu-

rities, subject to the institution's obligation to repurchase those interests, do not satisfy the requirements of § 563.84(b)(3).

Short Funding. Some thrifts fund the purchase of mortgage-backed securities (MBSs) by entering reverse repos. If there is a significant difference between short- and long-term interest rates (yield curve is positively sloped), sizable spreads can be achieved. However, these spreads can be achieved only by assuming a significant amount of interest-rate risk. If the dollar amount invested in this strategy comprises a significant percentage of assets or exceeds explicit exposure limits required by the board of directors in accordance with TB 13, Responsibilities of the Board of Directors and Management with Regard to Interest Rate Risk, the strategy may be considered unsafe and unsound.

Collateralized Mortgage Obligation (CMO)

Thrifts issuing CMOs use MBSs or mortgage loans to collateralize the CMO security. A CMO is structured so that the cash flows from the underlying collateral, given conservative prepayment and interest rate level assumptions, are sufficient to repay, with stated interest, the obligation arising from the issuance of the CMO. A high investment rating, resulting from conservative prepayment assumptions, coupled with the CMO's various maturity structures and interest rates provides appeal to a broad range of investors.

The issuer of a CMO agrees to pay monthly, semiannually or quarterly coupons on the outstanding bond value and to retire the bond principal according to prescribed structure. For instance, a CMO structure is characterized by classes, or "tranches." Typically, the tranches may consist of: (1) a short-term, fast-pay tranche, (2) a short-intermediate tranche, (3) a long-intermediate tranche, and (4) a slow-pay, zero-coupon ("Z" or "accretion") tranche. In a CMO, some tranches receive a coupon, while other tranches receive principal payments from the collateral as well. When the first tranche is retired (paid-off), the second tranche receives principal, and so on. Normally, the class with the shortest maturity receives all of the principal prepayments until it is retired. In the interim, the zero-coupon tranche accrues interest, which is added to its principal balance, resulting in negative amortization. Once faster paying tranches are retired, the zero-coupon tranche begins to receive payments on the then-higher principal.

In recent years, CMOs have been structured ranging from a single class to dozens of classes. Some CMOs contain floating-rate tranches in which the bond coupon is periodically readjusted based on an index, typically the London Interbank Offering Rate (LIBOR). A "straight" floating-rate tranche moves in the same direction as changes in the index; an "inverse" floating-rate tranche moves inversely to changes in the index. Many CMOs contain a planned amortization class (PAC) or targeted amortization class (TAC) tranche designed to provide investors increased protection against prepayment risk. PAC and TAC tranches transfer risk to the non-PAC and non-TAC tranches. Tranches that are specifically designed to absorb prepayment risk from PAC and TAC tranches are referred to as "support classes."

The effective interest rate (effective cost to the issuing thrift) and the term of the borrowing arising from the CMO will depend upon the prepayments of the collateral underlying the CMO. Also considered in the interest rate on the borrowing are the costs of issuing the CMO (legal, accounting, and other costs). These costs will be amortized over the expected life of the CMO. Therefore, faster prepayments of the underlying collateral will require a faster write-off of the expenses increasing the effective cost. It is very important to determine where the proceeds from the CMO are invested. Since the term and effective interest rate of the CMO will vary based upon prepayments of underlying collateral, it is important to determine the expected return from the assets in which the proceeds from the CMO are reinvested. The expected term of these assets should be determined.

Residual cash flows arise due to the conservative assumptions required by rating agencies to be used in structuring the CMO and assessing the characteristics of the underlying collateral to ensure that the CMO is self-supporting. To the extent that actual cash flow exceeds these conservative assumptions, "excess" or residual cash flows are created. The residual interest represents the present value of all amounts expected to revert to the issuer or its affiliates (including reinvestment earnings).

The shorter CMO tranches will generally bear a lower interest rate than the underlying mortgages that are collateral for the issuance. This means that during the early life of the CMO, the issuer will receive income in excess of the interest expense it pays, while during the later years, the income will be less than the interest expense it pays to the CMO holders. The excess of income over the interest expense during the early life of the CMO is known as phantom income. Since it will be offset in later years, it is not income in the real economic sense. This phantom income is accrued to the issuer as the holder of the residual interest and will be transferred to buyers of the residual interest.

Frequently, thrifts have established a finance subsidiary to issue a CMO. In the past, one benefit of issuing a CMO through a finance subsidiary had been the exclusion of the CMO security from the thrift's minimum capital requirement calculation. However, under the present capital regulations, this exclusion is eliminated. Effective January 1, 1997, specific authority for finance subsidiaries contained in former 12 CFR § 545.82 was removed and all existing finance subsidiaries are deemed operating subsidiaries under 12 CFR § 559.11. All the functions of a finance subsidiary may be done with fewer restrictions by an operating subsidiary.

