[Reserved]

INTRODUCTION

This section is designed to help the examiner develop an overview of a bank's financial condition and results of operations through the use of analytical review techniques. It also provides procedures to assist in evaluating the reasonableness and reliability of the bank's income and expense accounts. (However, no analytical view of a bank's operating results is complete without due consideration of the stability and probable continuity of the earnings. In this regard, the examiner must remain cognizant of the inextricable links between liquidity and earnings and the implications of a bank's funds-management decisions, particularly those dealing with interest-rate risk.

GENERAL EXAMINATION APPROACH

The review and analysis of the bank's financial condition and results of operations should begin during the pre-examination analysis of the bank (see ''Examination Strategy and Risk-Focused Examinations,'' section 1000). Pre-examination analysis is meant to determine potential problem areas so that proper staff levels and appropriate examination procedures can be used. The analysis will be performed using the most recent Uniform Bank Performance Report (UBPR). (See ''Federal Reserve System Surveillance Program,'' section 1020.)

Questions raised during the preliminary review should be answered and substantiated soon after commencing the examination, while performing the more comprehensive analytical review. The analytical review should use the UBPR financial statements and reports, detail trial balances, analyses of accounts, financial budgets, statistical information, and any other relevant data available at the bank. Explanations for unusual conditions identified during the review, and work performed to substantiate such explanations, should be documented in the examination workpapers.

If internal or external auditors have not performed adequate audit procedures relating to income and expenses, the examiner should test check computations for accuracy and trace entries to appropriate accounts. (See ''Internal Control,'' section 1010, for a discussion of procedures to use in reviewing the audit work of others.)

ANALYTICAL REVIEW

Analytical review involves a comparison of detail balances or statistical data on a period-to-period basis in an effort to substantiate reasonableness without systematic examination of the transactions that make up the account balances. Analytical review is based on the assumption that comparability of period-to-period balances and ratios shows them to be free from significant error. A well-performed analytical review not only benefits the examination by providing an understanding of the bank's operations, but also highlights matters of interest and potential problem situations which, if detected early, might avert more serious problems.

Analytical Tools

The basic analytical tools available to the examiner are the UBPR and the bank's financial statements. Internally prepared statements and supplemental schedules, if available, are excellent additions to an in-depth analytical review. The information from those schedules may give the examiner considerable insight into the interpretation of the bank's basic financial statements. However, internally prepared information alone is not sufficient to adequately analyze the financial condition of the bank. To properly understand and interpret financial and statistical data, the examiner should be familiar with current economic conditions and with any secular, cyclical, or seasonal factors in the nation, region, and local area, including general industry conditions. Economic and industry information, reports, and journals are an important source for knowledge of industry conditions. Finally, the examiner should be knowledgeable about new banking laws and pending legislation that could have a material impact on financial institutions.

Review of Financial Statements

An analytical review of a bank's financial statements requires professional judgment and an inquiring attitude. During the analysis, the examiner should avoid details not specifically related to his or her objective so that excessive time is not spent analyzing relatively immaterial amounts.

Generally, it is more efficient to review financial data that have been rounded to the nearest thousand. Undue precision in computing and reviewing ratios should be avoided. An evaluation of the meaning of the ratios and amounts being compared is important; little can be gained by computing ratios for totally unrelated items. When comparing bank data to peer-group data, the examiner should consider whether the bank is typical of its peer group (a group of banks of similar size and reporting characteristics). For example, the bank might be of comparable size to its peers, but still be atypical because its earning assets are composed principally of agricultural loans or mortgage loans. The age of the institution should also be taken into account when using peer-group data, as newly chartered de novo banks tend to produce distorted ratios (versus the peer group).

Alternative accounting treatments for similar transactions among peer banks also should be considered because they may produce significantly different results. The analytical review must be based on figures derived under valid accounting practices consistently applied, particularly in the accrual areas. Accordingly, during the analytical review, the examiner should determine any material inconsistencies in the application of accounting principles.

The examiner also should be aware of the difficulty of interpreting the cash basis accounting method. Any required adjustments should be documented and explained in the workpapers and examination report.

UBPR

Another analytical tool available to the examiner is the UBPR. The user's guide for the UBPR explains how a structured approach to financial analysis should be followed. This approach breaks down the income stream into its major components of interest margin performance, overhead, noninterest income, loan-loss provisions, tax factors, and extraordinary items. These major components can then be broken down into various subcomponents. Also, the balance-sheet composition, along with economic conditions, must be analyzed to explain the income stream and its possible future variability.

In addition to UBPR analysis and review of bank financial statements, the examiner should incorporate a review of management's budget and/or projections into his or her analysis. A review of projections and individual variances from the operating budget can often provide valuable insight into an institution's prior and future earnings. The examiner should also verify the reasonableness of the budgeted amounts, frequency of budget review by bank management and the board of directors, and level of involvement of key bank personnel in the budget process.

The primary source of information used to prepare UBPRs are the Consolidated Reports of Condition and Income, which are filed quarterly. The content and frequency of these reports are sufficient to allow the reviewer of the UBPR to detect unusual or significantly changed circumstances within a bank, and they normally will be adequate for the purposes of analytical review. Accordingly, the examiner must check these consolidated reports to ensure the resulting accuracy of the UBPRs.

Frequently, the examiner may be interested in a more detailed and current review of the bank than that provided by the UBPR system. Under certain circumstances, UBPR procedures may need to be supplemented because—

- asset-quality information must be linked to the income stream;
- more detailed information is necessary on asset-liability maturities and matching;
- more detailed information is necessary on other liquidity aspects, as they may affect earnings;
- yield or cost information, which may be difficult to interpret from the report, is needed;
- certain income or expense items may need clarification, as well as normal examination validation;
- volume information, such as the number of demand deposits, certificates of deposit, and other accounts, is not reported, and vulnerability in a bank subject to concentrations normally should be considered;
- components of interest and fees on loans are not reported separately by category of loan; thus, adverse trends in the loan portfolio may not be detected (For example, the yield of a particular bank's loan portfolio may be similar to those of its peer group, but the examiner

may detect an upward trend in yields for a specific category of loans. That upward trend might be partially or wholly offset by a downward trend of yields in another category of loans, and the examiner should consider further investigating the circumstances applicable to each of those loan categories. A change in yields could be a result of a change in the bank's "appetite" for certain types of loans or may indicate a change in loan underwriting standards.); or
- income or expense resulting from a change in the bank's operations, such as the opening of a new branch or starting of a mortgage banking activity or trust department, may skew performance ratios. (When there has been a significant change in a bank's operations, the examiner should analyze the potential impact of the change on future bank earnings.)

Written Analysis

After the examiner has completed the analytical review of income and expense, he or she should prepare a written analysis to be submitted to the examiner-in-charge. This evaluation should include, but is not limited to, a review of the bank's—

- quality and future prospects for core income;
- ability to cover losses and maintain adequate capital, including compliance with the minimum capital standard;
- earnings levels and trends;
- composition of earnings and sustainability of the various earnings components (This may include a discussion of balance-sheet composition, particularly the volume and type of earning assets and off-balance-sheet items, if applicable.);
- peer-group comparisons;
- vulnerability to interest-rate and other market or price risks;
- income and expense accounts, and their reliability, including applicable accounting practices, internal controls, and audit methods;
- compliance with laws and regulations relating to earnings and dividends; and
- budgeting process and the levels of management involved in it.

Examiners should consider the adequacy of provisions to the loan-loss reserve. If the examiners conducting the asset quality review determine that the loan-loss reserve is inadequate, the bank's earnings are inflated and should be restated accordingly. In turn, this determination should be factored into the examiner's assessment of management, including its responsibility to maintain an adequate loan-loss reserve.

Consideration should also be given to the interrelationships that exist between the dividend-payout ratio, the rate of growth of retained earnings, and the adequacy of bank capital. Examiners should consider the extent to which extraordinary items, securities transactions, and taxes affect net income. The links between earnings and liquidity and the implications of a bank's funds management decisions, particularly with respect to interest-rate sensitivity, should also be fully analyzed.

Analytical Review and Income and Expense

Examination Objectives

Effective date May 1996

Section 4010.2

1. To detect significantly changed circumstances before or as early as possible during the examination so that any impact on the determination of the scope and conduct of the examination may be assessed.
2. To analyze the financial position and operations of the bank and to investigate any unusual fluctuations.
3. To assist in determining the reliability of the bank's financial information and the consistency of the application of accounting principles.
4. To determine if accounting policies, practices, procedures, and internal controls relating to income and expenses are adequate.
5. To determine the scope and adequacy of the audit function.
6. To determine compliance with laws and regulations relating to income and expenses to the extent that such compliance is not covered elsewhere in the examination.
7. To initiate corrective action when deficiencies or violations of law or regulation have been discovered.

1. Obtain the Uniform Bank Performance Report and, through a general review of it, note any conditions of interest particularly significant changes in trends and levels of income and expense categories that would indicate present problems or shifts in business emphasis including new directions or activities undertaken.
2. Determine early in the examination if any significant changes have occurred in:
   - Operations.
   - Accounting practices or records.
   - Financial reporting.
   - General business conditions.
3. If selected for implementation complete or update the Income and Expense section of the Internal Control Questionnaire.
4. Based on the evaluation of internal controls, the work performed by internal/external auditors and the results of performing the above procedures, determine the scope of the examination.
5. Test for compliance with policies, practices, procedures and internal controls in conjunction with performing the remaining examination procedures.
6. Obtain the bank's current financial statements, internal operating reports, interim financial statements, reports filed with the Federal Reserve and daily statements of condition or other available financial information, then review balances and amounts relative to information in the UBPR staying alert for the development or continuation of adverse trends and other significant or unusual trends or fluctuations. Primary considerations should include whether:
   - Significant structural changes are occurring in the bank that may impact the earnings stream.
   - The bank is making use of tax carrybacks or carryforwards.
   - Earnings are static or declining as a percentage of total resources.
   - Income before securities gains and losses is decreasing as a percentage of total revenues.
   - The ratio of operating expense to operating revenue is increasing.
   - Earnings trends are inconsistent.
   - The spread between interest earned and interest paid is decreasing.
   - Loan losses are increasing.
   - Provisions for loan losses are sufficient to cover loan losses and maintain reserves at an adequate level.
   - There is evidence that sources of interest and other revenues have changed since the last examination.
   - Earnings are deemed inadequate to provide increased capitalization commensurate with the bank's growth.
7. Obtain and review the bank's formalized planning procedures, profit plans, budgets, mid- and long-range financial plans, economic advisory reports, and any progress reports related to any of those and:
   a. Compare actual results to budgeted amounts.
   b. Determine the impact of any broad and important specific goals which have been set.
   c. Determine the frequency of planning revisions.
   d. Determine what triggers a specific plan revision.
   e. Determine who initiates plan revisions.
   f. Determine whether explanations are required for significant variations and whether causes are ascertained in implementating corrective action.
   g. Determine the sources of input for forecasts, plans and budgets.
   h. Extract any information considered relevant to the completion of ''Management Assessment'' and ''Overall Conclusions Regarding Condition of the Bank.''
8. Scan ledger accounts for unusual entries, as considered necessary. Examples of such items include:
   - Significant deviations from the normal amounts of recurring entries.
   - Unusual debit entries in income accounts or unusual credit entries in expense accounts.
   - Significant entries from an unusual source, such as a journal entry.
   - Significant entries in ''other income'' or ''other expense'' which may indicate fees or service losses on an off balance sheet activity (i.e., financial advisory or underwriting services).

9. Investigate, as appropriate, conditions of interest disclosed by the procedures in steps 1 and 2 and 6 through 8 by:
   a. Discussing exceptions or questionable findings with the examiner responsible for conducting those aspects of the examination which are most closely related to the item of interest, to determine if a satisfactory explanation already has been obtained.
   b. Reviewing copies of work papers prepared by internal auditors or management that explain account fluctuations from prior periods or from budgeted amounts.
   c. Discussing unresolved items with management.
   d. Reviewing underlying supporting data and records, as necessary, to substantiate explanations advanced by management.
   e. Performing any other procedures considered necessary to substantiate the authenticity of the explanations given.
   f. Reaching a conclusion as to the reasonableness of any explanations offered by other examiners or management and deciding whether extensions of examination or verification procedures are necessary.
10. Determine compliance with appropriate laws and regulations.
11. Review with officers of the bank and prepare, in appropriate report format, listings of:
    a. Deficiencies in and deviations from, policies, practices, procedures, and internal controls.
    b. Violations of law.
    c. Adverse trends.
    d. Any UBPR peer group or local constructed peer group data which should be brought to the attention of management.
    e. Comments on earnings.
12. Update workpapers with any information that will facilitate future examinations.

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

GENERAL

1. Does the bank have a budget? If so:
   a. Is it reviewed and approved by managerial personnel and/or the board of directors?
   b. Is it periodically reviewed and updated for changed conditions?
   c. Are periodic statements compared to budget and are explanations of variances reviewed by managment?
   d. Is a separate budget prepared by the manager of each department or division?
2. Does the bank's accounting system provide sufficiently detailed breakdowns of accounts to enable it to analyze fluctuations?

*3. Are the general books of the bank maintained by someone who does not have access to cash?

4. Are all general ledger entries processed through the proof department?
5. Are all entries to the general ledger supported by a general ledger ticket?
6. Do general ledger tickets, both debit and credit, bear complete approvals, descriptions and an indication of the offset?

*7. Are all general ledger entries approved by a responsible person other than the general ledger bookkeeper or person associated with its preparation?

8. Is the general ledger posted daily?
9. Is a daily statement of condition prepared?

*10. Are corrections to ledgers made by posting a correcting entry and not by erasing (manual system) or deleting (computerized system) the incorrect entry?

11. Are supporting worksheets or other records maintained on accrued expenses and taxes?
12. Are those supporting records periodically reconciled with the appropriate general ledger controls?

PURCHASES

*13. If the bank has a separate purchasing department, is it independent of the accounting and receiving departments?

*14. Are purchases made only on the basis of requisitions signed by authorized individuals?

*15. Are all purchases routed through a purchasing department or personnel functioning in that capacity?

16. Are all purchases made by means of prenumbered purchase orders sent to vendors?
17. Are all invoices received checked against purchase orders and receiving reports?
18. Are all invoices tested for clerical accuracy?
19. Are invoice amounts credited to their respective accounts and tested periodically for accuracy?

DISBURSEMENTS

*20. Is the payment for all purchases, except minor items, made by official checks?

*21. Does the official signing the check review all supporting documents?

*22. Are supporting vouchers and invoices cancelled to prevent re-use?

*23. Are duties and responsibilities in the following areas segregated?
   a. Authorization to issue expense checks?
   b. Preparation of expense checks?
   c. Signing of expense checks?
   d. Sending of expense checks?
   e. Use and storage of facsimile signatures?
   f. General ledger posting?
   g. Subsidiary ledger posting?

PAYROLL

24. Is the payroll department separate from the personnel department?
25. Are signed authorizations on file for all payroll deductions including W-4s for withholding?
26. Are salaries authorized by the board of directors or its designated committee?

27. Are individual wage rates authorized in writing by an authorized officer?
28. Are vacation and sick leave payments fixed or authorized?
29. Are payrolls paid from a special bank account or directly credited to the employee's demand deposit account?
30. Are time records reviewed and signed by the employee's supervisor?
31. Are double checks made of hours, rates, deductions, extension, and footings?
32. Are payroll signers independent of the persons approving hours worked and preparation of the payroll?
33. If a check signing machine is used, are controls over its use adequate (such as a dual control)?
34. Are payrolls subject to final officer approval?
35. Are the names of persons leaving employment of the bank reported promptly, in writing, to the payroll department?
36. Are payroll expense distributions reconciled with the general payroll payment records?

CONCLUSION

37. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
38. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate, inadequate).

Funds management is at the core of sound bank planning and financial management. Although funding practices, techniques, and norms have been revised substantially in recent years, funds management is not a new concept. It is the process of managing the spread between interest earned and interest paid while ensuring adequate liquidity. Therefore, funds management has two components—liquidity and interest-rate risk management.

To evaluate a bank's funds management, an understanding of the bank, its customer mix, the nature of its assets and liabilities, and its economic and competitive environment is required. No single theory can be applied universally to all banks.

LIQUIDITY

Liquidity is the ability to accommodate decreases in liabilities and to fund increases in assets. A bank has adequate liquidity when it can obtain sufficient funds, either by increasing liabilities or converting assets, promptly and at a reasonable cost. Liquidity is essential in all banks to compensate for expected and unexpected balance-sheet fluctuations and to provide funds for growth. The price of liquidity is a function of market conditions and the market's perception of risks, both interest-rate and credit, as reflected in the bank's on-balance-sheet and off-balance-sheet activities. Additionally, market perceptions of a bank's management and strategic direction can be critical to the price of liquidity. To the extent that liquidity needs are met through holdings of high-quality short-term assets, the price of liquidity is the income sacrificed by not holding longer-term or lower-quality assets. If liquidity needs are not met through liquid asset holdings, a bank may be forced to restructure or acquire additional liabilities under adverse market conditions.

Liquidity exposure can stem from both internally (institution-specific) and externally generated factors. Sound liquidity-risk management should address both types of exposure. External liquidity risks can be geographic (such as the premiums required on deposits within a certain state), systemic (such as the adverse effects on several large banks of the near failure of a large regional bank), or instrument-specific (such as the collapse of a floating-rate-note market). Internal liquidity risk relates largely to how an institution is perceived in its various markets: local, regional, national, or international.

An analysis of the following factors will help to determine the adequacy of a bank's liquidity position:

- historical funding requirements
- current liquidity position
- anticipated future funding needs
- sources of funds
- options for reducing funding needs or attracting additional funds
- current and anticipated asset quality
- current and future earnings capacity
- current and planned capital position

To satisfy its funding needs, a bank must perform one or a combination of the following:

- dispose of liquid assets
- increase short-term borrowings (or issue additional short-term deposit liabilities)
- decrease holdings of less-liquid assets
- increase liabilities of a term nature
- increase capital funds

All banks are affected by changes in the economic climate, so the monitoring of economic and money market trends is key to liquidity planning. Sound financial management can minimize the negative effects of these trends while accentuating the positive ones. Factors that management should consider in liquidity planning include—

- internal costs of funds,
- maturity and repricing mismatches in the balance sheet,
- anticipated funding needs,
- economic and market forecasts, and
- the need to maintain a plan that ensures adequate access to a diversified array of readily accessible, confirmed funding sources, including liquid assets such as high-grade investment securities and a diversified mix of wholesale and retail borrowings.

Management must have an effective contingency plan that identifies minimum and maximum liquidity needs and weighs alternative courses of action designed to meet those needs.

Some factors that may affect a bank's liquidity include—

- a decline in earnings,
- an increase in nonperforming assets,
- deposit concentrations,
- a downgrading by a rating agency,
- expanded business opportunities,
- acquisitions, and
- new tax initiatives.

Once liquidity needs have been determined, management must decide how to meet them through asset management, liability management, or a combination of both.

See also the "Liquidity Risk" sections (3005.1 to 3005.5) of the Federal Reserve System's *Trading and Capital-Markets Activities Manual* for additional guidance on evaluating an institution's liquidity management.

Sound Liquidity-Risk Management

Sound liquidity-risk management requires the following four elements.[1]

- Well-established strategies, policies, and procedures for managing both the sources and uses of an institution's funds across various tenors or time frames. (This includes assessing and planning for short-term, intermediate-term, and long-term liquidity needs.)
- Liquidity-risk measurement systems that are appropriate for the size and complexity of the institution. (Depending upon the institution, such measurement systems can range from simple gap-derived cash-flow measures to very sophisticated cash-flow simulation models.)
- Adequate internal controls and internal audit processes. (Internal controls and internal audit reviews are needed to ensure compliance with internal liquidity-management policies and procedures.)
- Comprehensive liquidity contingency planning. (Contingency plans need to be well designed and should span a broad range of potential liquidity events that are tailored to an institution's specific business lines and liquidity-risk profile.)

Adequate liquidity contingency planning is critical to the ongoing maintenance of the safety and soundness of any depository institution. Contingency planning starts with an assessment of the possible liquidity events that an institution might encounter. The types of potential liquidity events considered should range from high-probability/low-impact events that can occur in day-to-day operations to low-probability/high-impact events that can arise through institution-specific or systemic market or operational circumstances. Responses to these events should be assessed in the context of their implications for an institution's short-term, intermediate-term, and long-term liquidity profile. A fundamental principle in designing contingency plans for each of these liquidity tenors is to ensure adequate diversification in the potential sources of funds that could be used to provide liquidity. Such diversification should not only focus on the number of potential funds providers but on the underlying stability, availability, and flexibility of funds sources in the context of the type of liquidity event they are expected to address.

Liquidity-Risk Management Using the Federal Reserve's Primary Credit Program

The Federal Reserve's primary credit program (discount window) offers depository institutions an additional source of available funds (at a rate above the target federal funds rate) for managing short-term liquidity risks.[2] Management should fully assess the potential role that the Federal Reserve's primary credit program might play in managing their institution's liquidity. The primary credit program can be a viable source of very short-term backup funds. Management may find it appropriate to incorporate the availability of the primary credit program into their institution's diversified liquidity-management policies, procedures, and contingency plans. The primary credit program has the following attributes that make the discount win-

1. See the July 23, 2003, Interagency Advisory on the Use of the Federal Reserve's Primary Credit Program in Effective Liquidity Management, issued by the federal financial institution regulatory agencies. The interagency advisory supplements and does not replace existing agency guidance or policy. See also section 4010.0 of the *Bank Holding Company Supervision Manual*.

2. See section 3010.1 for further discussion of the Federal Reserve's credit programs that are available to qualifying institutions.

dow a viable source of backup or contingency funding for short-term purposes:

- Primary credit provides a simpler, less-burdensome administrative process and a more accessible source of backup, short-term funding.
- Primary credit can enhance diversification in short-term funding contingency plans.
- Borrowings can be secured with an array of collateral, including consumer and commercial loans.
- Requests for primary credit advances can be made anytime during the day.[3]
- There are no restrictions on the use of short-term primary credit.

If an institution incorporates primary credit into its contingency plans, the institution should ensure that it has in place with the appropriate Reserve Bank the necessary collateral arrangements and documentation. This is particularly important when the intended collateral consists of loans or other assets that may involve significant processing or lead time for pledging to the Reserve Bank.

It is a long-established sound practice for institutions to periodically test all sources of contingency funding. Accordingly, if an institution incorporates primary credit in its contingency plans, management should occasionally test the institution's ability to borrow at the discount window. The goal of such testing is to ensure that there are no unexpected impediments or complications in the case that such contingency lines need to be used.

Institutions should ensure that any planned use of primary credit is consistent with the stated purposes and objectives of the program. Under the primary credit program, the Federal Reserve generally expects to extend funds on a very short-term basis, usually overnight. Therefore, as with any other type of short-term contingency funding, institutions should ensure that any use of primary credit facilities for short-term liquidity contingencies is accompanied by viable take-out or exit strategies to replace this funding expeditiously with other sources of funding. Institutions should factor into their contingency plans an analysis of their eligibility for primary credit under various scenarios, recognizing that if their financial condition were to deteriorate, primary credit may not be available. Under those scenarios, secondary credit may be available.

Another critical element of liquidity management is an appropriate assessment of the costs and benefits of various sources of potential liquidity. This assessment is particularly important in managing short-term and day-to-day sources and uses of funds. Given the above-market rates charged on primary credit, institutions should ensure that they adequately assess the higher costs of this form of credit relative to other available sources. Extended use of any type of relatively expensive source of funds can give rise to significant earnings implications which, in turn, may lead to supervisory concerns.

It is also important to note that the Federal Reserve's primary credit facility is only one of many tools institutions may use in managing their liquidity-risk profiles. An institution's management should ensure that the institution maintains adequate access to a diversified array of readily available and confirmed funding sources, including liquid assets such as high-grade investment securities and a diversified mix of wholesale and retail borrowings. (See SR-03-15.)

Supervisory and Examiner Considerations

Because primary credit can serve as a viable source of backup, short-term funds, supervisors and examiners should view the occasional use of primary credit as appropriate and unexceptional. At the same time, however, supervisors and examiners should be cognizant of the implications that too-frequent use of this source of relatively expensive funds may have for the earnings, financial condition, and overall safety and soundness of the institution. Overreliance on primary credit borrowings, or any one source of short-term contingency funds, regardless of the relative costs, may be symptomatic of deeper operational or financial difficulties. Importantly, the use of primary credit, as with the use of any potential sources of contingency funding, is a management decision that must be made in the context of safe and sound banking practices.

ASSET MANAGEMENT

Liquidity needs may be met by manipulating the bank's asset structure through the sale or planned runoff of a reserve of readily marketable assets.

3. Advances generally are booked at the end of the business day.

Because many banks (primarily the smaller ones) tend to have little influence over the size of their total liabilities, liquid assets enable a bank to provide funds to satisfy increased loan demand.

Banks that rely solely on asset management concentrate on adjusting the price and availability of credit and the level of liquid assets held in response to a change in customer asset and liability preferences. However, assets that are often assumed to be liquid are sometimes difficult to liquidate. For example, investment securities may be pledged against public deposits or repurchase agreements or may be heavily depreciated because of interest-rate changes. Trading accounts cannot be reduced materially if banks must maintain adequate inventories for their customers. Furthermore, the holding of liquid assets for liquidity purposes is less attractive because of their thin profit spreads.

Management must also consider the cost of maintaining liquidity. An institution that maintains a strong liquidity position may do so at the opportunity cost of generating higher earnings.

The amount of liquid assets a bank should hold depends on the stability of its deposit structure and the potential for rapid expansion of its loan portfolio. If deposit accounts are composed primarily of small stable accounts, a relatively low allowance for liquidity is necessary. Additionally, management must consider the current and expected ratings by regulatory and rating agencies when planning liquidity needs. A higher allowance for liquidity is required when—

- high interest rates increase the potential for deposit disintermediation,
- recent trends show a substantial increase or reduction in large deposits or borrowings,
- a significant portion of deposits are short-term municipal special assessment–type accounts,
- a substantial portion of the loan portfolio consists of large static loans with little likelihood of reduction,
- large unused lines of credit or commitments to lend are expected to be used in the near term,
- a strong relationship exists between individual deposit accounts and principal employers in the trade area who have financial problems, or
- a concentration of credit has been extended to industries with current or anticipated financial problems.

Asset liquidity, or how "salable" the bank's assets are in terms of both time and cost, is of primary importance in asset management. To maximize profitability, management must carefully weigh the full return on liquid assets (yield plus liquidity value) against the higher return associated with less-liquid assets. Income derived from higher-yielding assets may be offset if a forced sale, at less than book value, is necessary because of adverse balance-sheet fluctuations.

Seasonal, cyclical, or other factors may cause aggregate outstanding loans and deposits to move in opposite directions and result in loan demand that exceeds available deposit funds. A bank relying strictly on asset management would restrict loan growth to a level that could be supported by available deposits. As an alternative, liquidity needs may be met through liability sources, such as federal funds purchased and the sale of securities under agreements to repurchase, which would allow the bank to meet the loan demand of its trade area. If short-term funding is not readily available in the marketplace, the bank may qualify for borrowings from the local Federal Reserve Bank. The decision whether to use liability sources should be based on a complete analysis of seasonal, cyclical, and other factors and on the costs involved. In addition to supplementing asset liquidity, liability sources of liquidity may be an alternative even when asset sources are available. The number of banks relying solely on manipulation of the asset structure to meet liquidity needs is declining rapidly.

LIABILITY MANAGEMENT

Liquidity needs can be met through the discretionary acquisition of funds on the basis of interest rate competition. This does not preclude the option of selling assets to meet funding needs, and conceptually, the availability of asset and liability options should result in a lower liquidity maintenance cost. The alternative costs of available discretionary liabilities can be compared to the opportunity cost of selling various assets. The major difference between liquidity in larger banks and in smaller banks is that larger banks are better able to control the level and composition of their liabilities and assets. When funds are required, larger banks have a wider variety of options from which to select the least costly method of generating funds. In addition, discretionary access to the money markets should reduce the size of the liquid asset ''buffer'' that would be needed if the bank were solely dependent upon asset management to obtain funds.

The ability to obtain additional liabilities represents liquidity potential. The marginal cost of liquidity, the cost of incremental funds acquired, is of paramount importance in evaluating liability sources of liquidity. Consideration must be given to such factors as the frequency with which the banks must regularly refinance maturing purchased liabilities, as well as an evaluation of the bank's ongoing ability to obtain funds under normal market conditions. The obvious difficulty in estimating the latter is that, until the bank goes to the market to borrow, it cannot determine with complete certainty that funds will be available and/or at a price which will maintain a positive yield spread. Changes in money market conditions may cause a rapid deterioration in a bank's capacity to borrow at a favorable rate. In this context, liquidity represents the ability to attract funds in the market when needed, at a reasonable cost vis-à-vis asset yield.

As previously noted the access of a large bank to discretionary funding sources is a function of its position and reputation in the money markets. Although smaller institutions do not have a ''name'' in those markets, they are not precluded from liability management. The scope and volume of smaller institution's operations is somewhat limited, however, particularly as they attempt to access the brokered or purchased CD market.

Although the acquisition of funds at a competitive cost has enabled many banks to meet expanding customer loan demand, misuse or improper implementation of liability management can have severe consequences. Further, liability management is not riskless. For example,

- Purchased funds may not always be available at a reasonable cost when needed. If the market loses confidence in a bank, the availability of purchased funds may be threatened.
- Concentrations in funding sources increase liquidity risk. For example, a bank relying heavily on foreign interbank deposits will experience funding problems if overseas markets perceive instability in U.S. banks or the economy. Replacing foreign source funds might be difficult and costly because the domestic market may view the bank's sudden need for funds negatively.
- Over-reliance on liability management may cause a tendency to minimize holdings of short-term securities, relax asset liquidity standards, and result in a large concentration of short-term liabilities supporting assets of longer maturity. During times of tight money, this could cause an earnings squeeze and an illiquid condition.
- If rate competition develops in the money market, a bank may incur a high cost of funds and may elect to lower credit standards to book higher yielding loans and securities. If a bank is purchasing liabilities to support assets which are already on its books, the higher cost of purchased funds may result in a negative yield spread.
- When national monetary tightness occurs, heightened interest rate discrimination, or tiering, may develop, and may make the cost of purchased funds prohibitive to all but a small number of money center banks. Therefore, banks with limited funding sources should avoid heavy reliance on purchased funds.
- Preoccupation with obtaining funds at the lowest possible cost, without considering maturity distribution, greatly intensifies a bank's exposure to the risk of interest rate fluctuations.

In all banks, and particularly those relying on wholesale funding sources, management must constantly be aware of the composition, characteristics, and diversification of its funding sources.

Real or perceived deterioration in the financial condition of a bank because of weak asset quality, fraud, or external economic developments will adversely affect wholesale and retail funding. The extent of market reaction depends on the composition and risk tolerance of the bank's funding base. (Risk tolerance is the willingness and ability of an individual or institution to borrow/lend money for a given risk and reward).

Many factors affect the risk tolerance of funds providers, including these:

- Obligations to fiduciary investors, such as money market funds, trust funds and pensions.
- Reliance on rating firms—bylaws or internal guidelines may prohibit placing funds in banks that have low ratings.
- Obligations to disclose information on investment holdings.
- Self-interest in maintaining an orderly marketplace—for this reason major banks are slow in eliminating funding to other banks.
- Having a personal contact at the bank to provide timely and accurate information about its financial condition.

The following common fund providers are ranked generally (while subject to change) from the least to the most risk tolerant:

- Money market funds.
- Trust funds.
- Pension funds.
- Money market brokers-dealers
  - — small denomination certificates of deposit (under $100,000) sold through broker-dealers; and
  - — large denomination certificates of deposit ($100,000 and over) sold through brokers-dealers
- Regional banks.
- Government agencies.
- Community banks.
- Insurance companies.
- Corporations.
- Multinational banks.
- Individuals.

POLICY/MANAGEMENT REPORTING SYSTEMS

Regardless of the method or combination of methods chosen to manage a bank's liquidity position, it is of key importance that the bank formulate a policy and develop a measurement system to ensure that liquidity requirements are monitored and met on an ongoing basis. This should be done in anticipation of future occurrences, both expected and unexpected. It should also reflect the bank's strategy for managing its investment portfolio and the potential for those investments to provide liquidity to the bank. Such a policy should recognize the unique characteristics of the bank and should reflect its goals. The scope of the policy will vary with the sophistication of the institution.

The policy should provide for coordination between concerned bank departments and should establish clear responsibility for decisions affecting liquidity. Senior management should be apprised regularly of liquidity conditions. Furthermore, the policy should set forth guidelines delineating appropriate levels of liquidity. Examples of some typical guidelines are listed below:

- A limit on the loan to deposit ratio.
- A limit on the loan to capital ratio.
- A general limit on the relationship between anticipated funding needs and available sources for meeting those needs (for example: the ratio of anticipated needs/primary sources shall not exceed _____ percent).
- Primary sources for meeting funding needs should be quantified.
- Flexible limits on the percentage reliance on a particular liability category (for example: negotiable certificates of deposit should not account for more than _____ percent of total liabilities).
- Limits on the dependence on individual customers or market segments for funds in liquidity position calculations.
- Flexible limits on the minimum/maximum average maturity for different categories of liabilities (for example: the average maturity of negotiable certificates of deposit shall not be less than _____ months).
- Minimum liquidity provision to be maintained to sustain operations while necessary longer-term adjustments are made.

A workable management information system is integral to making sound funds management decisions. Reports containing certain basic information should be prepared and reviewed regularly. Report content and format will vary from bank to bank depending on the characteristics of the bank and the funds management methods and practices used. Normally, a good management information system will contain reports detailing liquidity needs and the sources of funds available to meet those needs. (The maturity distribution of assets and liabilities and expected funding of commitments would prove useful in preparing this report.) Additionally, policies should establish, and the management information system should be able to track, contingency liquidity plans for use in a variety of emergency funding situations.

1. To evaluate the management of the bank's assets, liabilities, and off-balance-sheet position to determine if management is planning adequately for liquidity needs, and if the bank can effectively meet anticipated and potential liquidity needs.
2. To determine if reasonable parameters have been established for the bank's liquidity position and if the bank is operating within those established parameters.
3. To determine if internal management reports provide the necessary information for informed liquidity decisions and for monitoring the results of those decisions.
4. To urge corrective action when liquidity policies, practices, or procedures are deficient.
5. To determine if guidelines and procedures have been developed to assess the adequacy of the following: a formal contingency plan; the level of liquid assets; the ability of the bank to liquidate the loan and investment portfolios; the level of term deposits and funding lines; and whether committed funds lines are needed.

1. If internal controls or the internal audit function is determined to be inadequate, complete or update the internal control questionnaire, and prepare a brief description of the bank's liquidity policies and practices.
2. Review the UBPR interim financial statements and internal management reports to assess the asset/liability mix and trends, paying particular attention to—
   a. deposit composition and stability,
   b. the ratios of loan commitments to total loans and of standby letters of credit to total loans,
   c. the loan-to-deposit ratio (at community banks),
   d. the ratio of temporary investments to volatile liabilities, and
   e. the ratio of pledged securities to total securities.

   When performing steps 3 through 9, evaluate the effectiveness of internal management reporting systems in providing for adequate liquidity management.
3. Determine if management has properly planned for liquidity needs.
   a. Are well-established strategies, policies, and procedures for managing both the sources and uses of an institution's funds across various tenors or time frames in place, and do these strategies include assessing and planning for short-term, intermediate-term, and long-term liquidity needs?
   b. Are there liquidity-risk measurement systems appropriate for the size and complexity of the institution?
   c. Are the short-term sources of funds to meet anticipated or potential needs adequate?
   d. Has management—
      - reviewed the internal management report detailing liquidity requirements and sources of liquidity, and
      - evaluated the bank's ability to meet anticipated or potential needs?
4. To determine if management is adequately planning for intermediate-term and longer-term liquidity or funding needs—
   a. discuss with management or review the bank's budget projections for the appropriate planning period;
   b. ascertain if management has planned the future direction of the bank, noting the projected growth, source of funding for the growth, and any projected changes in asset or liability mix;
   c. evaluate future plans regarding liquidity needs, ascertaining whether the bank can reasonably achieve the amounts and types of funding projected and can achieve the amounts and types of asset growth projected; and
   d. ascertain whether the appropriate interest-rate sensitivity concerns have been addressed in planning long-term funding strategies.
5. Assess the reasonableness of bank-established parameters for the use of volatile liabilities.
   a. Does the liquidity policy incorporate limits on both the volume and intended use of such liabilities?
   b. Does the policy establish permissible ranges for maturity mismatches between volatile liabilities and assets being supported by these liabilities?
6. Review the adequacy of the bank's contingency liquidity plan.
   a. Does management's plan ensure adequate access to a diversified array of readily accessible confirmed funding sources, including liquid assets such as high-grade investment securities and a diversified mix of wholesale and retail borrowings?
   b. Has management determined what potential funding losses could occur if unexpected financial or operational problems arise?
   c. Have alternative funding sources or assets that could be sold to cover such losses been identified?
   d. Is the contingency plan well designed, and does it span a broad range of potential liquidity events that are tailored to an institution's specific business lines and liquidity-risk profile?
7. Does the liquidity policy restrict borrowings from affiliated banks to reasonable levels?
8. Does the liquidity policy provide appropri-

ate control and supervision of the volume of loan commitments and other off-balance-sheet activities?

9. Are adequate internal controls and internal audit processes in place? Do the internal controls and internal audit reviews ensure compliance with internal liquidity-management policies and procedures?
10. Discuss the following issues with management, and summarize your findings in the report:
    a. the quality of the bank's planning to meet liquidity needs and the current ability of the bank to meet anticipated and potential liquidity needs
    b. the quality of administrative control and internal management reporting systems
    c. where appropriate, the effect of liquidity management decisions on earnings
11. Update the workpapers with any information that will facilitate future examinations. Discuss with senior management the findings of the examination of their liquidity policies and practices.

1. Has the board of directors, consistent with its duties and responsibilities, reviewed and ratified funds-management policies, practices and procedures that include—
   a. lines of authority and responsibility for liquidity management decisions?
   b. a formal mechanism to coordinate asset and liability management decisions?
   c. a method to identify liquidity needs and the means to meet those needs?
   d. guidelines for the level of liquid assets and other sources of funds in relationship to anticipated and potential needs?
2. Does the planning and budgeting function consider liquidity requirements?
3. Have provisions been made for the preparation of internal management reports that are an adequate basis for ongoing liquidity management decisions and for monitoring the results of the decisions?
4. Are internal management reports concerning liquidity needs and sources of funds to meet those needs prepared regularly and reviewed as appropriate by senior management and the board of directors?
5. Is the information obtained in questions 1–4 an adequate basis for evaluating internal controls over asset/liability management in that there are no significant additional deficiencies that impair any control? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
6. On the basis of a composite evaluation, as evidenced by answers to the foregoing questions, are the internal controls and internal audit procedures considered adequate? Do the internal controls and internal audit reviews ensure compliance with internal liquidity management policies and procedures?

Many banking organizations (BOs) have substantially increased their securitization activities. Asset securitization typically involves the transfer of potentially illiquid on-balance-sheet assets (for example, loans, leases, and other assets) to a third party or trust. In turn, the third party or trust issues certificates or notes to investors. The cash flow from the transferred assets supports repayment of the certificates or notes. BOs use asset securitization to access alternative funding sources, manage concentrations, improve financial-performance ratios, and more efficiently meet customer needs. Assets typically securitized include credit card receivables and automobile receivable paper, commercial and residential first mortgages, commercial loans, home-equity loans, and student loans.

Managing the risks of securitization activities poses increasing challenges, which may be less obvious and more complex than the risks of traditional lending activities. Securitization can involve credit, liquidity, operational, legal, and reputational risks in concentrations and forms that may not be fully recognized by bank management or adequately incorporated into an institution's risk-management systems. In reviewing these activities, examiners should assess whether BOs fully understand and adequately manage the full range of risks involved in securitization activities.

BOs have been involved with asset-backed securities (ABS), both as investors in them and as major participants in the securitization process. The federal government encourages the securitization of residential mortgages. In 1970, the Government National Mortgage Association (GNMA or Ginnie Mae) created the first publicly traded mortgage-backed security. Shortly thereafter, the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), both government-sponsored agencies, also developed mortgage-backed securities. The guarantees on the securities that these government or government-sponsored entities provide ensure investors of the payment of principal and interest. These guarantees have greatly facilitated the securitization of mortgage assets. Banks also securitize other types of assets, such as nonperforming loans and lease receivables.

While the objectives of securitization may vary from institution to institution, there are essentially five benefits that can be derived from securitized transactions. First, the sale of assets may reduce regulatory costs. The removal of an asset from an institution's books reduces capital requirements and reserve requirements on the deposits funding the asset. Second, securitization provides originators with an additional source of funding or liquidity. The process of securitization basically converts an illiquid asset into a security with greater marketability. Securitized issues often require a credit enhancement, which results in a higher credit rating than what would normally be obtainable by the institution itself. Consequently, these issues may provide the institution with a cheaper form of funding. Third, securitization may be used to reduce interest-rate risk by improving the institution's asset-liability mix. This is especially true if the institution has a large investment in fixed-rate, low-yield assets. Fourth, by removing assets, the institution enhances its return on equity and assets. Finally, the ability to sell these securities worldwide diversifies the institution's funding base, which reduces the bank's dependence on local economies.

While securitization activities can enhance both credit availability and bank profitability, the risks of these activities must be known and managed. Accordingly, BOs should ensure that their overall risk-management process explicitly incorporates the full range of risks involved in their securitization activities, and examiners should assess whether institutions fully understand and adequately manage these risks. Specifically, examiners should determine whether institutions are recognizing the risks of securitization activities by (1) adequately identifying, quantifying, and monitoring these risks; (2) clearly communicating the extent and depth of these risks in reports to senior management and the board of directors and in regulatory reports; (3) conducting ongoing stress testing to identify potential losses and liquidity needs under adverse circumstances; and (4) setting adequate minimum internal standards for allowances or liabilities for losses, capital, and contingency funding. Incorporating asset-securitization activities into BO's risk-management systems and internal capital-adequacy allocations is particularly important since the current regulatory capital rules may not fully capture the economic substance of the risk exposures arising from many of these activities.

Senior management and directors must have the requisite knowledge of the effect of securitization on the BO's risk profile, and they must be fully aware of the accounting, legal, and risk-based capital nuances of this activity. BOs must fully and accurately distinguish and measure the risks that are transferred versus those that are retained, and they must adequately manage the retained portion. It is essential that BOs engaging in securitization activities have appropriate front- and back-office staffing; internal and external accounting and legal support; audit or independent-review coverage; information systems capacity; and oversight mechanisms to execute, record, and administer these transactions correctly.

Appropriate valuation and modeling methodologies must be used. They must be able to determine the initial and ongoing fair value of retained interests. Accounting rules (generally accepted accounting principles, or GAAP) provide a method to recognize an immediate gain (or loss) on the sale through booking a ''retained interest.'' The carrying value, however, of that interest must be fully documented, based on reasonable assumptions, and regularly analyzed for any subsequent impairment in value. The best evidence of fair value is a quoted market price in an active market. When quoted market prices are not available, accounting rules allow fair value to be estimated. This estimate must be based on the ''best information available in the circumstances.''[1] An estimate of fair value must be supported by reasonable and current assumptions. If a best estimate of fair value is not practicable, the asset is to be recorded at zero in financial and regulatory reports.

Unforeseen market events that affect the discount rate or performance of receivables supporting a retained interest can swiftly and dramatically alter its value. Without appropriate internal controls and independent oversight, an institution that securitizes assets may inappropriately generate ''paper profits'' or mask actual losses through flawed loss assumptions, inaccurate prepayment rates, and inappropriate discount rates. Liberal and unsubstantiated assumptions can result in material inaccuracies in financial statements; substantial write-downs of retained interests; and, if retained interests represent an excessive concentration of the sponsoring institution's capital, the institution's demise.

An institution's failure to adequately understand the risks inherent in its securitization activities and to incorporate risks into its risk-management systems and internal capital allocations may constitute an unsafe and unsound banking practice. Furthermore, retained interests that lack objectively verifiable support or that fail to meet these supervisory standards will be classified as loss and disallowed for inclusion as assets of the institution for regulatory capital purposes. (See SR-99-37.) Accordingly, for those institutions involved in asset securitization or providing credit enhancements in connection with loan sales and securitization, examiners should assess whether the institutions' systems and processes adequately identify, measure, monitor, and control *all* the risks involved in its securitization activities. Examiners also will review an institution's valuation of retained interests and the concentration of these assets relative to capital. Consistent with existing supervisory authority, BOs may be required, on a case-by-case basis, to hold additional capital commensurate with their risk exposures.[2] An excessive dependence on securitizations for day-to-day core funding can present significant liquidity problems during times of market turbulence or if there are difficulties specific to the BO.