Effective January 1, 1987, REMIC legislation permitted various security structures such as CMOs, senior subordinated interests, and regular pass-through securities to be issued under the REMIC tax authority. The REMIC legislation provided flexibility in structuring multiclass mortgage securities as asset sales or financings subject to GAAP accounting standards. For example, a thrift using MBSs with unrealized losses as underlying collateral will likely choose to classify its CMO issuance as a financing, rather than a sale, for financial reporting to avoid recording the loss. However, for tax purposes, under REMIC treatment, the transaction can be structured as a sale to record the losses and thus reduce the tax liability. Prior to the REMIC legislation, if sale treatment was desired, CMO transactions needed to pass very stringent tests. Although the transaction could theoretically pass the tests for accounting purposes, the result was almost inevitably unacceptable from a tax viewpoint.

The underlying collateral of CMOs structured to meet the GAAP standards for a sale of assets are treated as if sold, and the liability associated with the issue does not appear on the issuer's financial statements. If the transaction is treated as a financing, the MBSs or mortgages stay on the issuer's books and the balance sheet is simply grossed up to reflect the cash received from the offering and the related liability under the bonds. (Any costs incurred are deferred and amortized over the life of the liability.)

Other Sources of Borrowed Funds

Common sources of thrift borrowed funds include the following:

- Federal funds purchased (commercial bank loans).
- Issuance of various other debt securities.
- Retail reverse repurchase agreements.
- Loans from a parent or affiliate.
- Loans secured by the thrift's office building.
- Underlying mortgage in a wrap-around loan unless the holder of the underlying mortgage has accepted a subordinate position.
- Liabilities for capital leases related to the institution's offices or premises and equipment.
- Redeemable preferred stock issued by consolidated subsidiaries to third parties.
- Commercial paper issued.
- Eurodollars issued.
- Liability from "sale" of loans with recourse accounted for as a financing.

Also considered a source of borrowed funds are overdrafts in the institution's transaction accounts in other depository institutions, where there is no right of offset against other accounts in the same financial institution, unless the overdraft is in a zero-balance account or an account that is not routinely maintained with sufficient balances to cover checks drawn in the normal course of business.

Deposits/Borrowed Funds Analysis

Cost and Risk Analysis

Management should analyze and monitor the deposit and borrowing composition to determine the effect of the financial costs on the net interest margin and profitability, and to assess the risks associated with these liabilities. The analysis should assist management in determining an acceptable liability mix. The regulator should evaluate the adequacy of management's analysis and its monitoring systems. Cost and risk analysis should include:

- The identification of the overall rate/volume/ mix of deposits and of borrowings and the periodic evaluation of changes (variance) in interest expense due to changes in rate/ volume/mix.
- An evaluation of the risk/benefit trade-offs of the various sources of funds. (See discussion of risk/benefit trade-offs below.)
- A procedure to estimate the effect of an instantaneous and sustained shift in interest rates of ± 100, ± 200, ± 300, ± 400 basis points on the net portfolio value of deposits and borrowings. (Refer to Thrift Activities Handbook Section 650, Interest Rate Risk Management, for detailed discussion.)
- An analysis of the marginal cost to generate additional funds.
- An analysis of the potential effects on profitability of paying below-market rates on deposits.

Risk/Benefit Trade-Offs

Management should not attempt to increase net interest income by merely increasing the level of risk in the liability structure without adequately analyzing and evaluating the risk/benefit trade-offs. Examples of risk/benefit trade-offs include:

Retail versus brokered (including money desk) deposits: Retail deposits generally are more stable and less interest costly than brokered deposits, but usually carry higher operating costs and are limited in total volume by the size of the local market area and the competition within the local market area. Brokered deposits, although usually higher risk in terms of volatility and interest costs, nevertheless, may be appropriate for some thrifts, provided that they are well-capitalized, or have a waiver from the FDIC permitting them to offer brokered deposits if they are adequately capitalized.

Borrowings versus deposits: Borrowings can provide a large volume of funds quickly, while retaining current deposit pricing strategies. The cost of certain large-volume borrowings (e.g., certain issuance costs, effective reverse repo rates) may benefit from economies of scale. However, borrowings introduce collateral risk. Depending upon their maturity and payment characteristics, an increase in either borrowings or deposits may aggravate interest rate risk.

Thrifts generating large volumes of volatile short-term deposits or accessing large volumes of short-term borrowings should evaluate the feasibility of hedging to alleviate their interest rate risk. (Refer to Thrift Activities Handbook Section 660, Hedging.)