Traditional lending activities are generally funded by deposits or other liabilities, with both the assets and related liabilities reflected on the balance sheet. Liabilities must generally increase in order to fund additional loans. In contrast, the securitization process generally does not increase on-balance-sheet liabilities in proportion to the volume of loans or other assets securitized. As discussed more fully below, when banking organizations securitize their assets and these transactions are treated as sales, both the assets and the related ABS (liabilities) are removed from the balance sheet. The cash proceeds from the securitization transactions are generally used to originate or acquire additional loans or other assets for securitization, and the process is

1. See Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 140 (FAS 140), ''Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities.''

2. For instance, an institution that has high concentrations of retained interests relative to its capital or is otherwise at risk from impairment of these assets may be subject to this requirement.

repeated. Thus, for the same volume of loan originations, securitization results in lower assets and liabilities compared with traditional lending activities.

THE SECURITIZATION PROCESS

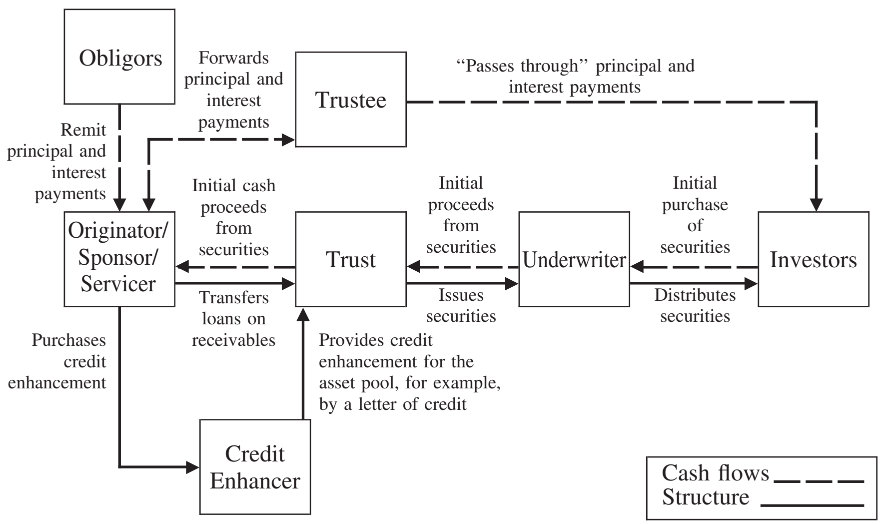
As depicted in figure 1, the asset-securitization process begins with the segregation of loans or leases into pools that are relatively homogeneous with respect to credit, maturity, and interest-rate risks. These pools of assets are then transferred to a trust or other entity known as an issuer because it issues the securities or ownership interests that are acquired by investors. These ABS may take the form of debt, certificates of beneficial ownership, or other instruments. The issuer is typically protected from bankruptcy by various structural and legal arrangements. A sponsor that provides the assets to be securitized owns or otherwise establishes the issuer.

Each issue of ABS has a servicer that is responsible for collecting interest and principal payments on the loans or leases in the underlying pool of assets and for transmitting these funds to investors (or a trustee representing them). A trustee is responsible for monitoring the activities of the servicer to ensure that it properly fulfills its role.

A guarantor may also be involved to ensure that principal and interest payments on the securities will be received by investors on a timely basis, even if the servicer does not collect these payments from the obligors of the underlying assets. Many issues of mortgage-backed securities are either guaranteed directly by GNMA, which is backed by the full faith and credit of the U.S. government, or by Fannie Mae or Freddie Mac, which are government-sponsored agencies that are perceived by the credit markets to have the implicit support of the federal government. Privately issued mortgage-backed securities and other types of ABS generally depend on some form of credit enhancement provided by the originator or third party to insulate the investor from a portion of or all credit losses. Usually, the amount of the credit enhancement is based on several multiples of the historical losses experienced on the particular asset backing the security.

The structure of an asset-backed security and the terms of the investors' interest in the collateral can vary widely depending on the type of collateral, the desires of investors, and the use of credit enhancements. Securitizations typically carve up the risk of credit losses from the

Figure 1—Pass-through, asset-backed securities: structure and cash flows



underlying assets and distribute it to different parties. The *first-dollar,* or most subordinate, loss position is first to absorb credit losses, and the most *senior* investor position is last to absorb losses; there may also be one or more loss positions in between (*second-dollar* loss positions). Each loss position functions as a credit enhancement for the more senior positions in the structure. In other words, when ABS reallocate the risks in the underlying collateral (particularly credit risk), the risks are moved into security tranches that match the desires of investors. For example, senior-subordinated security structures give holders of senior tranches greater credit-risk protection—albeit at lower yields—than holders of subordinated tranches. Under this structure, at least two classes of asset-backed securities, a senior and a junior or subordinated class, are issued in connection with the same pool of collateral. The senior class is structured so that it has a priority claim on the cash flows from the underlying pool of assets. The subordinated class must absorb credit losses on the collateral before losses can be charged to the senior portion. Because the senior class has this priority claim, cash flows from the underlying pool of assets must first satisfy the requirements of the senior class. Only after these requirements have been met will the cash flows be directed to service the subordinated class.

Credit Enhancement

ABS can use various forms of credit enhancements to transform the risk-return profile of underlying collateral. These include third-party credit enhancements, recourse provisions, overcollateralization, and various covenants and indentures. The sponsor of the asset securitization may provide a portion of the total credit enhancement internally, as part of the securitization structure, through the use of excess spread accounts, overcollateralization, retained subordinated interests, or other similar on-balance-sheet assets. When these or other on-balance-sheet internal enhancements are provided, the enhancements are "residual interests" and are a form of recourse.[3]

A seller may also arrange for a third party to provide credit enhancement in an asset securitization. If the third-party enhancement is provided by another bank, the other bank assumes some portion of the assets' credit risk. All forms of third-party enhancements, that is, all arrangements in which a bank assumes credit risk from third-party assets or other claims that it has not transferred, are referred to as *direct-credit substitutes.* The economic substance of a bank's credit risk from providing a direct-credit substitute can be identical to its credit risk from retaining recourse on assets it has transferred. Third-party credit enhancements include standby letters of credit, collateral or pool insurance, or surety bonds from third parties. Many asset securitizations use a combination of recourse and third-party enhancements to protect investors from credit risk. When third-party enhancements are not provided, the selling bank ordinarily retains virtually all of the credit risk on the assets transferred.

Some ABS, such as those backed by credit card receivables, typically use a *spread account.* This account is actually an escrow account. The funds in this account are derived from a portion of the spread between the interest earned on the assets in the underlying pool and the lower interest paid on securities issued by the trust. The amounts that accumulate in the account are used to cover credit losses in the underlying asset pool up to several multiples of historical losses on the particular asset collateralizing the securities. Overcollateralization, a form of credit enhancement covering a predetermined amount of potential credit losses, occurs when the value of the underlying assets exceeds the face value of the securities.

A similar form of credit enhancement is the cash-collateral account, which is established when a third party deposits cash into a pledged account. The use of cash-collateral accounts, which are considered by enhancers to be loans, grew as the number of highly rated banks and other credit enhancers declined in the early 1990s. Cash-collateral accounts eliminate *event risk,* or the risk that the credit enhancer will have its credit rating downgraded or that it will not be able to fulfill its financial obligation to absorb losses and thus provide credit protection to investors in a securitization.

An investment banking firm or other organization generally serves as an underwriter for ABS. In addition, for asset-backed issues that are publicly offered, a credit-rating agency will analyze the policies and operations of the originator and servicer, as well as the structure,

3. Purchased credit-enhancing interest-only strips are also considered "residual interests."

underlying pool of assets, expected cash flows, and other attributes of the securities. Before assigning a rating to the issue, the rating agency will also assess the extent of loss protection provided to investors by the credit enhancements associated with the issue.

TYPES OF ASSET-BACKED SECURITIES

Asset securitization involves different types of capital-market instruments. (For more information, see the *Trading and Capital-Markets Activities Manual,* section 4105.1, ''Asset-Backed Securities and Asset-Backed Commercial Paper,'' and section 4110.1, ''Residential Mortgage–Backed Securities.'') These instruments may be structured as ''pass-throughs'' or ''pay-throughs.'' Under a pass-through structure, the cash flows from the underlying pool of assets are passed through to investors on a pro rata basis. This type of security may be a single-class instrument, such as a GNMA pass-through, or a multiclass instrument, such as a real estate mortgage investment conduit (REMIC).[4]

The pay-through structure, with multiple classes, combines the cash flows from the underlying pool of assets and reallocates them to two or more issues of securities that have different cash-flow characteristics and maturities. An example is the collateralized mortgage obligation (CMO), which has a series of bond classes, each with its own specified coupon and stated maturity. In most cases, the assets that make up the CMO collateral pools are pass-through securities. Scheduled principal payments and any prepayments from the underlying collateral go first to the earliest maturing class of bonds. This first class of bonds must be retired before the principal cash flows are used to retire the later bond classes. The development of the pay-through structure resulted from the desire to broaden the marketability of these securities to investors who were interested in maturities other than those generally associated with pass-through securities.

Multiple-class ABS may also be issued as derivative instruments, such as ''stripped'' securities. Investors in each class of a stripped security will receive a different portion of the principal and interest cash flows from the underlying pool of assets. In their purest form, stripped securities may be issued as interest-only (IO) strips, for which the investor receives 100 percent of the interest from the underlying pool of assets, and as principal-only (PO) strips, for which the investor receives all of the principal.

In addition to these securities, other types of financial instruments may arise as a result of asset securitization, as follows:

- *Servicing assets.* These assets become a distinct asset recorded on the balance sheet when contractually separated from the underlying assets that have been sold or securitized and when the servicing of those assets is retained. (See FAS 140 for more information.) In addition, servicing assets are created when organizations purchase the right to act as servicers for loan pools. The value of the servicing assets is based on the contractually specified servicing fees, net of servicing costs.
- *Interest-only strips receivables.* These cash flows are accounted for separately from servicing assets and reflect the right to future interest income from the serviced assets in excess of the contractually specified servicing fees.
- *ABS residuals.* These residuals (sometimes referred to as ''residuals,'' ''residual interests,'' or ''retained interests'' represent claims on any cash flows that remain after all obligations to investors and any related expenses have been met. The excess cash flows may arise as a result of overcollateralization or from reinvestment income. Residuals can be retained by sponsors or purchased by investors in the form of securities.

RISKS ASSOCIATED WITH ASSET SECURITIZATION

While clear benefits accrue to banking organizations that engage in securitization activities

4. In the early 1980s, collateralized mortgage obligations (CMOs), or multiple-class securities, were introduced to help minimize the reinvestment and interest-rate risks inherent in the traditional fixed-rate mortgage-backed security. As a result of the Tax Reform Act of 1986, the REMIC was created. The REMIC is a more flexible mortgage security that expanded the appeal of the CMO structure to a wider investor base and offered preferred tax status to both investors and issuers. Today, almost all CMOs are issued in REMIC form. (''The ABCs of CMOs, REMICs and IO/POs: Rocket Science Comes to Mortgage Finance,'' *Journal of Accountancy*, April 1991, p. 41.)

and invest in ABS, these activities have the potential to increase the overall risk profile of the banking organization if they are not carried out prudently. For the most part, the types of risks that financial institutions encounter in the securitization process are identical to those that they face in traditional lending transactions, including credit risk, concentration risk, interest-rate risk (including prepayment risk), operational risk, liquidity risk, moral-recourse risk, and funding risk. However, since the securitization process separates the traditional lending function into several limited roles, such as originator, servicer, credit enhancer, trustee, and investor, the types of risks that a bank will encounter will differ depending on the role it assumes.

Investor-Specific Risks

Investors in ABS will be exposed to varying degrees of credit risk, that is, the risk that obligors will default on principal and interest payments. Like the investors in the direct investments of the underlying assets, ABS investors are also subject to the risk that the various parties in the securitization structure, for example, the servicer or trustee, will be unable to fulfill their contractual obligations. Moreover, investors may be susceptible to concentrations of risks across various asset-backed security issues (1) through overexposure to an organization that performs various roles in the securitization process or (2) as a result of geographic concentrations within the pool of assets providing the cash flows for an individual issue. Also, since the secondary markets for certain ABS are limited, investors may encounter greater than anticipated difficulties (liquidity risk) when seeking to sell their securities. Furthermore, certain derivative instruments, such as stripped asset-backed securities and residuals, may be extremely sensitive to interest rates and exhibit a high degree of price volatility. Therefore, they may dramatically affect the risk exposure of investors unless used in a properly structured hedging strategy. Examiner guidance in the *Trading and Capital-Markets Activities Manual,* section 3000.1, “Investment Securities and End-User Activities,” is directly applicable to ABS held as investments.

Issuer-Specific Risks

Banking organizations that issue ABS may be subject to pressures to sell only their best assets, thus reducing the quality of their own loan portfolios. On the other hand, some banking organizations may feel pressures to relax their credit standards because they can sell assets with higher risk than they would normally want to retain for their own portfolios.

To protect their name in the market, issuers may face pressures to provide “moral recourse” by repurchasing securities backed by loans or leases they have originated that have deteriorated and become nonperforming. Funding risk may also be a problem for issuers when market aberrations do not permit the issuance of asset-backed securities that are in the securitization pipeline.

Servicer-Specific Risks

Banking organizations that service securitization issues must ensure that their policies, operations, and systems will not permit breakdowns that may lead to defaults. Substantial fee income can be realized by acting as a servicer. An institution already has a fixed investment in its servicing systems, and achieving economies of scale relating to that investment is in its best interest. The danger, though, lies in overloading the system’s capacity, thereby creating enormous out-of-balance positions and cost overruns. Servicing problems may precipitate a technical default, which in turn could lead to the premature redemption of the security. In addition, expected collection costs could exceed fee income. (For further guidance, examiners should see section 2040.3, “Loan Portfolio Management: Examination Procedures,” under the “Loan Portfolio Review and Analysis” heading.)

ACCOUNTING ISSUES

Sale or Borrowing Treatment

Asset-securitization transactions are frequently structured to obtain certain accounting treatments, which in turn affect reported measures of profitability and capital adequacy. In transferring assets into a pool to serve as collateral for ABS, a key question is whether the transfer should be treated as a sale of the assets or as a collateralized borrowing, that is, a financing transaction secured by assets. Treating these transactions as a sale of assets results in their being removed from the banking organization's balance sheet, thus reducing total assets relative to earnings and capital, and thereby producing higher performance and capital ratios.[5] Treating these transactions as financings, however, means that the assets in the pool remain on the balance sheet and are subject to capital requirements and the related liabilities-to-reserve requirements.[6]

Valuation and Modeling Processes for Retained Interests

The methods and models BOs use to value retained interests and the difficulties in managing exposure to these volatile assets can raise supervisory concerns. Under GAAP, a BO recognizes an immediate gain (or loss) on the sale of assets by recording its retained interest at fair value. The valuation of the retained interest is based on the present value of future cash flows in excess of the amounts needed to service the bonds and cover credit losses and other fees of the securitization vehicle.[7]

Determinations of fair value should be based on reasonable, conservative assumptions about factors such as discount rates, projected credit losses, and prepayment rates. Bank supervisors expect retained interests to be supported by verifiable documentation of fair value in accordance with GAAP. In the absence of such support, the retained interests should not be carried as assets on an institution's books, but should be charged off. Other supervisory concerns include failure to recognize and hold sufficient capital against recourse obligations generated by securitizations, and the absence of an adequate and independent audit function.

The method and key assumptions used to value the retained interests and servicing assets or liabilities must be reasonable and fully documented. The key assumptions in all valuation analyses include prepayment or payment rates, default rates, loss-severity factors, and discount rates. Institutions are expected to take a logical and conservative approach when developing securitization assumptions and capitalizing future income flows. It is important that management quantifies the assumptions at least quarterly on a pool-by-pool basis and maintains supporting documentation for all changes to the assumptions as part of the valuation. Policies should define the acceptable reasons for changing assumptions and require appropriate management approval.

An exception to this pool-by-pool valuation analysis may be applied to revolving-asset trusts if the master-trust structure allows excess cash flows to be shared between series. In a master trust, each certificate of each series represents an undivided interest in all of the receivables in the trust. Therefore, valuations are appropriate at the master-trust level.

To determine the value of the retained interest at inception, and to make appropriate adjustments going forward, the institution must implement a reasonable modeling process to comply with FAS 140. Management is expected to employ reasonable and conservative valuation assumptions and projections, and to maintain verifiable objective documentation of the fair value of the retained interest. Senior management is responsible for ensuring that the valuation model accurately reflects the cash flows according to the terms of the securitization's structure. For example, the model should account for any cash collateral or overcollateralization triggers, trust fees, and insurance payments if appropriate. The board and management are accountable for the model builders' possessing the necessary expertise and technical proficiency to perform the modeling process. Senior management should ensure that internal controls are in place to provide for the ongoing integrity of management information systems (MIS) associated with securitization activities.

As part of the modeling process, the risk-management function should ensure that periodic validations are performed to reduce vulnerability to model risk. Validation of the model includes testing the internal logic, ensuring empirical support for the model assumptions, and back-testing the models using actual cash flows on a pool-by-pool basis. The validation process should be documented to support conclusions. Senior management should ensure the validation process is independent from line man-

5. See FAS 140 for criteria that must be met for the securitization of assets to be accounted for as a sale.

6. Note, however, that the Federal Reserve's Regulation D (12 CFR 204) defines what constitutes a reservable liability of a depository institution. Thus, although a given transaction may qualify as an asset sale for call report purposes, it nevertheless could result in a reservable liability under Regulation D. See the call report instructions for further guidance. Also, see section 3020.1, "Assessment of Capital Adequacy."

7. See FAS 140.

agement and from the modeling process. The audit scope should include procedures to ensure that the modeling process and validation mechanisms are both appropriate for the institution's circumstances and executed consistently with its asset-securitization policy.

Use of Outside Parties

Third parties are often engaged to provide professional guidance and support regarding an institution's securitization activities, transactions, and valuing of retained interests. The use of outside resources does not relieve directors of their oversight responsibility, nor does it relieve senior management of its responsibilities to provide supervision, monitoring, and oversight of securitization activities, particularly the management of the risks associated with retained interests. Management is expected to have the experience, knowledge, and abilities to discharge its duties; understand the nature and extent of the risks that retained interests present; and have the policies and procedures necessary to implement an effective risk-management system to control such risks. Management must have a full understanding of the valuation techniques employed, including the basis and reasonableness of underlying assumptions and projections.

Market Discipline and Disclosures

Transparency through public disclosure is crucial to effective market discipline and can reinforce supervisory efforts to promote high standards in risk management. Timely and adequate information on the institution's asset-securitization activities should be disclosed. The information in the disclosures should be comprehensive; however, the amount of disclosure that is appropriate will depend on the volume of securitizations and complexity of the BO. Well-informed investors, depositors, creditors, and other counterparties can provide a BO with strong incentives for maintaining sound risk-management systems and internal controls. Adequate disclosure allows market participants to better understand the BO's financial condition and apply market discipline, thus creating incentives to reduce inappropriate risk-taking or inadequate risk-management practices. Examples of sound disclosures include—

- accounting policies for measuring retained interests, including a discussion of the impact of key assumptions on the recorded value;
- the process and methodology used to adjust the value of retained interests for changes in key assumptions;
- risk characteristics, both quantitative and qualitative, of the underlying securitized assets;
- the role of retained interests as credit enhancements to special-purpose entities and other securitization vehicles, including a discussion of techniques used for measuring credit risk; and
- sensitivity analyses or stress testing conducted by the BO, showing the effect of changes in key assumptions on the fair value of retained interests.

CAPITAL ADEQUACY

As with all risk-bearing activities, institutions should fully support the risk exposures of their securitization activities with adequate capital. Banking organizations should ensure that their capital positions are sufficiently strong to support *all* the risks associated with these activities on a fully consolidated basis and should maintain adequate capital in all affiliated entities engaged in these activities. The Federal Reserve's risk-based capital guidelines establish *minimum* capital ratios, and those banking organizations exposed to high or above-average degrees of risk are expected to operate significantly *above* the minimum capital standards.

The current regulatory capital rules may not fully incorporate the economic substance of the risk exposures involved in many securitization activities. Therefore, when evaluating capital adequacy, examiners should ensure that banking organizations that (1) sell assets with recourse, (2) assume or mitigate credit risk through the use of credit derivatives, or (3) provide direct-credit substitutes and liquidity facilities to securitization programs are accurately identifying and measuring these exposures and maintaining capital at aggregate levels sufficient to support the associated credit, market, liquidity, reputational, operational, and legal risks.

Examiners should review the substance of securitizations when assessing underlying risk exposures. For example, partial, first-loss direct-credit substitutes providing credit protection to a securitization transaction can, in substance, involve the same credit risk as would be involved in holding the entire asset pool on the institution's balance sheet. Examiners should ensure that banks have implemented reasonable methods for allocating capital against the economic substance of credit exposures arising from early-amortization events and liquidity facilities associated with securitized transactions. These liquidity facilities are usually structured as short-term commitments in order to avoid a risk-based capital requirement, even though the inherent credit risk may be similar to that of a guarantee.[8]

If, in the examiner's judgment, an institution's capital level is not sufficient to provide protection against potential losses from the above credit exposures, this deficiency should be reflected in the banking organization's CAMELS rating. Furthermore, examiners should discuss the capital deficiency with the institution's management and, if necessary, its board of directors. Such an institution will be expected to develop and implement a plan for strengthening the organization's overall capital adequacy to levels deemed appropriate given all the risks to which it is exposed.

RISK-BASED CAPITAL PROVISIONS AFFECTING ASSET SECURITIZATION

The risk-based capital framework assigns risk weights to loans, ABS, off-balance-sheet credit enhancements, and other assets related to securitization.[9] Second, banks that transfer assets with recourse to the seller as part of the securitization process are explicitly required to hold capital against their off-balance-sheet credit exposures. However, the specific capital requirement will depend on the amount of recourse retained by the transferring institution and the type of asset sold with recourse. Third, banking organizations that provide credit enhancement to asset-securitization issues through standby letters of credit or by other means must hold capital against the related off-balance-sheet credit exposure.

Assigning Risk Weights

The risk weights assigned to an asset-backed security generally depend on the issuer and on whether the assets that compose the collateral pool are mortgage-related assets or assets guaranteed by a U.S. government agency. ABS issued by a trust or single-purpose corporation and backed by nonmortgage assets generally are to be assigned a risk weight of 100 percent.

Securities guaranteed by U.S. government agencies and those issued by U.S. government–sponsored agencies are assigned risk weights of 0 percent and 20 percent, respectively, because of the low degree of credit risk. Accordingly, mortgage pass-through securities guaranteed by GNMA are placed in the risk category of 0 percent. In addition, securities such as participation certificates and CMOs issued by Fannie Mae or Freddie Mac are assigned a 20 percent risk weight.

However, several types of securities issued by Fannie Mae and Freddie Mac are excluded from the lower risk weight and slotted in the 100 percent risk category. Residual interests (for example, CMO residuals) and subordinated classes of pass-through securities or CMOs that absorb more than their pro rata share of loss are assigned to the 100 percent risk-weight category. Furthermore, high-risk mortgage-derivative securities and all stripped, mortgage-backed securities, including IOs, POs, and similar instruments, are assigned to the 100 percent risk-weight category because of their high price volatility and market risk.

A privately issued mortgage-backed security that meets the criteria listed below is considered a direct or indirect holding of the underlying mortgage-related assets and is generally assigned to the same risk category as those assets (for example, U.S. government agency securities, U.S. government–sponsored agency securities, FHA- and VA-guaranteed mortgages, and con-

8. For further guidance on distinguishing, for risk-based capital purposes, whether a facility is a short-term commitment or a direct-credit substitute, see SR-92-11, "Asset-Backed Commercial Paper Programs." Essentially, facilities that provide liquidity, but which also provide credit protection to secondary-market investors, are to be treated as direct-credit substitutes for purposes of risk-based capital.

9. In addition to being subject to risk-based capital requirements, servicing assets are also subject to capital limitations. The total amount of servicing assets (including both mortgage-servicing assets and nonmortgage-servicing assets) and purchased credit-card relationships that may be included in a bank's capital may not, in the aggregate, exceed 100 percent of tier 1 capital. The total amount of nonmortgage-servicing assets and purchased credit-card relationships is subject to a separate aggregate sublimit of 25 percent of tier 1 capital.

ventional mortgages). However, under no circumstances will a privately issued mortgage-backed security be assigned to the 0 percent risk category. Therefore, private issues that are backed by GNMA securities will be assigned to the 20 percent risk category as opposed to the 0 percent category appropriate to the underlying GNMA securities. The criteria that a privately issued mortgage-backed security must meet to be assigned the same risk weight as the underlying assets are as follows:

- The underlying assets are held by an independent trustee, and the trustee has a first-priority, perfected security interest in the underlying assets on behalf of the holders of the security.
- The holder of the security has an undivided pro rata ownership interest in the underlying mortgage assets, or the trust or single-purpose entity (or conduit) that issues the security has no liabilities unrelated to the issued securities.
- The cash flow from the underlying assets of the security in all cases fully meets the cash-flow requirements of the security without undue reliance on any reinvestment income.
- No material reinvestment risk is associated with any funds awaiting distribution to the holders of the security.

Those privately issued mortgage-backed securities that do not meet the above criteria are to be assigned to the 100 percent risk category.

If the underlying pool of mortgage-related assets is composed of more than one type of asset, then the entire class of mortgage-backed securities is assigned to the category appropriate to the highest risk-weighted asset in the asset pool. For example, if the security is backed by a pool consisting of U.S. government–sponsored agency securities (for example, Freddie Mac participation certificates) that qualify for a 20 percent risk weight and conventional mortgage loans that qualify for the 50 percent risk category, then the security would receive the 50 percent risk weight.

While not set forth specifically in the risk-based capital guidelines, securities backed by student loans that meet the above-mentioned criteria may also be considered an indirect holding of the underlying assets and assigned to the same risk category as those assets. For instance, the U.S. Department of Education conditionally guarantees banks originating student loans for 98 percent of each loan under the Federal Family Education Loan Program. The guaranteed portion of the student loans is eligible for the 20 percent risk category. Therefore, senior ABS that are supported solely by student loans that are conditionally guaranteed by the Department of Education and that meet the four criteria listed above may be assigned to the 20 percent risk category to the extent they are guaranteed. As with mortgage-backed securities, subordinated student loan–backed securities and securities backed by pools of conditionally guaranteed and nonguaranteed student loans would be assigned to the 100 percent risk category.

Banks report their activities in accordance with GAAP, which permits asset-securitization transactions to be treated as sales when certain criteria are met even when there is recourse to the seller. In accordance with the RBC guideline, banks are required to hold capital against the off-balance-sheet credit exposure arising from the contingent liability associated with the recourse provisions. This exposure, generally the outstanding principal amount of the assets sold with recourse, is considered a direct-credit substitute that is converted at 100 percent to an on-balance-sheet credit-equivalent amount for appropriate risk weighting.

Recourse Obligations

For regulatory purposes, recourse is generally defined as an arrangement in which an institution retains the risk of credit loss in connection with an asset transfer, if the risk of credit loss exceeds a pro rata share of its claim on the assets.[10] In addition to broad contractual language that may require the seller to support a securitization, recourse can arise from retained interests, retained subordinated security interests, the funding of cash-collateral accounts, or other forms of credit enhancements that place a BO’s earnings and capital at risk. These enhancements should generally be aggregated to determine the extent of a BO’s support of securitized assets. Although an asset securitization qualifies for sales treatment under GAAP, the underlying assets may still be subject to regulatory risk-

10. See the risk-based capital treatment for sales with recourse at 12 CFR 3, appendix A, section (3)(b)(1)(iii) (for the OCC), and 12 CFR 567.6(a)(2)(i)(c) (for the OTS). For a further explanation of recourse, see the glossary of the call report instructions at “sales of assets for risk-based capital purposes.”

based capital requirements. Assets sold with recourse should generally be risk-weighted as if they had not been sold.

Credit-Equivalent Amounts and Risk Weights of Recourse Obligations and Direct-Credit Substitutes

The credit-equivalent amount for a recourse obligation or direct-credit substitute is the full amount of the credit-enhanced assets for which the bank directly or indirectly retains or assumes credit risk, multiplied by a 100 percent conversion factor. A bank that extends a partial direct-credit substitute, for example, a financial standby letter of credit that absorbs the first 10 percent of loss on a transaction, must maintain capital against the full amount of the assets being supported.

To determine the bank's risk-weighted assets for an off-balance-sheet recourse obligation, a third-party direct-credit substitute, or a letter of credit, the credit-equivalent amount is assigned to the risk category appropriate to the obligor in the underlying transaction, after considering any associated guarantees or collateral. For a direct-credit substitute that is an on-balance-sheet asset, for example, a purchased subordinated security, a bank must calculate risk-weighted assets using the amount of the direct-credit substitute and the full amount of the assets it supports, that is, all the more senior positions in the structure. This treatment is subject to the low-level-exposure rule discussed below. (The risk-based capital treatment for asset securitizations is discussed in more detail in section 3020.1.)

If a bank has no claim on a transferred asset, then the retention of any risk of credit loss is recourse. A recourse obligation typically arises when a bank transfers assets and retains an explicit obligation to repurchase the assets or absorb losses due to a default on the payment of principal or interest, or due to any other deficiency in the performance of the underlying obligor or some other party. Recourse may also exist implicitly if a bank provides credit enhancement beyond any contractual obligation to support assets it has sold. The following are examples of recourse arrangements:

- credit-enhancing representations and warranties made on the transferred assets
- loan-servicing assets retained under an agreement that requires the bank to be responsible for credit losses associated with the loans being serviced (mortgage-servicer cash advances that meet the conditions of section III.B.3.a.viii. of the capital adequacy guidelines (12 CFR 208, appendix A) are not recourse arrangements)
- retained subordinated interests that absorb more than their pro rata share of losses from the underlying assets
- assets sold under an agreement to repurchase, if the assets are not already included on the balance sheet
- loan strips sold without contractual recourse when the maturity of the transferred loan is shorter than the maturity of the commitment under which the loan is drawn
- credit derivatives issued that absorb more than the bank's pro rata share of losses from the transferred assets
- clean-up calls at inception that are greater than 10 percent of the balance of the original pool of transferred loans (clean-up calls that are 10 percent or less of the original pool balance and that are exercisable at the option of the bank are not recourse arrangements)

The risk-based capital treatment for asset securitizations is discussed in detail in section 3020.1. In general, a multilevel, ratings-based approach is used to assess the capital requirements on recourse obligations, residual interests (except credit-enhancing interest-only (I/O) strips), direct-credit substitutes, and senior and subordinated securities in asset securitizations, based on their relative exposure to credit risk. Credit ratings from rating agencies are used to measure relative exposure to credit risk and to determine the associated risk-based capital requirement. The Federal Reserve is relying on these credit ratings to make determinations of credit quality for the regulatory capital treatment for loss positions that represent different gradations of credit risk, the same as investors and other market participants. As discussed later in this section, residual interests are subject to (1) a dollar-for-dollar capital charge and (2) a 25 percent of tier 1 capital concentration limit on a subset of residual interests, credit-enhancing I/O strips.

Implicit Recourse Provided to Asset Securitizations

Implicit recourse arises when a bank provides credit support to one of more of its securitizations beyond its contractual obligation. Implicit recourse, like contractual recourse, exposes an institution to the risk of loss arising from deterioration in the credit quality of the underlying assets of the securitization. Implicit recourse is of supervisory concern because it demonstrates that the securitizing institution is reassuming risk associated with the securitized assets—risk that the institution initially transferred to the marketplace. For risk-based capital purposes, banks deemed to be providing implicit recourse are generally required to hold capital against the entire outstanding amount of assets sold, as though the assets remained on the bank's books.

Banks have typically provided implicit recourse in situations where the originating bank perceived that the failure to provide this support, even though not contractually required, would damage its future access to the asset-backed securities market. An originating bank can provide implicit recourse in a variety of ways. The ultimate determination as to whether implicit recourse exists depends on the facts. The following actions point to a finding of implicit recourse:

- selling assets to a securitization trust or other special-purpose entity (SPE) at a discount from the price specified in the securitization documents, which is typically par value
- purchasing assets from a trust or other SPE at an amount greater than fair value
- exchanging performing assets for nonperforming assets in a trust or other SPE
- funding credit enhancements[10a] beyond contractual requirements

By providing implicit recourse, a bank signals to the market that it still holds the risks inherent in the securitized assets, and, in effect, the risks have not been transferred. Accordingly, examiners must be attentive to banks that provide implicit support, given the risk these actions pose to a bank's financial condition. Increased attention should be given to situations where a bank is more likely to provide implicit support.

Particular attention should be paid to revolving securitizations, such as those used for credit card lines and home equity lines of credit, in which receivables generated by the lines are sold into the securitizations. These securitizations typically provide that, when certain performance criteria hit specified thresholds, no new receivables can be sold into the securitization, and the principal on the bonds issued will begin to pay out. These early-amortization events are intended to protect investors from further deterioration in the underlying asset pool. Once an early-amortization event has occurred, the bank could have difficulties using securitization as a continuing source of funding and, at the same time, have to fund the new receivables generated by the lines of credit on its balance sheet. Thus, banks have an incentive to avoid early amortization by providing implicit support to the securitization.

Examiners should be alert for securitizations that are approaching early-amortization triggers, such as a decrease in the excess spread[10b] below a certain threshold or an increase in delinquencies beyond a certain rate. Providing implicit recourse can pose a degree of risk to a bank's financial condition and to the integrity of its regulatory and public financial statements and reports. Examiners should review securitization documents (for example, pooling and servicing agreements) to ensure that the selling institution limits any post-sale support to that specified in the terms and conditions in the securitization documents. Examiners should also review a sample of receivables transferred between the seller and the trust to ensure that these transfers were conducted in accordance with the contractual terms of the securitization, particularly in cases where the overall credit quality of the securitized loans or receivables has deteriorated. While banks are not prohibited from providing implicit recourse, such support will generally result in higher capital requirements.

Examiners should recommend that prompt supervisory action be taken when implicit recourse is identified. To determine the appropriate action, examiners need to understand the bank's reasons for providing support and the extent of the impact of this support on the bank's earnings and capital. As with contractual recourse, actions involving noncontractual post-sale credit enhancement generally result in the requirement that the bank hold risk-based capital against the entire outstanding amount of the

10a. Credit enhancements include retained subordinated interests, asset-purchase obligations, overcollateralization, cash-collateral accounts, spread accounts, and interest-only strips.

10b. Excess spread generally is defined as finance-charge collections minus certificate interest, servicing fees, and charge-offs allocated to the series.

securitized assets. Supervisors may require the bank to bring all assets in existing securitizations back on the balance sheet for risk-based capital purposes, as well as require the bank to increase its minimum capital ratios. Supervisors may also prevent a bank from removing assets from its risk-weighted asset base on future transactions until the bank demonstrates its intent and ability to transfer risk to the marketplace. In addition, supervisors may consider other actions to ensure that the risks associated with implicit recourse are adequately reflected in the capital ratios. For example, supervisors may require the bank to deduct residual interests from tier 1 capital as well as hold risk-based capital on the underlying assets.

The following examples illustrate post-sale actions that banks have taken on assets they have securitized. These examples are intended to provide guidance on whether these actions would be considered implicit recourse for risk-based capital and other supervisory purposes. A key factor in each scenario and analysis is the potential risk of loss the bank's earnings and capital may be exposed to as a result of its actions.

Account removal: Example 1a

Facts. A bank originates and services credit card receivables throughout the country. The bank decides to divest those credit card accounts of customers who reside in specific geographic areas where the bank lacks a significant market presence. To achieve the maximum sales price, the sale must include both the credit card relationships and the receivables. Because many of the credit card receivables are securitized through a master-trust structure, the bank needs to remove the receivables from the trust. The affected receivables are not experiencing any unusual performance problems. In that respect, the charge-off and delinquency ratios for the receivables to be removed from the trust are substantially similar to those for the trust as a whole.

The bank enters into a contract to sell the specified credit card accounts before the receivables are removed from the trust. The terms of the transaction are arm's length, wherein the bank will sell the receivables at market value. The bank separately agrees to purchase the receivables from the trust at this same price. Therefore, no loss is incurred as a result of removing the receivables from the trust. The bank will only remove receivables from the trust that are due from customers located in the geographic areas where the bank lacks a significant market presence, and it will remove all such receivables from the trust.

Analysis. The removal of the above-described receivables from the trust does not constitute implicit recourse for regulatory capital purposes. Supporting factors for this conclusion include the following:

- The bank's earnings and capital are not exposed to actual or potential risk of loss as a result of removing the receivables from the trust.
- There is no indication that the receivables are removed from the trust because of performance concerns.
- The bank is removing the receivables from the trust for a legitimate business purpose other than to systematically improve the quality of the trust's assets. The legitimate business purpose is evidenced by the bank's prearranged, arm's-length sale agreement that facilitates exiting the business in identified geographic locations.

Examiners should review the terms and conditions of the transaction to ensure that the market value of the receivables is documented and well supported before concluding that this transaction does not represent implicit recourse. Examiners should also ensure that the selling bank has not provided the purchaser with any guarantees or credit enhancements on the sold receivables.

Account removal: Example 1b

Facts. After the establishment of a master trust for a pool of credit card receivables, the receivables in the trust begin to experience adverse performance. A combination of lower-than-expected yields and higher-than-anticipated charge-offs on the pool causes spreads to compress significantly (although not to zero). The bank's internally generated forecasts indicate that spreads will likely become negative in the near future.

Management takes action to support the trust by purchasing the low-quality (delinquent) receivables from the trust at par, although their market value is less than par. The receivables purchased from the trust represent approximately one-third of the trust's total receivables.

This action improves the overall performance of the trust and avoids a potential early-amortization event.

Analysis. The purchase of low-quality receivables from a trust at par constitutes implicit recourse for regulatory capital purposes. The purchase of low-quality receivables at an above-market price exposes the bank's earnings and capital to potential future losses from assets that had previously been sold. Accordingly, the bank is required to hold risk-based capital for the remaining assets in the trust as if they were retained on the balance sheet, as well as hold capital for the assets that were repurchased.

Additions of future assets or receivables: Example 2a

Facts. Months after the issuance of credit card asset-backed securities, charge-offs and delinquencies on the underlying pool of receivables rise dramatically. A rating agency places the securities on watch for a potential rating downgrade, causing the bank to negotiate additional credit support for the securitized assets. The securitization documents require the bank to transfer new receivables to the securitization trust at par value. However, to maintain the rating on the securities, the bank begins to sell replacement receivables into the trust at a discount from par value.

Analysis. The sale of receivables to the trust at a discount constitutes implicit recourse for regulatory capital purposes. The sale of assets at a discount from the price specified in the securitization documents, par value in this example, exposes earnings and capital to future losses. The bank must hold regulatory capital against the outstanding assets in the trust.

Additions of future assets or receivables: Example 2b

Facts. A bank established a credit card master trust. The receivables from the accounts placed in the trust were, on average, of lesser quality than the receivables from accounts retained on the bank's balance sheet. Under the criteria for selecting the receivables to be transferred to the master trust, the bank was prevented from including the better-performing affinity accounts in the initial pool of accounts because the affinity-relationship contract was expiring. The bank and the affinity client subsequently revised the terms of their contract, enabling the affinity accounts to meet the selection criteria and be included in future securitization transactions. Later, rising charge-offs within the pool of receivables held by the trust caused spread compression in the trust. To improve the performance of the assets in the trust, the bank begins to include the better-performing and now-eligible receivables from the affinity accounts among the receivables sold to the trust. This action improves the trust's performance, including its spread levels and charge-off ratios. However, the replacement assets were sold at par in accordance with the terms of the trust agreement, so no current or future charge to the bank's earnings or capital will result from these asset sales. As another result of this action, the performance of the trust's assets closely tracks the credit card receivables that remain on the bank's balance sheet.

Analysis. The actions described above do not constitute implicit recourse for regulatory capital purposes. The bank did not incur any additional risk to earnings or capital after the affinity accounts met the selection criteria for replacement assets and after the associated receivables were among the receivables sold to the trust. The replacement assets were sold at par in accordance with the terms of the trust agreement, so no future charge to earnings or capital will result from these asset sales. The sale of replacement assets into a master-trust structure is part of normal trust management.

In this example, the credit card receivables that remain on the bank's balance sheet closely track the performance of the trust's assets. Nevertheless, examiners should ascertain whether a securitizing bank sells disproportionately higher-quality assets into securitizations while retaining comparatively lower-quality assets on its books; if so, examiners should consider the effect of this practice on the bank's capital adequacy.

Additions of future assets or receivables: Example 2c

Facts. A bank establishes a credit card master trust composed of receivables from accounts that were generally of lower quality than the receivables retained on the bank's balance sheet. The difference in the two portfolios is primarily due to logistical and operational problems that prevent the bank from including certain better-quality affinity accounts in the initial pool from which accounts were selected for securitization. Rising charge-offs and other factors later result in margin compression on the assets in the master trust, which causes some concern in the market regarding the stability of the outstanding asset-backed securities. A rating agency places several securities on its watch list for a potential rating downgrade. In response to the margin compression, as part of the bank's contractual obligations, spread accounts are increased for all classes by trapping excess spread in conformance with the terms and conditions of the securitization documents. To stabilize the quality of the receivables in the master trust as well as to preclude a downgrade, the bank takes several actions beyond its contractual obligations:

- Affinity accounts are added to the pool of receivables eligible for inclusion in the trust. This change results in improved overall trust performance. However, these receivables are sold to the trust at par value, consistent with the terms of the securitization documents, so no current or future charge to the bank's earnings or capital will result from these asset sales.
- The charge-off policy for cardholders that have filed for bankruptcy is changed from criteria that were more conservative than industry standards and the FFIEC Uniform Retail Credit Classification and Account Management Policy to criteria that conform to industry standards and the FFIEC's policy.
- Charged-off receivables held by the trust are sold to a third party. The funds generated by this sale, effectively accelerating the recovery on these receivables, improve the trust's spread performance.

Analysis. The actions described above do not constitute implicit recourse for regulatory capital purposes. None of the noncontractual actions results in a loss or exposes the bank's earnings or capital to the risk of loss. Because of the margin compression, the bank is obligated to increase the spread accounts in conformance with the terms and conditions of the securitization documents. To the extent this results in an increase in the value of the subordinated spread accounts (residual interests) on the bank's balance sheet, the bank will need to hold additional capital on a dollar-for-dollar basis for the additional credit risk it retains. In contrast, if the bank increased the spread accounts beyond its contractual obligation under the securitization documents in order to provide additional protection to investors, this action would be considered a form of implicit recourse. None of the other actions the bank took would affect the bank's earnings or capital:

- Like other additions to credit card trusts, the additions of receivables from the new affinity accounts were made at par value, in accordance with the securitization documents. Therefore, the addition of receivables to the new affinity accounts would not affect the bank's earnings or capital.
- The trust's policy on the timing of charge-offs on accounts of cardholders who have filed for bankruptcy was changed to meet the less-stringent standards of the industry and those required under the Federal Reserve's policy to improve trust performance, at least temporarily. Nonetheless, this would not affect the bank's earnings or capital.
- In accordance with the securitization documents, proceeds from recoveries on charged-off accounts are the property of the trust. These and other proceeds would continue to be paid out in accordance with the pooling and servicing agreement. No impact on the bank's earnings or capital would result.

Modification of loan-repayment terms: Example 3

Facts. In performing the role of servicer for its securitization, a bank is authorized under its pooling and servicing agreement to modify loan-repayment terms when it appears that this action will improve the likelihood of repayment on the loan. These actions are part of the bank's process of working with customers who are delinquent or otherwise experiencing temporary financial difficulties. All of the modifications are consistent with the bank's internal loan policy. However, in modifying the loan terms, the contractual maturity of some loans may be extended beyond the final maturity date of the most junior class of securities sold to investors. When this occurs, the bank repurchases these loans from the securitization trust at par.

Analysis. The modification of terms and repurchase of loans held by the trust constitutes implicit recourse for regulatory capital purposes. The combination of the loan-term modification for securitized assets and the subsequent repurchase constitutes implicit recourse. While the modification of loan terms is permitted under the pooling and servicing agreement, the repurchase of loans with extended maturities at par exposes the bank's earnings and capital to potential risk of loss.

Servicer's payment of deficiency balances: Example 4

Facts. A wholly owned subsidiary of a bank originates and services a portfolio of home equity loans. After liquidation of the collateral for a defaulted loan, the subsidiary makes the trust whole in terms of principal and interest if the proceeds from the collateral are not sufficient. However, there is no contractual commitment that requires the subsidiary to support the pool in this manner. The payments made to the trust to cover deficient balances on the defaulted loans are not recoverable under the terms of the pooling and servicing agreement.