Marginal Cost Analysis

When interest rates are changing, average cost and marginal cost of deposits will differ. Consideration of marginal cost is especially appropriate for monitoring and evaluating the cost of new deposits. When rates are rising, the true cost of acquiring new deposits (marginal cost) will be greater than the simple average of the incremental cost of a higher rate paid on new deposits and an unchanged cost on existing deposits. The higher rate must be paid not only to the new depositors, but also to the existing depositors who would have been willing to hold deposits at the lower rate. The larger the volume of existing accounts, the higher the marginal cost. In addition, the cost of servicing accounts will rise as deposits increase. Moreover, an increase in the rate at one maturity level might necessitate a change in rate at other maturity levels. The reaction of competing thrifts should also be considered in setting interest rates on deposits.

Analysis of the true cost of additional deposits places management in a better position to control these costs. Some thrifts have paid high rates to attract new deposits, resulting in a marginal cost that exceeds the return on the loans and investments funded by those deposits. Such conditions encourage decisions to relax loan and investment credit underwriting standards.

Marginal cost analysis may not be as appropriate for monitoring and evaluating the cost of additional borrowings because the rate paid on new borrowings is limited to the incremental funds raised, not total funds. However, a comparative analysis of the marginal cost of new deposits to the incremental cost of new borrowings should be done. (See Thrift Activities Handbook Section 530, Cash Flow and Liquidity Management.)

Below-Market Rates

Thrifts considering a strategy to shrink the balance sheet by paying below-market rates on deposits must research their market. A primary risk of the strategy is underestimating the expected deposit outflow. The rate sensitivity of deposits differs from product to product, among different locations, and among different customer groups.

The effect of a below-market rate strategy on profitability may be approximated by comparing estimated cost savings (represented by the expected volume of deposit outflow times the rate that had been paid on these deposits; plus the cost savings represented by the spread between the market rate and the below-market rate paid on the remaining deposits); with the estimated cost (represented by the yield given up on interest-earning assets expected to be sold times the volume expected to be sold, and/or the cost of any anticipated new borrowings needed to replace the deposit outflow as a continuing funding source).

References

United States Code (12 USC)

Chapter 16: Federal Deposit Insurance Corporation

§ 1831f Brokered Deposits

Code of Federal Regulations (12 CFR)

Federal Deposit Insurance Corporation
Subchapter B: Regulations and Statements of General Policy

§ 337.6 Brokered Deposits

Office of Thrift Supervision

§ 545.16 Public Deposits, Depositories, and Fiscal Agents
Part 557 Deposits
§ 561.16 Demand Accounts
§ 561.28 Money Market Deposit Accounts
§ 561.29 Negotiable Order of Withdrawal Accounts
§ 563.80 Borrowing Limitations
§ 563.81 Issuance of Subordinated Debt Securities and Mandatorily Redeemable Preferred Stock
§ 563.84 Transfer and Repurchase of Government Securities
§ 563.174 Futures Transactions
§ 563.175 Financial Options Transactions
Part 563g Securities Offerings

Office of Thrift Supervision Bulletins

RB 3b Policy Statement on Growth for Savings Associations
TB 13 Responsibilities of the Board of Directors and Management with Regard to Interest Rate Risk

Deposits/Borrowed Funds
Program

Examination Objectives

To determine if the established strategic plans, policies, procedures, and practices related to deposit solicitation/retention, liquidity, and borrowed funds adequately addresses safety and soundness, near- and longer-term profitability, and compliance with laws and regulations.

To determine whether the thrift's officers and employees are operating in conformance with the established plans, policies, procedures, laws, and regulations.

To determine the thrift's ability to generate market rate deposits, and its ability to access borrowed funds.

To determine the adequacy of management's monitoring of deposits/borrowed funds.

Examination Procedures

Wkp.Ref.

Level I

1. Coordinate responsibilities and communicate findings with the examiner(s) assigned to the review of cash flow/liquidity management and funds management.

______________________________ ________

2. Obtain and review strategic plans, marketing plans, policies, and procedures related to deposits and borrowed funds. Determine whether these plans and policies are integrated in the goals and objectives of the business plan. Planning and policy guidelines should address safety and soundness issues, near-term and longer-term profitability, and compliance with laws and regulations.

______________________________ ________

3. Determine that written plans, policies, and procedures are reviewed and updated as necessary and that policy changes are communicated to appropriate personnel.

______________________________ ________

4. Analyze the present sources, volumes, and trends of deposits and other borrowed money (e.g., core deposits, volatile deposits, short- or longer-term borrowings).

______________________________ ________

Exam Date: ____________
Prepared By: ____________
Reviewed By: ____________
Docket #: ____________

Wkp.Ref.

5. Assess the adequacy of management's evaluation of the thrift's near-term and longer-term funding needs, and of the advantages/disadvantages of alternative funding sources as well as the thrift's access to those sources.