Analysis. The subsidiary's action constitutes implicit recourse to the bank for regulatory capital purposes. This action is considered implicit recourse because it adversely affects the bank's earnings and capital since the bank absorbs losses on the loans resulting from the actions taken by its subsidiary. Further, no mechanism exists to provide for, and ensure that, the subsidiary will be reimbursed for the payments made to the trust. In addition, examiners will consider any servicer advance a credit enhancement if the servicer is not entitled to full reimbursement[10c] or if the reimbursement is subordinate to other claims.

Reimbursement of credit enhancer's actual losses: Example 5

Facts. A bank sponsoring a securitization arranges for an unrelated third party to provide a first-loss credit enhancement, such as a financial standby letter of credit that will cover losses up to the first 10 percent of the securitized assets. The bank agrees to pay a fixed amount as an annual premium for this credit enhancement. The third party initially covers actual losses that occur in the underlying asset pool in accordance with its contractual commitment under the letter of credit. Later, the selling bank agrees not only to pay the credit enhancer the annual premium on the credit enhancement, but also to reimburse the credit enhancer for the losses it absorbed during the preceding year. This reimbursement for actual losses was not originally provided for in the contractual arrangement between the bank and the credit-enhancement provider.

Analysis. The selling bank's subsequent reimbursement of the credit-enhancement provider's losses constitutes implicit recourse because the bank's reimbursement of losses went beyond its contractual obligations. Furthermore, the Federal Reserve would consider any requirement contained in the original credit-enhancement contract that obligates the bank to reimburse the credit-enhancement provider for its losses to be a recourse arrangement.

Low-Level Exposure

Securitization transactions involving recourse may be eligible for ''low-level-recourse'' treatment.[11] A bank that contractually limits its maximum off-balance-sheet recourse obligation or direct-credit substitute (except credit-enhancing I/O strips) to an amount less than the effective risk-based capital requirement for the enhanced assets is required to hold risk-based capital equal to the maximum contractual exposure, [12] less any recourse liability established in accordance with GAAP. The low-level-recourse capital treatment thus applies to transactions accounted for as sales under GAAP. The low-level-exposure rule provides that the dollar amount of risk-based capital required for assets transferred with recourse should not exceed the maximum dollar amount for which a bank is contractually liable, less any recourse liability account established in accordance with GAAP. The limitation does not apply when the bank provides credit enhancement beyond any con-

10c. A servicer advance will also be considered a form of credit enhancement if, for any one loan, nonreimbursable advances are not contractually limited to an insignificant amount of that loan's outstanding principal.

11. See the Federal Reserve's Regulation H, appendix A. See also 60 *Fed. Reg.* 17986, April 10, 1995 (OCC); 60 *Fed. Reg.* 8177, February 13, 1995 (FRB); and 60 *Fed. Reg.* 15858, March 28,1995 (FDIC). The OTS low-level-recourse rule is found at 12 CFR 567.6(a)(2)(i)(c).

12. For example, the effective risk-based capital requirement generally would be 4 percent for residential mortgages and 8 percent for commercial loans.

tractual obligation to support assets it has sold. The low-level capital treatment applies to low-level-recourse transactions involving all types of assets, including commercial loans and residential mortgages.

Low-level-recourse transactions can arise when a bank sells or securitizes assets and uses contractual cash flows, such as spread accounts and I/O strips receivables, as a credit enhancement for the sold or securitized assets. A spread account is an escrow account that a bank typically establishes to absorb losses on receivables it has sold in a securitization, thereby providing credit enhancement to investors in the securities backed by the receivables, for example, credit card receivables. As defined in paragraph 14 of FAS 140, an I/O strip receivable is the contractual right to receive some or all of the interest due on a bond, a mortgage loan, or other interest-bearing financial assets. I/O strips are to be measured at fair value with gains or losses recognized either in earnings (if classified as trading) or a separate component of shareholders' equity (if classified as available-for-sale). Paragraph 14 of FAS 140 states that I/O strips, retained interests in securitizations, loans, other receivables, or other financial assets that can contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment (except for instruments that are within the scope of Statement of Financial Accounting Standards No. 133 (FAS 133), ''Accounting for Derivative Instruments and Hedging Activities,'' shall be subsequently measured like investments in debt securities classified as available-for-sale or trading under Statement of Financial Accounting Standards No. 115 (FAS 115), ''Accounting for Certain Investments in Debt and Equity Securities.'' Retained interests that lack objectively verifiable support or that fail to meet the supervisory standards (discussed previously in this section) will be classified as loss and disallowed as assets of the BO for regulatory capital purposes.

Another divergence from the general risk-based capital treatment for assets sold with recourse concerns small-business obligations. Qualifying institutions that transfer small-business obligations with recourse are required, for risk-based capital purposes, to maintain capital against only the amount of recourse retained, provided two conditions are met. First, the transactions must be treated as a sale under GAAP. Second, the transferring institutions must establish, pursuant to GAAP, a noncapital reserve sufficient to meet the reasonably estimated liability under their recourse arrangements.

Banking organizations will be considered qualifying institutions for the purpose of treatment of recourse for small-business organizations if, pursuant to the Board's prompt-corrective-action regulation (12 CFR 208.40), they are well capitalized or, by order of the Board, adequately capitalized.[13] To qualify, an institution must be determined to be well capitalized or adequately capitalized without taking into account the preferential capital treatment for any previous transfers of small-business obligations with recourse. The total outstanding amount of recourse retained by a qualifying BO on transfers of small-business obligations receiving the preferential capital treatment cannot exceed 15 percent of the institution's total risk-based capital.

Standby Letters of Credit

Banking organizations that issue standby letters of credit as credit enhancements for ABS issues must hold capital against these contingent liabilities under the risk-based capital guidelines. According to the guidelines, financial standby letters of credit are direct-credit substitutes. A direct-credit substitute is an arrangement in which a bank assumes, in form or substance, credit risk associated with an on- or off-balance-sheet credit exposure that it did not previously own (a third-party asset), and the risk assumed by the bank exceeds the pro rata share of its interest in the third-party asset. If the bank has no claim on the third-party asset, then its

13. Under 12 CFR 208.43, a state member bank is deemed to be well capitalized if it (1) has a total risk-based capital ratio of 10.0 percent or greater; (2) has a tier 1 risk-based capital ratio of 6.0 percent or greater; (3) has a leverage ratio of 5.0 percent or greater; and (4) is not subject to any written agreement, order, capital directive, or prompt-corrective-action directive issued by the Board pursuant to section 8 of the FDI Act, the International Lending Supervision Act of 1983, or section 38 of the FDI Act or any regulation thereunder to meet and maintain a specific capital level for any capital measure.

A state member bank is deemed to be adequately capitalized if it (1) has a total risk-based capital ratio of 8.0 or greater, (2) has a tier 1 risk-based capital ratio of 4.0 percent or greater, (3) has a leverage ratio of 4.0 percent or greater or a leverage ratio of 3.0 percent or greater if the bank is rated composite 1 under the CAMELS rating system in its most recent examination and is not experiencing or anticipating significant growth, and (4) does not meet the definition of a well-capitalized bank.

assumption of *any* credit risk with respect to the third-party asset is a direct-credit substitute. Direct-credit substitutes are converted in their entirety to credit-equivalent amounts. The credit-equivalent amounts are then risk-weighted according to their credit rating, like other direct-credit substitutes, and the risk weight for the corresponding credit rating.

Concentration Limits Imposed on Residual Interests

The creation of a residual interest (the debit) typically results in an offsetting gain on sale (the credit), and thus the generation of an asset. Banking organizations that securitize high-yielding assets with long durations may create a residual-interest asset value that exceeds the risk-based capital charge that would be in place if it had not sold the assets. Serious problems can arise for those banking organizations that distribute earnings too generously, only to be faced later with a downward valuation and charge-off of part or all of the residual interests.

Under the Federal Reserve's capital adequacy guidelines, there is a dollar-for-dollar capital charge on residual interests and a concentration limit on a subset of residual interests, credit-enhancing I/O strips. These strips include any on-balance-sheet assets that represent a contractual right to receive some or all of the interest due on transferred assets, after taking into account trustee and other administrative expenses, interest payments to investors, servicing fees, reimbursements to investors for losses attributable to beneficial interests they hold, and reinvestment income and ancillary revenues (for example, late fees) on the transferred assets. Credit-enhancing I/O strips expose the bank to more than its pro rata share of credit risk and are limited to 25 percent of tier 1 capital, whether they are retained or purchased. Any amount of credit-enhancing I/O strips that exceeds the 25 percent limit will be deducted from tier 1 capital and assets. An example of the concentration calculation required for banks that hold credit-enhancing I/O strips is described below.

A bank has purchased and retained on its balance sheet credit-enhancing I/O strips with a face amount of $100, and it has tier 1 capital of $320 (before any disallowed servicing assets, disallowed purchased credit-card relationships, disallowed credit-enhancing I/O strips, disallowed deferred tax assets, and amounts of nonfinancial equity investments required to be deducted). To determine the amount of credit-enhancing I/O strips that fall within the concentration limit, the bank would multiply the tier 1 capital of $320 by 25 percent, which is $80. The amount of credit-enhancing I/O strips that exceeds the concentration limit, in this case $20, is deducted from tier 1 capital for risk-based and leverage capital calculations and from assets.

Credit-enhancing I/O strips that are not deducted from tier 1 capital (that is, the remaining $80 in the above example), along with all other residual interests not subject to the concentration limit, are subject to a dollar-for-dollar capital requirement. Banks are not required to hold capital for more than 100 percent of the amount of the residual interest. Credit-enhancing I/O strips are not aggregated with any servicing assets or purchased credit-card relationships for purposes of calculating the 25 percent concentration limit.

Continuing the above illustration, once a bank deducts the $20 in disallowed credit-enhancing I/O strips, it must hold $80 in total capital for the $80 that represents the credit-enhancing I/O strips not deducted from tier 1 capital. The $20 deducted from tier 1 capital, plus the $80 in total risk-based capital required under the dollar-for-dollar treatment, equals $100, the face amount of the credit-enhancing I/O strips. Banks may apply a net-of-tax approach to any credit-enhancing I/O strips that have been deducted from tier 1 capital, as well as to the remaining residual interests subject to the dollar-for-dollar treatment. A bank is permitted, but not required, to net the deferred tax liabilities recorded on its balance sheet, if any, that are associated with the residual interests. This netting of the deferred tax liabilities may result in a bank's holding less than 100 percent capital against residual interests.

Normally, a sponsor will eventually receive any excess cash flow remaining from securitizations after investor interests have been met. As previously stated, residual interests are vulnerable to sudden and sizeable write-downs that can hinder a bank's access to the capital markets; damage its reputation in the marketplace; and, in some cases, threaten its solvency. An institution's board of directors and management are expected to develop and implement policies that limit the amount of residual interests that may be carried as a percentage of total equity capital, based on the results of their valuation and modeling processes. Well-constructed internal limits also lessen the incentives for an institution's personnel to engage in activities designed to generate near-term ''paper profits'' that may be at the expense of the institution's long-term financial position and reputation.

Asset-Backed Commercial Paper Programs

Although banks' involvement in the securitization of commercial paper has increased significantly over time, asset-backed commercial paper programs differ from other methods of securitization. One difference is that more than one type of asset may be included in the receivables pool.[14] Moreover, in certain cases, the cash flow from the receivables pool may not necessarily match the payments to investors because the maturity of the underlying asset pool does not always parallel the maturity of the structure of the commercial paper. Consequently, when the paper matures, it is usually rolled over or funded by another issue. In certain circumstances, a maturing issue of commercial paper cannot be rolled over. To address this problem, many banks have established backup liquidity facilities. Certain banks have classified these backup facilities as pure liquidity facilities, despite the credit-enhancement element present in them, and, as a result, have incorrectly assessed the risks associated with these facilities. In these cases, the backup liquidity facilities have been more similar to direct-credit substitutes than to loan commitments.

Risk-Based Capital Exclusion of Asset-Backed Commercial Paper Program Assets and Related Minority Interests

An asset-backed commercial paper (ABCP) program typically is a program through which a bank provides funding to its corporate customers by sponsoring and administering a bankruptcy-remote special-purpose entity that purchases asset pools from, or extends loans to, those customers.[15] The asset pools in an ABCP program might include, for example, trade receivables, consumer loans, or ABS. The ABCP program raises cash to provide funding to the bank's customers through the issuance of externally rated commercial paper into the market. Typically, the sponsoring bank provides liquidity and credit enhancements to the ABCP program. These enhancements aid the program in obtaining high credit ratings that facilitate the issuance of the commercial paper.[16]

In January 2003, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 46, ''Consolidation of Variable Interest Entities'' (FIN 46), which was effective the first annual reporting period after June 15, 2003. FIN 46 required, for the first time, the consolidation of variable interest entities (VIEs) onto the balance sheets of companies deemed to be the primary beneficiaries of those entities. FASB revised FIN 46 in December 2003 as FIN 46-R (effective for publicly owned banking organizations by March 31, 2004). FIN 46-R requires the consolidation of many ABCP programs onto the balance sheets of BOs. Banks that are required to consolidate ABCP program assets must include all of the program assets (mostly receivables and securities) and liabilities (mainly commercial paper) on their balance sheets for purposes of the bank Reports of Condition and Income (Call Reports).

Sponsoring BOs generally face limited risk exposure to ABCP programs. This risk usually is confined to the credit enhancements and liquidity-facility arrangements that sponsoring BOs provide to these programs. In addition, operational controls and structural provisions, along with overcollateralization or other credit enhancements provided by the companies that sell assets into ABCP programs, mitigate the risks to which sponsoring BOs are exposed.

14. See the Federal Reserve System's Supervision and Regulation Task Force on Securitization, ''An Introduction to Asset Securitization,'' issued as an attachment to SR-90-16. See also ''Asset-Backed Commercial Paper Programs,'' *Federal Reserve Bulletin*, February 1992.

15. The definition of *ABCP program* generally includes structured investment vehicles (entities that earn a spread by issuing commercial paper and medium-term notes and using the proceeds to purchase highly rated debt securities) and securities arbitrage programs.

16. A bank is considered the *sponsor of an ABCP program* if it establishes the program; approves the sellers permitted to participate in the program; approves the asset pools to be purchased by the program; or administers the program by monitoring the assets, arranging for debt placement, compiling monthly reports, or ensuring compliance with the program documents and with the program's credit and investment policy.

Because of the limited risks, the agencies[17] adopted on July 17, 2004 (effective September 30, 2004) a revised rule that permits sponsoring BOs to exclude from risk-weighted assets (for purposes of calculating the risk-based capital ratios) ABCP program assets that require consolidation under FIN 46-R (subject to certain requirements).

Under the Board's risk-based capital rule, a bank that must consolidate an ABCP program that is defined as a VIE under GAAP may exclude the consolidated ABCP program assets from risk-weighted assets, provided that the bank is the sponsor of the ABCP program. If a bank excludes such consolidated ABCP program assets, the bank must assess the appropriate risk-based capital charge against any exposures of the bank arising in connection with such ABCP programs, including direct-credit substitutes, recourse obligations, residual interests, liquidity facilities, and loans, in accordance with sections III.B.5., III.C., and III.D. (12 CFR 208, appendix A) of the risk-based capital rule. When calculating the bank's tier 1 and total capital, any associated minority interests must also be excluded from tier 1 capital. As a result of FIN 46-R, banks are to include all assets of consolidated ABCP programs as part of their on-balance-sheet assets for purposes of calculating the tier 1 leverage capital ratio.

A bank is able to exclude ABCP program assets from its risk-weighted asset base only with respect to those programs for which it is the sponsor and that meet the rule's definition of an *ABCP program.* An ABCP program is defined as a program that primarily issues (that is, more than 50 percent) externally rated commercial paper backed by assets or other exposures held in a bankruptcy-remote, special-purpose entity. Thus, a bank sponsoring a program issuing ABCP that does not meet the rule's definition of an ABCP program must continue to include the program's assets in the institution's risk-weighted asset base.

Liquidity facilities supporting ABCP. Liquidity facilities supporting ABCP often take the form of commitments to lend to, or to purchase assets from, the ABCP programs in the event that funds are needed to repay maturing commercial paper. Typically, this need for liquidity is due to a timing mismatch between cash collections on the underlying assets in the program and scheduled repayments of the commercial paper issued by the program.

A bank that provides liquidity facilities to ABCP is exposed to credit risk, regardless of the term of the liquidity facilities. For example, an ABCP program may require a liquidity facility to purchase assets from the program at the first sign of deterioration in the credit quality of an asset pool, thereby removing such assets from the program. In such an event, a draw on the liquidity facility exposes the bank to credit risk.

Short-term commitments with an original maturity of one year or less expose banks to a lower degree of credit risk than longer-term commitments. This difference in the degree of credit risk is reflected in the risk-based capital requirement for the different types of exposures through liquidity facilities.

The Board's risk-based capital guidelines impose a 10 percent credit-conversion factor on unused portions of eligible short-term liquidity facilities supporting ABCP. Under the risk-based capital guidelines and the Board's interpretations thereof, the credit conversion factor for an eligible ABCP liquidity facility is based on whether the facility has an original maturity of one year or less.[18] A 50 percent credit-conversion factor applies to eligible ABCP liquidity facilities having a maturity greater than one year. To be an eligible ABCP liquidity facility and qualify for the 10 or 50 percent credit-conversion factor, the facility must be subject to an asset quality test at the time of inception that does not permit funding against (1) assets that are 90 days or more past due, (2) assets that are in default, and (3) assets or exposures that are externally rated below investment grade at the time of funding if the assets or exposures were externally rated at the inception of the facility. However, a liquidity facility may also be an eligible liquidity facility if it funds against assets that are guaranteed—either conditionally or unconditionally—by the U.S. government, U.S. government agencies, or by an OECD central government, regardless of whether the assets are 90 days past due, in default, or externally rated investment grade.

The 10 or 50 percent credit-conversion factors apply, regardless of whether the structure

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

18. See the Board staff's October 12, 2007, legal interpretation regarding the risk-based capital treatment of ABCP liquidity facilities.

issuing the ABCP meets the rule's definition of an ABCP program. For example, a capital charge would apply to an eligible short-term liquidity facility that provides liquidity support to ABCP where the ABCP constitutes less than 50 percent of the securities issued by the program, thus causing the issuing structure not to meet the rule's definition of an ABCP program. However, if a bank (1) does not meet this definition and must include the program's assets in its risk-weighted asset base or (2) otherwise chooses to include the program's assets in risk-weighted assets, then no risk-based capital requirement will be assessed against any liquidity facilities provided by the bank that support the program's ABCP. Ineligible liquidity facilities will be treated as recourse obligations or direct-credit substitutes for the purposes of the Board's risk-based capital guidelines.

The Board's risk-based capital guidelines do not specifically mandate, authorize, or prohibit a look-through approach to eligible ABCP liquidity facilities. The Federal Reserve and other federal banking agencies have taken the position that a risk weight may be applied to the credit equivalent amount of an eligible ABCP liquidity facility by looking through to the underlying assets of the ABCP conduit after considering any collateral or guarantees, or external credit ratings, if applicable. For example, if an eligible short-term liquidity facility providing liquidity support to ABCP covered an asset-backed security (ABS) externally rated AAA, then the notional amount of the liquidity facility would be converted at 10 percent to an on-balance-sheet credit-equivalent amount and assigned to the 20 percent risk-weight category appropriate for AAA-rated ABS.

Overlapping exposures to an ABCP program. A bank may have multiple overlapping exposures to a single ABCP program (for example, both a program-wide credit enhancement and multiple pool-specific liquidity facilities to an ABCP program that is not consolidated for risk-based capital purposes). A bank must hold risk-based capital only once against the assets covered by the overlapping exposures. Where the overlapping exposures are subject to different risk-based capital requirements, the bank must apply the risk-based capital treatment that results in the highest capital charge to the overlapping portion of the exposures.

For example, assume a bank provides a program-wide credit enhancement that would absorb 10 percent of the losses in all of the underlying asset pools in an ABCP program and also provides pool-specific liquidity facilities that cover 100 percent of each of the underlying asset pools. The bank would be required to hold capital against 10 percent of the underlying asset pools because it is providing the program-wide credit enhancement. The bank would also be required to hold capital against 90 percent of the liquidity facilities it is providing to each of the underlying asset pools. For risk-based capital purposes, the bank would not be required to hold capital against any credit enhancements or liquidity facilities that comprise the same program assets.

If different banks have overlapping exposures to an ABCP program, however, each organization must hold capital against the entire maximum amount of its exposure. As a result, while duplication of capital charges will not occur for individual banks, some systemic duplication may occur where multiple BOs have overlapping exposures to the same ABCP program.

Asset-quality test. For a liquidity facility, either short- or long-term, that supports ABCP *not* to be considered a recourse obligation or a direct-credit substitute, it must meet the risk-based capital rule's definition of an *eligible ABCP liquidity facility.* An eligible ABCP liquidity facility must meet a reasonable asset-quality test that, among other things, precludes funding against assets that are 90 days or more past due or in default. When assets are 90 days or more past due, they typically have deteriorated to the point where there is an extremely high probability of default. Assets that are 90 days past due, for example, often must be placed on nonaccrual status in accordance with the agencies' Uniform Retail Credit Classification and Account Management Policy.[19] Further, they generally must also be classified substandard under that policy.

In addition to the above, if the assets covered by the liquidity facility are initially externally rated (at the time the facility is provided), the facility can be used to fund only those assets that are externally rated investment grade at the time of funding. The practice of purchasing assets that are externally rated below investment grade out of an ABCP program is considered to be the equivalent of providing credit protection to the commercial paper investors. Thus, liquidity facilities permitting purchases of below-

19. See 65 *Fed. Reg.* 36904 (June 12, 2000).

investment-grade securities will be considered either recourse obligations or direct-credit substitutes.

However, neither the "90-days-past-due" limitation nor the "investment grade" limitation apply to the asset-quality test with respect to assets that are conditionally or unconditionally guaranteed by the U.S. government or its agencies or by another OECD central government.

An ABCP liquidity facility is considered to be in compliance with the requirement for an asset quality test if (1) the liquidity provider has access to certain types of acceptable credit enhancements and (2) the notional amount of such credit enhancements available to the liquidity facility provider exceeds the amount of underlying assets that are 90 days or more past due, defaulted, or below investment grade for which the liquidity provider may be obligated to fund under the facility. In this circumstance, the liquidity facility may be considered "eligible" for purposes of the risk-based capital rule because the provider of the credit enhancement generally bears the credit risk of the assets that are 90 days or more past due, in default, or below investment grade rather than the banking organization providing liquidity.[19a]

The following forms of credit enhancements are generally acceptable for purposes of satisfying the asset quality test:

- "funded" credit enhancements that the BO may access to cover delinquent, defaulted, or below-investment-grade assets, such as overcollateralization, cash reserves, subordinated securities, and funded spread accounts;
- surety bonds and letters of credit issued by a third party with a nationally recognized statistical rating organization with a rating of single A or higher that the BO may access to cover delinquent, defaulted, or below-investment-grade assets, provided that the surety bond or letter of credit is irrevocable and legally enforceable; and
- one month's worth of excess spread that the BO may access to cover delinquent, defaulted, or below-investment-grade assets if the following conditions are met: (1) excess spread is contractually required to be trapped when it falls below 4.5 percent (measured on an annualized basis) and (2) there is no material adverse change in the BO's ABCP underwriting standards. The amount of available excess spread may be calculated as the average of the current month's and the two previous months' excess spread.

Recourse directly to the seller, other than the funded credit enhancements enumerated above, regardless of the seller's external credit rating, is not an acceptable form of credit enhancement for purposes of satisfying the asset quality test. Seller recourse—for example, a seller's agreement to buy back nonperforming or defaulted loans or downgraded securities—may expose the liquidity provider to an increased level of credit risk. A decline in the performance of assets sold to an ABCP conduit may signal impending difficulties for the seller.

If the amount of acceptable credit enhancement associated with the pool of assets is less than the current amount of assets that are 90 days or more past due, in default, or below investment grade that the liquidity facility provider may be obligated to fund against, the liquidity facility should be treated as recourse or a direct credit substitute. The full amount of assets supported by the liquidity facility would be subject to a 100 percent credit conversion factor.[19b] The Federal Reserve Board reserves the right to deem an otherwise eligible liquidity facility to be, in substance, a direct credit substitute if a member bank uses the liquidity facility to provide credit support.

The bank is responsible for demonstrating to the Federal Reserve Board whether acceptable credit enhancements cover the 90 days or more past due, defaulted, or below-investment-grade assets that the organization may be obligated to fund against in each seller's asset pool. If the bank cannot adequately demonstrate satisfaction of the conditions in the above-referenced interagency guidance, the Federal Reserve Board further reserves the right to determine that a credit enhancement is unacceptable for purposes of the requirement for an asset quality test and, therefore, it may deem the liquidity facility to be ineligible.

Market risk capital requirements for ABCP programs. Any facility held in the trading book whose primary function, in form or in substance, is to provide liquidity to ABCP—even if the

19a. See SR-05-13 and its attachment, "Interagency Guidance on the Eligibility of Asset-Backed Commercial Paper Liquidity Facilities and the Resulting Risk-Based Capital Treatment."

19b. See 12 CFR 208, appendix A, section III.B.3.b.i.

facility does not qualify as an eligible ABCP liquidity facility under the rule—will be subject to the banking-book risk-based capital requirements. Specifically, banks are required to convert the notional amount of all trading-book positions that provide liquidity to ABCP to credit-equivalent amounts by applying the appropriate banking-book credit-conversion factors. For example, the full amount of all eligible ABCP liquidity facilities with an original maturity of one year or less will be subject to a 10 percent conversion factor, regardless of whether the facility is carried in the trading account or the banking book.

SOUND RISK-MANAGEMENT PRACTICES

An institution must incorporate the risks involved in its securitization activities into its overall risk-management system. The system should entail (1) inclusion of risk exposures in reports to the institution's senior management and board to ensure proper management oversight; (2) adoption of appropriate policies, procedures, and guidelines to manage the risks involved; (3) appropriate measurement and monitoring of risks; and (4) assurance of appropriate internal controls to verify the integrity of the management process with respect to these activities.

Board and Senior Management Oversight

Both the board of directors and senior management are responsible for ensuring that they fully understand the degree to which the organization is exposed to the credit, market, liquidity, operational, legal, and reputational risks involved in the institution's securitization activities. They are also responsible for ensuring that the formality and sophistication of the techniques used to manage these risks are commensurate with the nature and volume of the organization's activities. Institutions with significant securitization activities are expected to have more elaborate and formal approaches to manage the risk of these activities. The board should approve all significant policies relating to the management of risk arising from securitization activities and should ensure that risk exposures are fully incorporated in board reports and risk-management reviews.

Policies and Procedures

Senior management is responsible for ensuring that the risks arising from securitization activities are adequately managed on both a short-term and long-run basis. Management should ensure that adequate policies and procedures are in place for incorporating the risk of these activities into the overall risk-management process of the institution. Such policies should ensure that the economic substance of the risk exposures generated by these activities is fully recognized and appropriately managed. In addition, BOs involved in securitization activities should have appropriate policies, procedures, and controls for underwriting ABS; funding the possible return of revolving receivables (for example, credit card receivables and home-equity lines); and establishing limits on exposures to individual institutions, types of collateral, and geographic and industrial concentrations. The institution's directors and managers need to ensure that—

- independent risk-management processes are in place to monitor securitization-pool performance on an individual and aggregate transaction level (an effective risk-management function includes appropriate information systems to monitor securitization activities);
- conservative valuation assumptions and modeling methodologies are used to establish, evaluate, and adjust the carrying value of retained interests on a regular and timely basis;
- audit or internal-review staffs periodically review data integrity, model algorithms, key underlying assumptions, and the appropriateness of the valuation and modeling process for the securitized assets the institution retains (the findings of such reviews should be reported directly to the board or an appropriate board committee);
- accurate and timely risk-based capital calculations are maintained, including recognition and reporting of any recourse obligation resulting from securitization activity;
- internal limits are in place to govern the maximum amount of retained interests as a

percentage of total equity capital; and
- the institution has a realistic liquidity plan in place in case of market disruptions.

Independent Risk-Management Function

Institutions engaged in securitizations need to have an independent risk-management function commensurate with the complexity and volume of their securitizations and their overall risk exposures. The risk-management function should ensure that securitization policies and operating procedures, including clearly articulated risk limits, are in place and appropriate for the institution's circumstances. A sound asset-securitization policy should include or address, at a minimum—

- a written and consistently applied accounting methodology;
- regulatory reporting requirements;
- valuation methods, including FAS 140 residual-value assumptions, and procedures to formally approve changes to those assumptions;
- a management reporting process; and
- exposure limits and requirements for both individual- and aggregate-transaction monitoring.

It is essential that the risk-management function monitor origination, collection, and default-management practices. This includes regular evaluations of the quality of underwriting, soundness of the appraisal process, effectiveness of collections activities, ability of the default-management staff to resolve severely delinquent loans in a timely and efficient manner, and appropriateness of loss-recognition practices. Because the securitization of assets can result in the current recognition of anticipated income, the risk-management function should pay particular attention to the types, volumes, and risks of assets being originated, transferred, and serviced. Senior management and the risk-management staff must be alert to any pressures on line managers to originate abnormally large volumes or higher-risk assets to sustain ongoing income needs. Such pressures can lead to a compromise of credit-underwriting standards. This may accelerate credit losses in future periods, impair the value of retained interests, and potentially lead to funding problems.

Risk Measurement and Monitoring

An institution's risk-management function should include information and risk-measurement and -monitoring systems that fully incorporate the risks involved in its securitization activities. BOs must be able to identify credit exposures from all securitization activities, as well as measure, quantify, and control those exposures on a fully consolidated basis. The economic substance of the credit exposures of securitization activities should be fully incorporated into the institution's efforts to quantify its credit risk, including efforts to establish more formal grading of credits to allow for statistical estimation of loss-probability distributions. Securitization activities should also be included in any aggregations of credit risk by borrower, industry, or economic sector.

An institution's information systems should identify and segregate those credit exposures arising from the institution's loan-sale and securitization activities. Such exposures include the sold portions of participations and syndications, exposures arising from the extension of credit-enhancement and liquidity facilities, the effects of an early-amortization event, and the investment in ABS. The management reports should provide the board and senior management with timely and sufficient information to monitor the institution's exposure limits and overall risk profile.

Stress Testing

The use of stress testing, including combinations of market events that could affect a BO's credit exposures and securitization activities, is another important element of risk management. Stress testing involves identifying possible events or changes in market behavior that could have unfavorable effects on the institution, and assessing the organization's ability to withstand them. Stress testing should consider not only the probability of adverse events but also likely worst-case scenarios. Stress testing should be done on a consolidated basis and should consider, for instance, the effect of higher-than-expected levels of delinquencies and defaults, as well as the consequences of early-amortization events with respect to credit card securities, that could raise concerns regarding the institution's capital adequacy and its liquidity and funding capabilities. Stress-test analyses should also include contingency plans for possible management actions in certain situations.

Internal Controls

One of management's most important responsibilities is establishing and maintaining an effective system of internal controls. Among other things, internal controls should enforce the official lines of authority and the appropriate separation of duties in managing the risks of the institution. These internal controls must be suitable for the type and level of risks at the institution, given the nature and scope of its activities. Moreover, these internal controls should ensure that financial reporting is reliable (in published financial reports and regulatory reports), including adequate allowances or liabilities for expected losses.

Effective internal controls are essential to an institution's management of the risks associated with securitization. When properly designed and consistently enforced, a sound system of internal controls will help management safeguard the institution's resources; ensure that financial information and reports are reliable; and comply with contractual obligations, including securitization covenants. Internal controls will also reduce the possibility of significant errors and irregularities, and assist in their timely detection. Internal controls typically (1) limit authorities; (2) safeguard access to and use of records; (3) separate and rotate duties; and (4) ensure both regular and unscheduled reviews, including testing.

Operational and managerial standards have been established for internal control and information systems.[20] A system of internal controls should be maintained that is appropriate to the institution's size and nature, its scope, and the risk of its activities.[21]

Audit Function or Internal Review

The institution's board of directors is responsible for ensuring that its audit staff or independent-review function is competent to review its securitization activities. The audit function should perform periodic reviews of securitization activities, including transaction testing and verification, and report all findings to the board or appropriate board committee. The audit function also may be useful to senior management in identifying and measuring risk related to securitization activities. Principal audit targets should include compliance with securitization policies, operating and accounting procedures (FAS 140), deal covenants, and the accuracy of MIS and regulatory reports. The audit function also should confirm that the institution's regulatory reporting process is designed and managed to facilitate timely and accurate report filing. Furthermore, when a third party services loans, the auditors should perform an independent verification of the existence of the loans to ensure that balances reconcile to internal records.

Management Information Systems

An institution's reporting and documentation methods must support the initial valuation of any retained interests and provide ongoing impairment analyses of these assets. Pool-performance information will help well-managed institutions ensure, on a qualitative basis, that a sufficient amount of economic capital is being held to cover the various risks inherent in securitization transactions. The absence of an adequate management information system (MIS) will hinder management's ability to monitor specific pool performance and securitization activities. MIS reports, at a minimum, should address the following:

- *Securitization summaries for each transaction.* The summary should include relevant transaction terms such as collateral type, facility amount, maturity, credit-enhancement and subordination features, financial covenants (termination events and spread-account capture ''triggers''), right of repurchase, and counterparty exposures. Management should ensure that the summaries for each transaction are distributed to all personnel associated with securitization activities.
- *Performance reports by portfolio and specific product type.* Performance factors include gross portfolio yield, default rates and loss severity, delinquencies, prepayments or payments, and excess spread amounts. The reports should reflect the performance of assets, both on an individual-pool basis and total managed assets. These reports should segregate specific products and different marketing campaigns.
- *Vintage analysis for each pool using monthly data.* Vintage analysis will help management understand historical performance trends and their implications for future default rates, prepayments, and delinquencies, and therefore retained interest values. Management can use

20. See the safety-and-soundness standards for national banks at 12 CFR 30 (OCC) and for savings associations at 12 CFR 570 (OTS).

21. Institutions that are subject to the requirements of FDIC regulation 12 CFR 363 should include an assessment of the effectiveness of internal controls over their asset-securitization activities as part of management's report on the overall effectiveness of the system of internal controls over financial reporting. This assessment implicitly includes the internal controls over financial information that is included in regulatory reports.

these reports to compare historical performance trends with underwriting standards, including the use of a validated credit-scoring model, to ensure loan pricing is consistent with risk levels. Vintage analysis also helps in the comparison of deal performance at periodic intervals and validates retained-interest valuation assumptions.

- *Static-pool cash-collection analysis.* A static-pool cash-collection analysis involves reviewing monthly cash receipts relative to the principal balance of the pool to determine the cash yield on the portfolio, comparing the cash yield to the accrual yield, and tracking monthly changes. Management should compare monthly the timing and amount of cash flows received from the trust with those projected as part of the FAS 140 retained-interest valuation analysis. Some master-trust structures allow excess cash flow to be shared between series or pools. For revolving-asset trusts with this master-trust structure, management should perform a cash-collection analysis for each master-trust structure. These analyses are essential in assessing the actual performance of the portfolio in terms of default and prepayment rates. If cash receipts are less than those assumed in the original valuation of the retained interest, this analysis will provide management and the board with an early warning of possible problems with collections or extension practices and impairment of the retained interest.
- *Sensitivity analysis.* A sensitivity analysis measures the effect of changes in default rates, prepayment or payment rates, and discount rates to assist management in establishing and validating the carrying value of the retained interest. Stress tests should be performed at least quarterly. Analyses should consider potential adverse trends and determine "best," "probable," and "worst-case" scenarios for each event. Other factors that need to be considered are the impact of increased defaults on collections staffing, the timing of cash flows, spread-account capture triggers, overcollateralization triggers, and early-amortization triggers. An increase in defaults can result in higher-than-expected costs and a delay in cash flows, thus decreasing the value of the retained interests. Management should periodically quantify and document the potential impact to both earnings and capital and should report the results to the board of directors. Management should incorporate this analysis into their overall interest-rate risk measurement system.[22] Examiners will review the institution's analysis and the volatility associated with retained interests when assessing the Sensitivity to Market Risk component rating (the "S" in the CAMELS rating system for banks or the "R" for the BHC RFI/C(D) rating system).[23]
- *Statement of covenant compliance.* Ongoing compliance with deal-performance triggers as defined by the pooling and servicing agreements should be affirmed at least monthly. Performance triggers include early amortization, spread capture, changes to overcollateralization requirements, and events that would result in servicer removal.

Securitization Convenants Linked to Supervisory Actions or Thresholds

A bank's board of directors and senior management are responsible for initiating policies and procedures and for monitoring processes and internal controls that will provide reasonable assurance that the bank's contracts and commitments do not include detrimental covenants that affect the safety and soundness of the bank. When examiners review a bank's securitization contracts and related documentation, they should be alert to any covenants that use adverse supervisory actions or the breach of supervisory thresholds as triggers for early-amortization events or the transfer of servicing. Examples of such supervisory actions include a downgrade in the organization's CAMELS rating, an enforcement action, or a downgrade in a bank's prompt-corrective-action capital category. The inclusion of supervisory-linked covenants in securitization documents is considered to be an "unsafe and unsound banking practice" that undermines the objective of supervisory actions and thresholds. An early amortization or transfer of servicing triggered by such events can create or exacerbate liquidity and earnings problems for a bank that may lead to further deterioration in its financial condition.

22. The Joint Agency Policy Statement on Interest-Rate Risk (see SR-96-13 and section 4090.1) advises institutions with a high level of exposure to interest-rate risk relative to capital that they will be directed to take corrective action.

23. See the appendix to section 5020.1 (section A.5020.1) for a description of the CAMELS rating system. See SR-04-18 for a description of the RFI/C(D) rating system.

Convenants that contain triggers tied, directly or indirectly, to supervisory actions or thresholds can also result in the early amortization of a securitization at a time when the sponsoring organization's ability to access other funding sources is limited. If an early-amortization event occurs, investors may lose confidence in the stability of the sponsoring organization's asset-backed securities, thus limiting its ability to raise new funds through securitization. At the same time, the organization must fund new receivables on the balance sheet, potentially resulting in liquidity problems. Moreover, the existence of a supervisory-linked trigger potentially could inhibit supervisors from taking action intended to address problems at a troubled institution because the action could trigger an event that worsens the institution's condition or causes its failure.

The Federal Reserve and the other federal banking agencies (the OCC, the FDIC, and the OTS) also are concerned that covenants related to supervisory actions may obligate a bank's management to disclose confidential examination information, such as the CAMELS rating. Disclosure of such information by a bank's directors, officers, employees, attorneys, auditors, or independent auditors, without explicit authorization by the institution's primary regulator, violates the agencies' information-disclosure rules and may result in follow-up supervisory actions. (See SR-02-14.)

Because of the supervisory concerns about convenants linked to supervisory actions, a federal bank interagency advisory was issued on May 23, 2002. The advisory emphasizes that a bank's management and board of directors should ensure that covenants related to supervisory actions or thresholds are not included in securitization documents. Covenants that provide for the early termination of the transaction or compel the transfer of servicing due, directly or indirectly, to the occurrence of a supervisory action or event will be criticized, under appropriate circumstances, as an unsafe and unsound banking practice. The agencies also may take other supervisory actions, such as requiring additional capital or denying capital relief for risk-based capital calculations, regardless of the GAAP treatment.

Examiners should consider the potential impact of such covenants in existing transactions when evaluating both the overall condition of the bank and the specific component ratings of capital, liquidity, and management. Early-amortization triggers will specifically be considered in the context of the bank's overall liquidity position and contingency funding plan. For organizations with limited access to other funding sources or a significant reliance on securitization, the existence of these triggers presents a greater degree of supervisory concern. Any bank that uses securitization as a funding source should have a viable contingency funding plan in the event it can no longer access the securitization market. Examiners should encourage bank management to amend, modify, or remove covenants linked to supervisory actions from existing transactions. Any impediments a bank may have to taking such actions should be documented and discussed with the appropriate supervisory staff of its responsible Reserve Bank.

APPRAISALS AND MORTGAGE-BACKED SECURITIES

Under 12 CFR 225.63(a)(8), an appraisal performed by a state-certified or -licensed appraiser is not required for any real estate–related financial transaction in which a regulated institution purchases a loan or interest in a loan; pooled loans; or an interest in real property, including mortgage-backed securities, provided that the appraisal prepared for each pooled loan or real property interest met the requirements of the regulation. Banks must establish procedures for determining and ensuring that applicable appraisals meet the requirements.

EXAMINATION GUIDELINES FOR ASSET SECURITIZATION

A banking organization may be involved in originating the assets to be pooled, packaging the assets for securitization, servicing the pooled assets, acting as trustee for the pool, providing credit enhancements, underwriting or placing the ABS, or investing in the securities. Individual securitization arrangements often possess unique features, and the risks addressed in this abbreviated version of the examiner guidelines[24]

24. A complete version of the "Examination Guidelines for Asset Securitization" is attached to SR-90-16.

do not apply to all securitization arrangements. Conversely, arrangements may entail risks not summarized here. Examiners should judge a banking organization's exposure to securitization with reference to the specific structures in which the organization is involved and the degree to which the organization has identified exposures and implemented policies and controls to manage them. Examiners may tailor the scope of their examinations if the banking organization's involvement in securitization is immaterial relative to its size and financial strength.

A banking organization participating in securitization, in any capacity, should ensure that the activities are clearly and logically integrated into the overall strategic objectives of the organization. The management of the organization should understand the risks and should not rely excessively on outside expertise to make crucial decisions regarding securitization activities.

As mentioned earlier, the degree of securitization exposure faced by an individual banking organization depends on the role of the organization in the securitization process. An organization involved in the issuance of ABS as originator, packager, servicer, credit enhancer, underwriter, or trustee may face combinations and degrees of risk different than those faced by an organization that only invests in ABS. Examiners should assess a BO's level, identification, and management of risks within the context of its roles.

A BO should conduct an independent analysis of its exposures before participating in any aspect of securitization and should continue to monitor its exposures throughout its involvement. The analysis and subsequent monitoring should take into account the entire securitization arrangement, emphasizing different risks according to the role that the organization plays. Excessive reliance on opinions of third parties and reported collateral values should be avoided.

An organization involved in the issuance of ABS should scrutinize the underlying assets, giving consideration to their yield, their maturity, their credit risk, their prepayment risk, and the accessibility of collateral in cases of default, as well as the structure of the securitization arrangement and the ability of the other participants in the transaction to meet their obligations. On the other hand, a BO investing in ABS can be expected to place greater emphasis on the characteristics of the ABS as securities, paying attention primarily to credit risk, prepayment risk, liquidity risk, and concentration risk; the underlying assets and structure of the securitization arrangement would be evaluated only within this context.

Appropriate policies, procedures, and controls should be established by a BO before participating in asset securitization. Controls should include well-developed management information systems. In addition, significant policies and procedures should be approved and reviewed periodically by the organization's board of directors.

In addition to evaluating and monitoring exposure to particular securitization deals, a BO should manage its overall exposure on a consolidated holding company basis. Management of these exposures should include—

- reasonable limits on geographic and industrial concentrations, as well as on exposures to individual institutions;
- internal systems and controls to monitor these exposures and provide periodic and timely reports to senior management and the board of directors on performance and risks; and
- procedures for identifying potential or actual conflicts of interest and policies for resolving those conflicts.

The following general guidelines are intended to help examiners assess the exposures of banks and bank holding companies to asset securitization.

Banking Organizations Involved in Issuing or Managing ABS

A BO involved in the issuance of ABS as originator, packager, servicer, credit enhancer, underwriter, or trustee should analyze the assets underlying the asset-backed security and the structure of the arrangement, including—

- the characteristics and expected performance of the underlying assets,
- the BO's ability to meet its obligations under the securitization arrangement, and
- the ability of the other participants in the arrangement to meet their obligations.

Analysis of the underlying assets should be conducted independently by each participant in the process, giving consideration to yield, maturity, credit risk, prepayment risk, and the accessibility of collateral in cases of default. An originator should further consider the impact of securitization on the remaining asset portfolio and on the adequacy of loan-loss reserves and overall capital.

Financial position and operational capacity should be adequate to meet obligations to other parties in a securitization arrangement, even under adverse scenarios. Accordingly, a BO should ensure that the pricing of services is adequate to cover costs over the term of the obligation, as well as to compensate for associated risks. Further, the organization should have contingency plans to transfer responsibilities to another institution in the event that those responsibilities can no longer be fulfilled. Examiners should determine that the BO has policies and controls for managing contractual obligations, including management of collateral, if applicable. Staffing levels should be adequate to fulfill responsibilities.

If a BO's obligations, under a securitization agreement, are subcontracted to other parties, an assessment of the subcontractor's financial position and operational capacity should be conducted before delegating responsibility. Further, the subcontractor's financial position and compliance with contractual obligations should be monitored periodically.

A BO involved in issuing ABS should make certain that the agreement permits it to assess the ability of other participants in the securitization arrangement to meet their obligations (considering obligations that they may have under other securitization arrangements). The rights and obligations of each of the participants under possibly novel legal and institutional arrangements should be clearly documented.