______________________________ __________

6. Evaluate the present deposit and other borrowing structure in terms of:

- Deposit pricing (e.g., at, above, or below-market competition);
- Cost of the various major types of deposits and borrowings in relation to the thrift's overall cost of funds and the spreads between these sources of funds and the earnings of the assets funded;
- Availability of assets to collateralize borrowings;
- Major mismatching of short-term sources of funds financing long-term assets;
- Liquidity;
- Level of capital; and
- Ability to extend or repay maturing borrowings.

______________________________ __________

7. Evaluate whether planned growth is achievable, cost-beneficial, and supported by adequate capital. Refer to the supervisory guidelines contained in Regulatory Bulletin 3b**,** Policy Statement on Growth for Savings Associations.

______________________________ __________

8. Review the adequacy of management reports and the information systems to provide management and the directors with information that is accurate, relevant, and useful for decision making and for monitoring compliance with on-going plans and policy guidelines.

______________________________ __________

Exam Date: ______________
Prepared By: ______________
Reviewed By: ______________
Docket #: ______________

Wkp.Ref.

9. Evaluate management's expertise to carry out its responsibilities to conduct deposit solicitation/ retention and borrowing activities in a prudent, safe, and sound manner.

10. Analyze brokered deposits to determine the volume of uninsured deposits, concentrations of deposits from a particular broker or group of brokers, money desk activity, and adequacy and completeness of records.

11. Determine if more than two percent of the deposits are concentrated under the control of, or payable to, one entity.

12. If the thrift is not well-capitalized, determine compliance with the restrictions or prohibition on brokered deposits.

13. Review reports of broker fees paid and subsidiary expense ledgers for any unusual brokered deposit activity. Confirm that a deposit broker is registered with the FDIC per § 337.6 if needed.

14. Review a sample of trade tickets and confirmations of financial market borrowing transactions such as reverse repurchase agreements. Test check that these transaction records correspond to the transaction logs, reports to management and the directors, and to the general and subsidiary ledgers.

15. Evaluate the appropriateness of amounts of collateral for reverse repurchase agreements, and report any evidence of over-collateralization.

16. Review the reconciliation of suspense accounts.

Exam Date: ____________
Prepared By: ____________
Reviewed By: ____________
Docket #: ____________

Wkp.Ref.

17. Review the Level II procedures and perform those necessary to test, support, and present conclusions derived from the performance of Level I procedures.

____ __________

Level II

18. Obtain a listing of deposit accounts of directors, officers, and other affiliated persons. Test check these accounts for preferential rates and appropriate board approval of overdrafts.

____ __________

19. Reconcile borrowed funds balances to the general ledger.

____ __________

20. Ensure that the *Objectives* of this Handbook Section have been met. State your findings and conclusions, as well as appropriate recommendations for any necessary corrective measures, on the appropriate work papers and report pages.

____ __________

Exam Date: __________
Prepared By: __________
Reviewed By: __________
Docket #: __________

Deposits/Borrowed Funds
Questionnaire

General Questionnaire

	Yes	No
General Questionnaire		
1. Has management developed a clearly defined retail deposit marketing strategy that identifies desired market share and assesses present and potential competition?		
2. Is the retail deposit marketing strategy integrated with the goals and objectives of the business plan?		
3. Does management analyze the deposit structure and identify core and volatile deposits?		
4. Have substantial amounts of funds been obtained through deposit brokers or money desk operations?		
• Is the board of directors aware of the high amount of brokered or money desk deposits?		
• Are more than two percent of the deposits concentrated under the control of, or payable to, one entity?		
5. If accepting "brokered deposits" (including brokered, money desk, and deposits paying a significantly higher rate of interest than the prevailing rate offered by other thrifts in the normal market area), is the thrift well-capitalized, or if adequately capitalized, does it have a waiver from the FDIC?		
6. Does management analyze its present and anticipated funding needs?		
7. Does management analyze the cost of deposits versus the cost of other borrowing alternatives?		
8. Does management analyze and monitor the availability of collateral for borrowings?		
9. Does management regularly monitor pricing, volume, sources, volatility, and trends of its deposits and borrowings in relation to the overall goals of interest rate risk management, liquidity management, funds management, and near- and longer-term profitability?		
10. If the association has stock market-indexed certificates of deposit, has it complied with the safety and soundness, legal, reporting, and records requirements for offering these instruments?		
11. Is the level of over-collateralization of reverse repurchase agreements acceptable?		
12. Are the savings and borrowings trial balances reconciled to the general ledger on at least a weekly basis?		
13. Are files of trade tickets and confirmations of borrowings from the financial markets maintained?		
14. Are the trade tickets and confirmations accurate?		
15. Are internal control procedures regarding deposits and borrowings adequate?		

Comments

____

____

____

____

____

Exam Date: ______________
Prepared By: ______________
Reviewed By: ______________
Docket #: ______________