Funding and liquidity management for originators and packagers of securitized assets should avoid excessive reliance on the device of securitization. Originators and packagers should monitor the securitization market closely, develop a broad customer base for their securitization activities, and maintain diversified funding sources.

BOs should not rely excessively on the expertise of a single individual or a small group of individuals, either inside or outside the organization, for the management of participation in securitization activities. Examiners should ensure that an organization acting as trustee for ABS follows the usual standards for trust services.

Policy and Portfolio Analysis

Credit risk. Institutions should be aware that the credit risk involved in many securitization activities may not always be obvious. For certain types of loan-sales and securitization transactions, a BO may actually be exposed to essentially the same credit risk as in traditional lending activities, even though a particular transaction may, superficially, appear to have isolated the institution from any risk exposure. In such cases, removal of an asset from the balance sheet may not result in a commensurate reduction in credit risk. Transactions that can give rise to such instances include loan sales with recourse; credit derivatives; direct-credit substitutes, such as letters of credit; and liquidity facilities extended to securitization programs, as well as certain asset-securitization structures, such as the structure typically used to securitize credit card receivables.

The partial, first-loss recourse obligations an institution retains when selling assets, and the extension of partial credit enhancements (for example, 10 percent letters of credit) in connection with asset securitization, can be sources of concentrated credit risk by exposing institutions to the full amount of expected losses on the protected assets. For instance, the credit risk associated with whole loans or pools of assets that are sold to secondary-market investors can often be concentrated within the partial, first-loss recourse obligations retained by the BOs that are selling and securitizing the assets. In these situations, even though institutions may have reduced their exposure to catastrophic loss on the assets sold, they generally retain the same credit-risk exposure that they would have had if they continued to hold the assets on their balance sheets.

In addition to recourse obligations, institutions assume concentrated credit risk through the extension of partial direct-credit substitutes, such as through the purchase (or retention) of subordinated interests in their own asset securitizations or through the extension of letters of credit. For example, BOs that sponsor certain asset-backed commercial paper programs, or so-called remote-origination conduits, can be exposed to high degrees of credit risk even though it may seem that their notional exposure is minimal. A remote-origination conduit lends directly to corporate customers referred to it by the sponsoring BO that used to lend directly to these same borrowers. The conduit funds this lending activity by issuing commercial paper that, in turn, is guaranteed by the sponsoring BO. The net result is that the sponsoring institution has much the same credit-risk exposure through this guarantee that it would have had if it had made the loans directly and held them on its books. This is an off-balance-sheet transaction, however, and its associated risks may not be fully reflected in the institution's risk-management system.

Furthermore, BOs that extend liquidity facilities to securitized transactions, particularly to asset-backed commercial paper programs, may be exposed to high degrees of credit risk which may be subtly embedded within a facility's provisions. Liquidity facilities are commitments to extend short-term credit to cover temporary shortfalls in cash flow. While all commitments embody some degree of credit risk, certain commitments extended to asset-backed commercial paper programs to provide liquidity may subject the extending institution to the credit risk of the underlying asset pool, often trade receivables, or of a specific company using the program for funding. Often, the stated purpose of these liquidity facilities is to provide funds to the program to retire maturing commercial paper when a mismatch occurs in the maturities of the underlying receivables and the commercial paper, or when a disruption occurs in the commercial paper market. However, depending on the provisions of the facility—such as whether the facility covers dilution of the underlying receivable pool—credit risk can be shifted from the program's explicit credit enhancements to the liquidity facility.[25] Such provisions may enable certain programs to fund riskier assets and yet maintain the credit rating on the program's commercial paper without increasing the program's credit-enhancement levels.

The structure of various securitization transactions can also result in an institution's retaining the underlying credit risk in a sold pool of assets. Examples of this contingent credit-risk retention include credit card securitizations in which the securitizing organization explicitly sells the credit card receivables to a master trust, but, in substance, retains the majority of the economic risk of loss associated with the assets because of the credit protection provided to investors by the excess yield, spread accounts, and structural provisions of the securitization. Excess yield provides the first level of credit protection that can be drawn upon to cover cash shortfalls between the principal and coupon owed to investors and the investors' pro rata share of the master trust's net cash flows. The excess yield is equal to the difference between the overall yield on the underlying credit card portfolio and the master trust's operating expenses.[26] The second level of credit protection is provided by the spread account, which is essentially a reserve funded initially from the excess yield.

In addition, the structural provisions of credit card securitizations generally provide credit protection to investors through the triggering of early-amortization events. Such an event usually is triggered when the underlying pool of credit card receivables deteriorates beyond a certain point and requires that the outstanding credit card securities begin amortizing early to pay off investors before the prior credit enhancements are exhausted. As the early amortization accelerates the redemption of principal (paydown) on the security, the credit card accounts that were assigned to the master credit-card trust return to the securitizing institution more quickly than had originally been anticipated. Thus, the institution is exposed to liquidity pressures and any further credit losses on the returned accounts.

Examiner procedures for reviewing credit risk are outlined below:

- Examiners should review a BO's policies and procedures to ensure that the organization follows prudent standards of credit assessment and approval for all securitization exposure. Procedures should include an initial thorough and independent credit assessment of each loan or pool for which it has assumed credit risk, followed by periodic credit reviews to monitor performance throughout the life of the exposure.
- Examiners should determine that rigorous credit standards are applied, regardless of the role an organization plays in the issuance of ABS. The servicer, credit enhancer, and under-

25. Dilution essentially occurs when the receivables in the underlying asset pool—before collection—are no longer viable financial obligations of the customer. For example, dilution can arise from returns of consumer goods or unsold merchandise by retailers to manufacturers or distributors.

26. The monthly excess yield is the difference between the overall yield on the underlying credit card portfolio and the master trust's operating expenses. It is calculated by subtracting from the gross portfolio yield (1) the coupon paid to investors; (2) charge-offs for that month; and (3) a servicing fee, usually 200 basis points, paid to the banking organization sponsoring the securitization.

writer must perform assessments and approvals independent of and distinct from reviews provided by the originator or packager.
- Major policies and procedures, including internal credit-review and -approval procedures and in-house exposure limits, should be reviewed periodically and approved by the institution's board of directors.
- Failure, fraud, or mismanagement on the part of one participant in an ABS issue could result in loss to any of the other institutions involved in the issue. A BO involved in securitization should have adequate procedures for evaluating the internal control procedures and financial strength of other institutions with which it is involved.
- Securitization arrangements may remove a credit enhancer from direct access to the collateral. The remedies available to a BO involved in the provision of credit enhancement in the event of a default should be clearly documented.
- Examiners should ensure that, regardless of the role an institution plays in securitization, ABS documentation clearly specifies the limitations of the institution's legal responsibility to assume losses.
- Examiners should verify that a banking organization acting as originator, packager, or underwriter has written policies addressing the repurchase of assets and other reimbursement to investors in the event that a defaulted package results in losses exceeding any contractual credit enhancement. A BO that repurchases defaulted assets or pools in contradiction of the underlying agreement in effect sets a standard by which it could potentially be found legally liable for all "sold" assets. A BO that responds in this manner to the "moral hazard" or reputational risk arising from its securitization activities may face additional risk from other areas of its securitization activities. Examiners should review any situations in which the organization has repurchased or otherwise reimbursed investors for poor-quality assets.
- A BO's records should be reviewed to ensure that credit, pricing, and servicing standards for securitized assets are equivalent to standards for assets that remain on the books. The quality of securitized assets should be accurately characterized to investors and other parties to the securitization arrangement to avoid unforeseen pressures to repurchase defaulted issues.
- Pricing policies and practices should be reviewed to determine that they incorporate an analysis of the tradeoff between risk and return.
- Examiners should consider securitization risks when analyzing the adequacy of an organization's capital or reserve levels. Adverse credit risk should be classified accordingly.

Concentration risk. A banking organization involved in originating, packaging, servicing, underwriting, or enhancing the creditworthiness of ABS must take special care to follow in-house diversification requirements for aggregate outstandings to a particular institution, industry, or geographic area. Examiner procedures for reviewing concentration risk are outlined below:

- When determining compliance with internal credit-exposure limits, securitization exposure should be aggregated with all loans, extensions of credit, debt and equity securities, legally binding financial guarantees, commitments, and any other investments involving the same obligor.
- Examiners should review all pools of sold assets for industrial or geographic concentrations. Excessive exposures to an industry or region among these assets should be noted in the review of the BO's loan portfolio.
- Inherent in securitization is the risk that, if another party involved in the securitization arrangement becomes unable to perform according to contract terms, the issue might default even while the underlying credits are performing. This credit exposure to the other managing parties in a securitization transaction should be included under a BO's general line to those institutions. Examiners should, therefore, ensure that, in addition to policies limiting direct credit exposure, an institution has developed exposure limits with respect to particular originators, credit enhancers, and servicers.

Reputational risk. The securitization activities of many institutions may also expose them to significant reputational risks. Often, BOs that sponsor the issuance of asset-backed securities act as servicers, administrators, or liquidity providers in the securitization transactions. These institutions must be aware of the potential losses and risk exposure associated with reputational risk that arise from these securitization activities. The securitization of assets whose performance has deteriorated may result in a negative market reaction that could increase the spreads on an institution's subsequent issuances. To avoid a possible increase in their funding costs, institutions have supported their securitization transactions by improving the performance of the securitized asset pool (for example, by selling discounted receivables or adding higher-quality assets to the securitized asset pool). Thus, an institution's voluntary support of its securitization in order to protect its reputation can adversely affect the sponsoring or issuing organization's earnings and capital.

Liquidity and market risk. The existence of recourse provisions in asset sales, the extension of liquidity facilities to securitization programs, and early-amortization triggers of certain asset-securitization transactions can involve significant liquidity risk to institutions engaged in these securitization activities. Institutions should ensure that their liquidity contingency plans fully incorporate the potential risk posed by their securitization activities. When new ABS are issued, the issuing banking organization should determine their potential effect on its liquidity at the inception of each transaction and throughout the life of the securities to better ascertain its future funding needs.

An institution's contingency plans should consider the need to obtain replacement funding and specify the possible alternative funding sources, in the event of the amortization of outstanding ABS. Replacement funding is particularly important for securitizations of revolving receivables, such as credit cards, in which an early amortization of the ABS could unexpectedly return the outstanding balances of the securitized accounts to the issuing institution's balance sheet. Early amortization of a banking organization's ABS could impede an institution's ability to fund itself—either through reissuance or other borrowings—since the institution's reputation with investors and lenders may be adversely affected. Moreover, the liquidity risk and market risk to which ABS are subject may be exacerbated by thin secondary markets for them. Examiner procedures for reviewing liquidity and market risk are outlined below:

- Examiners should review the policies of a BO engaged in underwriting, looking for situations in which it cannot sell underwritten ABS. Credit review, funding capabilities, and approval limits should allow the institution to purchase and hold unsold securities. In the absence of this analysis, the institution should only handle ABS on a best-efforts basis. All potential credit exposure should be within legal lending limits.
- Examiners should ensure that a BO engaged in underwriting or market making has implemented adequate hedging or other risk-management policies to limit its exposure to adverse price movements.
- Examiners should determine whether an organization targets certain loans at origination to be packaged and securitized. If so, examiners should review the length of time these assets are held while being processed. Examiners should review management information systems reports to age targeted loans and to determine if there is any decline in value while the loans are in the pipeline. Loans held for resale in this pipeline should be segregated and carried at the lower of cost or market value.

Transfer risk and operational risk. Transfer risk is analogous to liquidity risk. It is the risk that an organization with obligations under securitization arrangements may wish to relinquish those obligations but may not be able to do so. Operational risk arises from uncertainty about an organization's ability to meet its obligations under securitization arrangements and may arise from insufficient computer resources or from a failure of fees to cover associated costs. An organization filling a role that potentially requires long-term resource commitments, such as servicer or credit enhancer, is most susceptible to transfer risk and operational risk. Examiner procedures for reviewing transfer and operational risk are outlined below:

- Examiners should determine that a BO has reviewed the relevant contracts to verify that they are free of any unusual features that increase the potential cost of transfer of obligations.
- Examiners should ascertain that a BO has evaluated the fee structure of the securitization to determine that fees are sufficient to cover the costs of associated services. Further, examiners should determine that a BO has reviewed the projected cash flow from the underlying assets to ensure that principal and interest payments will be timely and will be sufficient to cover costs, even under adverse scenarios.

- A servicer or credit enhancer subcontracting or participating responsibilities should initially assess the financial condition and reputation of any organization to which responsibility may be delegated. Subsequent periodic monitoring by the servicer or credit enhancer should assess the financial condition of organizations to which responsibility has been delegated, as well as their compliance with contractual obligations. Trustees should, likewise, monitor the financial condition and compliance of all participants in the securitization arrangement.

Conflicts of interest. With respect to the various functions performed by a BO, the potential for conflicts of interest exists when an organization plays multiple roles in securitization. Policies and procedures must address this potential conflict, especially the risk of legal ramifications or negative market perceptions if the organization appears to compromise its fiduciary responsibility to obligors or investors. Examiner procedures for reviewing conflicts of interest are outlined below:

- Examiners should review a BO's policies for disclosure of confidential but pertinent information about the underlying assets and obligors. An organization involved in the origination or processing of a securitization transaction should have written statements from obligors allowing the disclosure of pertinent confidential information to potential investors. In addition, the underwriting bank must follow proper procedures of due diligence.
- If the securitization business of an originator, underwriter, or credit enhancer is volume-driven, legal obligations or prudent banking practices may be breached. Examiners should review credit standards used in analyzing assets earmarked for securitization to determine that sound banking practices are not being compromised to increase volume or to realize substantial fees.
- Examiners should determine that the organization's policies addressing activities at various subsidiaries or affiliates are managed consistently and prudently in compliance with regulatory policies.

Legal Review and Liability

The complexity of asset-securitization transactions requires a BO that participates in them in any capacity to fully investigate all applicable laws and regulations, to establish policies and procedures to ensure legal review of all securitization activities, and to take steps to protect the organization from liability in the case of problems with particular asset-backed issues. Organizations and examiners should be aware of the continual evolution of criteria on the types of assets that may be securitized and the types of BOs that may engage in the various aspects of securitization. Examiner procedures for checking an institution's legal-review and liability-protection measures are outlined below:

- Different responsibilities in connection with securitizations may be split among various subsidiaries of an organization. Examiners should, therefore, review the overall risk exposure to an organization. Specifically, examiners should be alert to situations in which the structure of a securitization obscures the concentration risk in individual ABS or in a portfolio of ABS. Examiners should also be mindful of structures that may effectively conceal low-quality assets or contingent liabilities from examination scrutiny and possible classification.
- Examiners should review a BO's insurance coverage to determine if it is sufficient to cover its fiduciary responsibilities under securitization arrangements. At least one rating agency requests that servicers carry errors and omissions insurance that will cover a minimum of 5 percent of the outstanding obligation.
- Private placements of ABS are not subject to the same legal-disclosure requirements as public placements. An organization involved in private placements of ABS should, therefore, exercise special caution with regard to disclosure of the risks and attributes of the securitized assets.

Banking Organizations Investing in ABS

ABS may appear similar to corporate notes; however, ABS possess many unique characteristics that affect their riskiness as investments. A BO should independently analyze all potential risk exposures before investing in ABS and should continue to monitor exposures throughout the life of the ABS. Analyses should focus primarily on characteristics of ABS, such as credit risk, concentrations of exposures, interest-rate risk, liquidity risk, market risk, and prepayment risk. As an integral part of these analyses, a BO investing in ABS should evaluate the underlying assets, the participants in the securitization arrangement, and the structure of the securitization arrangement, although it should not be expected to analyze these factors in the same detail as BOs involved in the issuance of ABS.

Any purchase of ABS should be consistent with the overall objectives of the organization. The securities should constitute an integrated component of the investment or hedging plans of the organization and should not be purchased for speculative purposes. A banking organization should not rely on investment or trading strategies, which depend on the existence of liquid secondary ABS markets.

Policy and Portfolio Analysis

Credit risk. While ABS are often insulated, to some extent, from the credit risk of the underlying assets, credit risk is still affected by a number of factors, in addition to the performance of the underlying asset pool. These factors include the ability of the parties involved in the securitization arrangement to fulfill their obligations and the structure of the securitization itself.

In the event of default by obligors or other failure of the securitization structure, access to collateral may be difficult and recourse to the various providers of credit enhancement may be time-consuming and costly. Some forms of credit enhancement may be revocable. Banking organizations should not place undue reliance on collateral values and credit enhancement in evaluating ABS.

In many cases, ratings of the creditworthiness of ABS issues are available from external credit agencies. A banking organization may use credit ratings as a source of information, but should not depend solely on external agencies' evaluations of creditworthiness. Unrated ABS should be subject to particular scrutiny. Examiner procedures for reviewing credit risk are outlined below:

- Examiners should review a BO's policies and procedures to ensure that the organization follows prudent standards of credit assessment and has approval criteria for all ABS exposure. Procedures should include an initial thorough and independent credit assessment of ABS issues for which the organization has assumed any degree of credit risk, followed by periodic reviews to monitor performance of the ABS throughout the life of the exposure.
- Examiners should determine that a banking organization does not rely solely on conclusions of external rating services in evaluating ABS.
- Examiners should determine that a banking organization investing in ABS has independently made use of available documents in evaluating the credit risk of ABS. These documents include indentures, trustee reports, rating-agency bulletins, and prospectuses.
- Examiners should determine that a banking organization investing in privately placed ABS is aware of the differences in disclosure requirements between publicly placed and privately placed securities, and has taken extra steps to obtain and analyze information relevant to the evaluation of holdings of any privately placed ABS.
- Major policies and procedures, including internal credit-review and -approval procedures and in-house exposure limits, should be reviewed periodically and approved by the institution's board of directors.
- Failure, fraud, or mismanagement on the part of another party could result in loss to investors. A banking organization should have adequate procedures for assessing the financial strength and operational capacity of institutions involved in enhancing the credit quality of or managing an ABS issue.
- A banking organization should have procedures for evaluating the structural soundness of securitization arrangements for ABS in which it invests. The degree of investor control over transfer of servicing rights should be clearly delineated.
- Securitization arrangements may remove the ultimate investor from direct access to the collateral; the remedies available to an investor, in the event of default, should be clearly documented.

Concentration risk. Banking organizations may face concentrations of risk within the pool of assets, underlying an individual ABS issue, across different ABS issues, or through combinations of ABS and other credit exposures. Banking organizations that invest in ABS must take special care to follow in-house diversification requirements for aggregate outstandings to a particular institution, industry, or geographic area. Examiner procedures for reviewing concentration risk are outlined below:

- When determining compliance with internal credit-exposure limits, securitization exposure should be aggregated with all loans, extensions of credit, debt and equity securities, legally binding financial guarantees and commitments, and any other investments involving the same obligor.
- Inherent in securitization is the risk that, if another party involved in the transaction becomes unable to perform, according to contract terms, the issue might default, even while the underlying credits are performing. Examiners should, therefore, ensure that, in addition to policies limiting direct credit exposure, an institution has developed exposure limits for particular credit enhancers, servicers, or trustees. Credit exposure to the other managing parties in a securitization should be included under a BO's general line to those institutions.
- Examiners should review the ABS portfolio for any industrial or geographic concentrations. Excessive exposures to a particular industry or region within the portfolio should be noted in the examiner's review.

Liquidity risk and market risk. Limited secondary markets may make ABS, especially unrated or innovative ABS, less liquid than many other debt instruments. Examiner procedures for reviewing liquidity and market risk are outlined below:

- If an investing bank is purchasing securitized assets for trading purposes, the examiner should ensure that the trading assets are carried at market value or at the lower of market or book value, and that market values are determined regularly. The risks involved are similar in character to the risks involved in trading other marketable securities. As with any trading activity, the BO must take proper steps to analyze market character and depth.
- A banking organization investing in ABS should not depend on secondary-market liquidity for the securities, especially in the case of ABS involving novel structures or innovative types of assets.
- Management information systems should provide management with timely and periodic information on the historical costs, market values, and unrealized gains and losses on ABS held in investment, trading, or resale portfolios.

Prepayment risk. The prepayment of assets underlying ABS may create prepayment risk for an investor in ABS. Prepayment risk may not be adequately reflected in agency ratings of ABS. Examiner procedures for reviewing prepayment risk are outlined below:

- Examiners should determine that a BO investing in ABS has analyzed the prepayment risk of ABS issues in its portfolio. Special care should be taken in the analysis of issues involving multiple tranches.
- Prepayment risk for ABS should be incorporated into an organization's net income-at-risk model, if such a model is used.

Legal Review

Examiners should review policies and procedures for compliance with applicable state lending limits and federal law, such as section 5136 of the Revised Codes. These requirements must be analyzed to determine whether a particular ABS issue is considered a single investment or a loan to each of the creditors underlying the pool. Collateralized mortgage obligations may be exempt from this limitation, if they are issued or guaranteed by an agency or instrumentality of the U.S. government.

Internal Audit and Management Information Systems

A BO's management of securitization risk depends on the providing of timely and accurate information about the organization's exposure to those responsible for monitoring risks. Examiners must be aware that a BO's involvement in asset securitization can be very extensive and place significant demands on systems without being readily evident, either as an on-balance-sheet exposure or a contingent liability. System overload or other technical default in the organization's systems could render the organization unable to provide proper monitoring or servicing. While the risk is not clearly associated with the servicer (whose responsibility is long term and requires ongoing resource commitments), systems breakdowns may have risk implications for the credit enhancer and trustee. Examiners should ensure that internal auditors examine all facets of securitization regularly, as outlined below:

- Examiners should ensure that internal systems and controls adequately track the performance and condition of internal exposures and should monitor the organization's compliance with internal procedures and limits. In addition, adequate audit trails and internal-audit coverage should be provided.
- Cost-accounting systems should be adequate to permit a reliable determination of the profitability and volatility of asset-securitization activities.
- Management information systems and reporting procedures should be reviewed to determine that they—
  — provide a listing of all securitizations for which the banking organization is either originator, servicer, credit enhancer, underwriter, trustee, or investor;
  — provide concentration listings by industry and geographic area;
  — generate information on total exposure to specific originators, servicers, credit enhancers, trustees, or underwriters;
  — generate information on portfolio aging and performance relative to expectations; and
  — provide periodic and timely information to senior management and directors on the organization's involvement in, and credit exposure arising from, securitization.

ADDITIONAL REFERENCES

The following is a list of accounting literature issued by FASB and the AICPA that relates to asset securitization or asset transfers.

FASB Statements

FASB Statement No. 5	Accounting for Contingencies
FASB Statement No. 6	Classification of Short-Term Obligations Expected to Be Refinanced
FASB Statement No. 48	Revenue Recognition When Right of Return Exists
FASB Statement No. 65	Accounting for Certain Mortgage Banking Enterprises, as amended
FASB Statement No. 66	Accounting for Sales of Real Estate
FASB Statement No. 77	Reporting by Transferors for Transfers of Receivables with Recourse
FASB Statement No. 91	Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases
FASB Statement No. 105	Disclosure of Information About Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk
FASB Statement No. 115	Accounting for Certain Investments in Debt and Equity Securities
FASB Statement No. 122	Accounting for Mortgage-Servicing Rights
FASB Statement No. 133	Accounting for Derivative Instruments and Hedging Activities
FASB Statement No. 134	Accounting for Mortgage-Backed Securities Retained After the Securitization of Mortgage Loans Held for Sale by a Mortgage Banking Enterprise
FASB Statement No. 137	Accounting for Derivative Instruments and Hedging Activities—Deferral of the Effective Date of FASB Statement No. 133 (an amendment of FASB Statement No. 133)
FASB Statement No. 138	Accounting for Certain Derivative Instruments and Hedging Activities (an amendment of FASB Statement No. 133)

FASB Statement No. 140	Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (a replacement of FASB Statement No. 125)
FASB Statement No. 149	Amendment of Statement 133 on Derivative Instruments and Hedging Activities
FASB Statement No. 150	Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity

FASB Interpretations

FIN 8	Classification of a Short-Term Obligation Repaid Prior to Being Replaced by a Long-Term Security
FIN 45	Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others
FIN 46-R	Consolidation of Variable Interest Entities

Technical Bulletins

TB 85-2	Accounting for Collateralized Mortgage Obligations
TB 87-3	Accounting for Mortgage Servicing Fees and Rights
TB 01-1	Effective Date for Certain Financial Institutions of Certain Provisions of Statement 140 Related to the Isolation of Transferred Financial Assets

EITF (Emerging Issues Task Force) Abstracts

84-15	Grantor Trusts Consolidation
84-21	Sale of a Loan with a Partial Participation Retained
84-30	Sales of Loans to Special-Purpose Entities
85-13	Sale of Mortgage-Service Rights on Mortgages Owned by Others
85-20	Recognition of Fees for Guaranteeing a Loan
85-26	Measurement of Servicing Fees Under FASB Statement No. 65 When a Loan Is Sold with Servicing Retained
85-28	Consolidation Issues Relating to Collateralized Mortgage Obligations
86-24	Third-Party Establishment of CMO
86-38	Implications of Mortgage Prepayments on Amortization of Servicing Rights
86-39	Gains from the Sale of Mortgage Loans with Servicing Rights Retained
87-25	Sales of Convertible, Adjustable-Rate Mortgages with Contingent Repayment Agreement
87-34	Sales of Mortgage-Servicing Rights with a Subservicing Agreement
88-11	Sale of Interest-Only or Principal-Only Cash Flows from Loans Receivable
88-17	Accounting for Fees and Costs Associated with Loan Syndications and Loan Participations
88-20	Difference Between Initial Investment and Principal Amount of Loans in a Purchased Credit-Card Portfolio
88-22	Securitization of Credit Card Portfolios
89-4	Collateralized Mortgage Obligation Residuals
89-5	Sale of Mortgage-Loan-Servicing Rights
89-18	Divestitures of Certain Investment Securities to an Unregulated Common Controlled Entity Under FIRREA
90-2	Exchange of Interest-Only or Principal-Only Securities for a Mortgage-Backed Security
90-18	Effect of a ''Removal of Accounts'' Provision on the Accounting for a Credit Card Securitization
93-18	Recognition for Impairment of an Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate

94-4 Classification of an Investment in a Mortgage-Backed Interest-Only Certificate as Held-to-Maturity
94-8 Accounting for Conversion of a Loan into a Debt Security in a Debt Restructuring
94-5 Determination of What Constitutes All Risks and Rewards and No Significant Unresolved Contingencies in a Sale of Mortgage-Loan-Servicing Rights
95-5 Determination of What Risks and Rewards, If Any, Can Be Retained and Whether Any Unresolved Contingencies May Exist in a Sale of Mortgage-Loan-Servicing Rights
D-39 Questions Related to the Implementation of FASB Statement No. 115
D-75 When to Recognize Gains and Losses on Assets Transferred to a Qualifying Special-Purpose Entity
D-94 Questions and Answers Related to the Implementation of FASB Statement No. 140
D-99 Questions and Answers Related to Servicing Activities in a Qualifying Special-Purpose Entity Under FASB Statement No. 140

AICPA Statements of Position

90-3 Definition of the Term ''Substantially the Same'' for Holders of Debt Instruments, as Used in Certain Audit Guides and a Statement of Position
94-6 Disclosure of Certain Significant Risks and Uncertainties

1. To determine if the bank is in compliance with laws, regulations, and policy statements.
2. To determine if the bank has originated, serviced, credit-enhanced, served as a trustee for, or invested in securitized assets.
3. To determine that securitization activities are integrated into the overall strategic objectives of the organization.
4. To determine that management has an appropriate level of experience in securitization activities.
5. To ensure that the bank does not hold any asset-backed securities that are inappropriate, for example, interest-only strips (IOs) and principal-only strips (POs), given the size of the bank and the sophistication of its operations.
6. To ensure that all asset-backed securities owned, any assets sold with recourse, retained interests, and variable interest entities (VIEs) (for example, asset-backed commercial paper (ABCP) programs that are defined as VIEs under GAAP) are properly accounted for on the bank's books and are correctly reported on the bank's regulatory reports.
7. To determine that sources of credit risk are understood, properly analyzed, and managed, without excessive reliance on credit ratings by outside agencies.
8. To determine that credit, operational, and other risks are recognized and addressed through appropriate policies, procedures, management reports, and other controls.
9. To determine if officers are operating in conformance with established bank policies and procedures.
10. To determine whether liquidity and market risks are recognized and whether the organization is excessively dependent on securitization as a substitute for day-to-day core funding or as a source of income.
11. To determine that steps have been taken to minimize the potential for conflicts of interest arising from the institution's securitization activities.
12. To determine that possible sources of structural failure in securitization transactions are recognized and that the organization has adopted measures to minimize the impact of these failures if they occur.
13. To determine that the organization is aware of the legal risks and uncertainty of various aspects of securitization.
14. To determine that concentrations of exposure in the underlying asset pools, asset-backed securities portfolio, or structural elements of securitization transactions are avoided.
15. To determine that all sources of risk are evaluated at the inception of each securitization activity and are monitored on an ongoing basis.
16. To determine whether the institution's retained interests from asset securitization are properly documented, valued, and accounted for.
17. To verify that the amount of retained interests not supported by adequate documentation has been charged off and that the assets involved in those retained interests are not used for risk-based calculation purposes.
18. To ascertain the existence of sound risk modeling, management information systems (MIS), and disclosure practices for asset securitization.
19. To obtain assurances that the board of directors and management oversee sound policies and internal controls concerning the recording of asset-securitization transactions and any valuation of retained interests derived therefrom.
20. To determine that capital is commensurate with, and that there are accurate determinations of, the risk weights for the risk exposures arising from recourse obligations, direct-credit substitutes, asset- and mortgage-backed securities, ABCP programs and ABCP liquidity facilities, and other asset-securitization transactions.
21. To determine whether there is an independent audit function that is capable of evaluating asset-securitization activities and any associated retained interests.
22. To initiate corrective action if policies, practices, procedures, or internal controls are deficient or when violations of law, regulations, or policy statements are disclosed.

1. a. Request a schedule of all asset-backed securities owned by the bank. Reconcile the balance of these assets to the subsidiary ledgers of the balance sheet, and review credit ratings assigned to these securities by independent rating agencies. Determine that the accounting methods and procedures used for these assets, at inception and throughout the carrying life, are appropriate.
   b. Request and review information on the types and amount of assets that have been securitized by the bank. In addition, request information concerning potential contractual or contingent liability arising from any guarantees, underwriting, and servicing of the securitized assets.
2. Review the parent company's policies and procedures to ensure that its banking and nonbanking subsidiaries follow prudent standards of credit assessment and approval for all securitization exposure. Procedures should include a thorough and independent credit assessment of each loan or pool for which it has assumed credit risk, followed by periodic credit reviews to monitor performance throughout the life of the exposure. If a banking organization (BO) invests in asset-backed securities (ABS), determine whether it relies soley on conclusions of external rating services when evaluating the securities.
3. Determine that rigorous credit standards are applied regardless of the role the organization plays in the securitization process, for example, servicer, credit enhancer, or investor.
4. Determine that major policies and procedures, including internal credit-review and credit-approval procedures and ''in-house'' exposure limits, are reviewed periodically and approved by the bank's board of directors.
5. Determine whether adequate procedures for evaluating the organization's internal control procedures and the financial strength of the other institutions involved in the securitization process are in place.
6. Obtain the documentation outlining the remedies available to provide credit enhancement in the event of a default. Both originators and purchasers of securitized assets should have prospectuses on the issue. Obtaining a copy of the prospectus can be an invaluable source of information. Prospectuses generally contain information on credit enhancement, default provisions, subordination agreements, etc. In addition to the prospectus, obtain the documentation confirming the purchase or sale of a security.
7. Ensure that, regardless of the role an institution plays in securitization, the documentation for an asset-backed security clearly specifies the limitations of the institution's legal responsibility to assume losses.
8. Determine the existence of independent risk-management processes and management information systems (MIS). Determine whether these processes and systems are being used to monitor securitization-pool performance on an aggregate and individual transaction level.
9. Verify whether the BO, acting as originator, packager, or underwriter, has written policies addressing the repurchase of assets and other measures to reimburse investors in the event that a defaulted package results in losses exceeding any contractual credit enhancement. The repurchase of defaulted assets or pools in contradiction of or outside the terms of the underlying agreement in effect sets a standard by which a banking organization could potentially be found legally liable for all ''sold'' assets. Review and report any situations in which the organization has repurchased or otherwise reimbursed investors for poor-quality assets.
10. Classify adverse credit risk associated with the securitization of assets when analyzing the adequacy of an organization's capital or reserve levels. Evaluate credit risk of ABS, and classify any adverse credit risk. List classified assets. Evaluate the impact of the classification on capital adequacy and the overall soundness of the institution.
11. Aggregate securitization exposures with all loans, extensions of credit, debt and equity securities, legally binding financial guarantees and commitments, and any other investments involving the same obligor when

determining compliance with internal credit-exposure limits.

12. Review the bank's valuation assumptions and modeling methodology used for ABS to determine if they are conservative and appropriate and are being used to establish, evaluate, and adjust the carrying value of retained interests on a regular and timely basis.
13. Determine if audit or internal-review staffs periodically review data integrity, model algorithms, key underlying assumptions, and the appropriateness of the valuation and modeling process for the securitized assets that the institution retains.
14. Review the risk-based capital calculations, and determine if they include recognition and the correct reporting of any recourse obligations, direct-credit substitutes, residual interests, asset- and mortgage-backed securities, asset-backed commercial paper (ABCP) programs, liquidity facilities, and other transactions involving such securitization activities.
15. Determine if the bank consolidates, in accordance with GAAP (FASB's FIN 46-R, "Consolidation of Variable Interest Entities"), the assets of any ABCP program or other such program that it sponsors.
    a. Determine if the bank's ABCP program met the definition of a sponsored ABCP program under the risk-based capital guidelines.
    b. Verify that the assets of the bank's eligible ABCP program and any associated minority interest were excluded from the bank's calculation of its risk-based capital ratios.
    c. Ascertain whether the liquidity facilities the bank extends to the ABCP program satisfy the risk-based capital definition and requirements, including the appropriate asset-quality test, of an eligible ABCP program liquidity facility. (See 12 CFR 208, appendix A, III.B.3.a.iv.)
    d. Determine whether the bank applied the correct credit-conversion factor to eligible ABCP liquidity facilities when it determined the amount of risk-weighted assets for its risk-based capital ratios. (See 12 CFR 208, appendix A, section III.D.)
    e. Determine if all ineligible ABCP liquidity facilities were treated as either direct-credit substitutes or as recourse obligations, as required by the risk-based capital guidelines.
    f. If the bank had multiple positions with overlapping exposures, determine if the bank applied the risk-based capital treatment that resulted in the highest capital charge. (See 12 CFR, appendix A, section III.B.6.c.)
16. Ascertain that internal limits govern the amount of retained interests held as a percentage of total equity capital.
17. Establish that an adequate liquidity contingency plan is in place and will be used in the event of market disruptions. Determine whether liquidity problems may arise as the result of an overdependence on asset-securitization activities for day-to-day core funding.
18. Determine whether consistent, conservative accounting practices are in place that satisfy the reporting requirements of regulatory supervisors, GAAP reporting requirements, and valuation assumptions and methods. Ascertain that adequate disclosures of asset-securitization activities are made commensurate with the volume of securitizations and the complexities of the institution.
19. Establish that risk-exposure limits and requirements exist and are adhered to on an aggregate and individual transaction basis.
20. Review securitized assets for industrial or geographic concentrations. Excessive exposures to an industry or region among the underlying assets should be noted in the review of the loan portfolio.
21. Ensure that, in addition to policies limiting direct credit exposure, an institution has developed exposure limits for particular originators, credit enhancers, trustees, and servicers.
22. Review the policies of the banking organization engaged in underwriting, watching for situations in which it cannot sell underwritten asset-backed securities. Credit review, funding capabilities, and approval limits should allow the institution to purchase and hold unsold securities. All potential credit exposure should be within legal lending limits.
23. Ensure that internal systems and controls adequately track the performance and condition of internal exposures and monitor the organization's compliance with internal procedures and limits. In addition, adequate audit trails and internal audit coverage

should be provided. Ensure that the reports have adequate scope and frequency of detail.

24. Determine that management information systems provide—
    a. a listing of each securitization transaction in which the organization is involved;
    b. a listing of industry and geographic concentrations;
    c. information on total exposure to specific originators, servicers, credit enhancers, trustees, or underwriters;
    d. information regarding portfolio monthly vintage or aging and information on a portfolio's performance by specific product type relative to expectations;
    e. periodic and timely information to senior management and directors on the organization's involvement in, and credit exposure arising from, securitization;
    f. static-pool cash-collection analysis;
    g. sensitivity analysis; and
    h. a statement of covenant compliance.
25. Ensure that internal auditors examine all facets of securitization regularly.
26. Review policies and procedures for compliance with applicable state lending limits and federal law, such as section 5136 of the Revised Codes. These requirements must be analyzed to determine whether a particular asset-backed-security issue is considered a single investment or a loan to each of the creditors underlying the pool. Collateralized mortgage obligations may be exempt from this limitation, if they are issued or guaranteed by an agency or instrumentality of the U.S. government.
27. Determine whether the underwriting of ABS of affiliates is—
    a. rated by an unaffiliated, nationally recognized statistical rating organization; or
    b. issued or guaranteed by Fannie Mae, FHLMC, or GNMA, or represents interests in such obligations.
28. Determine if purchases of high-risk mortgage-backed securities were made to reduce the overall interest-rate risk of the bank. Determine if the bank evaluates and documents at least quarterly whether these securities have reduced the interest-rate risk.
29. Review and discuss any documentation exceptions, violations, internal control exceptions, and classifications with management, and obtain management's response.
30. Review the bank's liquidity agreements with any asset-backed commercial paper programs and determine whether the agreements have any credit-related components. Is the bank required to purchase the assets? Are these assets repurchased from the bank? If the facility is determined to be a commitment, determine whether its maturity is short term or long term. Do any of the liquidity agreements contain a material adverse clause or any other credit-contingency provision?

Review the bank's internal controls, policies, practices, and procedures for all aspects of asset securitization. The bank's system should be documented completely and concisely and should include, where appropriate, narrative descriptions, flow charts, copies of forms used, and other pertinent information.

POLICIES

1. Does the bank employ the services of a securities dealer? If so, does the bank rely solely on the advice of such dealer when purchasing asset-backed securities for the bank's investment portfolio? Does the bank have persons who are responsible for reviewing or approving the investment manager's acquisitions? Are minimum criteria established for selecting a securities dealer?
2. Has the board of directors, consistent with its duties and responsibilities, reviewed and ratified asset-securitization policies, practices, and procedures? Do these policies, practices, and procedures—
   a. require an initial thorough and independent credit assessment of each pool for which the bank has assumed credit risk, as either a participant in the securitization process or as an investor?
   b. address the bank's repurchase of assets and other forms of reimbursement to investors, when the bank is acting as the originator, packager, or underwriter, in the event that a default results in losses exceeding any contractual credit enhancement?
   c. ensure that the credit, pricing, and servicing standards for securitized assets are equivalent to standards for assets that remain on the bank's books?
   d. ensure that the credit, pricing, and servicing standards and that compliance with any provisions relating to government guarantees are reviewed periodically by the board of directors?
   e. establish in-house diversification requirements for aggregate outstanding exposures to a particular institution, industry, or geographic area?
   f. hedge the bank's exposure to adverse price movements when it is engaged in underwriting or market-making activities?
3. Are the bank's securitization policies reviewed and reaffirmed at least annually to determine if they are compatible with changing market conditions?

INTERNAL CONTROL AND MANAGEMENT INFORMATION SYSTEMS

1. Do the internal systems and controls adequately track the performance and condition of internal exposures, and do the systems monitor the bank's compliance with internal procedures and limits? Are adequate audit trails and internal audit coverage provided?
2. Do the cost accounting systems provide a reliable determination of the profitability and volatility of asset-securitization activities?
3. Are management information systems and reporting procedures adequate in that they provide—
   a. a listing of all securitizations for which the bank is either originator, servicer, credit enhancer, underwriter, or trustee?
   b. a listing of industry and geographic concentrations?
   c. information on total exposure to specific originators, servicers, credit enhancers, trustees, or underwriters?
   d. information regarding portfolio aging and performance relative to expectations?
   e. periodic and timely information to senior management and directors on the organization's involvement in, and credit exposure arising from, securitization?
   f. credit ratings assigned by independent rating agencies to all asset-backed securities held by the bank?
4. Do management information systems and reporting procedures adequately document the bank's calculation and determination of risk-based capital ratios (including the assignment of the appropriate risk-based capital charges (risk weights and credit-conversion factors)) against the exposures arising from asset-backed and mortgage-backed securitization transactions or activities, including asset-backed commercial paper programs

(including exposures arising from direct-credit substitutes, recourse obligations, residual interests, liquidity facilities, and mortgage-backed and other types of asset-backed loans)?

This section sets forth the Interagency Statement on Sound Practices Concerning Elevated-Risk Complex Structured Finance Activities, issued January 11, 2007.[1] The supervisory guidance addresses risk-management principles that should assist institutions to identify, evaluate, and manage the heightened legal and reputational risks that may arise from their involvement in complex structured finance transactions (CSFTs). The guidance is focused on sound practices related to CSFTs that may create heightened legal or reputational risks to the institution and are defined as "elevated-risk CSFTs." Such transactions are typically conducted by a limited number of large financial institutions.[2] (See SR-07-05.)

INTERAGENCY STATEMENT ON SOUND PRACTICES CONCERNING ELEVATED-RISK COMPLEX STRUCTURED FINANCE ACTIVITIES

Financial markets have grown rapidly over the past decade, and innovations in financial instruments have facilitated the structuring of cash flows and allocation of risk among creditors, borrowers, and investors in more efficient ways. Financial derivatives for market and credit risk, asset-backed securities with customized cash-flow features, specialized financial conduits that manage pools of assets, and other types of structured finance transactions serve important business purposes, such as diversifying risks, allocating cash flows, and reducing cost of capital. As a result, structured finance transactions have become an essential part of U.S. and international capital markets. Financial institutions have played and continue to play an active and important role in the development of structured finance products and markets, including the market for the more complex variations of structured finance products.

When a financial institution[3] participates in a CSFT, it bears the usual market, credit, and operational risks associated with the transaction. In some circumstances, a financial institution also may face heightened legal or reputational risks due to its involvement in a CSFT. For example, in some circumstances, a financial institution may face heightened legal or reputational risk if a customer's regulatory, tax, or accounting treatment for a CSFT, or disclosures to investors concerning the CSFT in the customer's public filings or financial statements, do not comply with applicable laws, regulations, or accounting principles. Indeed, in some instances, CSFTs have been used to misrepresent a customer's financial condition to investors, regulatory authorities, and others. In these situations, investors have been harmed and financial institutions have incurred significant legal and reputational exposure. In addition to legal risk, reputational risk poses a significant threat to financial institutions because the nature of their business requires them to maintain the confidence of customers, creditors, and the general marketplace.

The agencies[4] have long expected financial institutions to develop and maintain robust control infrastructures that enable them to identify, evaluate, and address the risks associated with their business activities. Financial institutions also must conduct their activities in accordance with applicable statutes and regulations.

Scope and Purpose of Statement

The agencies issued this statement to describe the types of risk-management principles they believe may help a financial institution to identify CSFTs that may pose heightened legal or reputational risks to the institution and to evalu-

1. See 72 *Fed. Reg.* 1372, January 11, 2007.

2. The statement will not affect or apply to the vast majority of financial institutions, including most small institutions.

3. As used in this statement, the term *financial institution* or *institution* refers to state member banks and bank holding companies (other than foreign banking organizations) in the case of the Board of Governors of the Federal Reserve System (FRB); to national banks in the case of the Office of the Comptroller of the Currency (OCC); to federal and state savings associations and savings and loan holding companies in the case of the Office of Thrift Supervision (OTS); to state nonmember banks in the case of the Federal Deposit Insurance Corporation (FDIC); and to registered broker-dealers and investment advisers in the case of the Securities and Exchange Commission (SEC). The U.S. branches and agencies of foreign banks supervised by the FRB, the OCC, and the FDIC also are considered to be financial institutions for purposes of this statement.

4. The federal banking agencies (the FRB, the OCC, the FDIC, and the OTS) and the SEC.

ate, manage, and address these risks within the institution's internal control framework.

Structured finance transactions encompass a broad array of products with varying levels of complexity. Most structured finance transactions, such as standard public mortgage-backed securities transactions, public securitizations of retail credit cards, asset-backed commercial paper conduit transactions, and hedging-type transactions involving "plain vanilla" derivatives and collateralized loan obligations, are familiar to participants in the financial markets, and these vehicles have a well-established track record. These transactions typically would not be considered CSFTs for the purpose of this statement.

Because this statement focuses on sound practices related to CSFTs that may create heightened legal or reputational risks—transactions that typically are conducted by a limited number of large financial institutions—it will not affect or apply to the vast majority of financial institutions, including most small institutions. As in all cases, a financial institution should tailor its internal controls so that they are appropriate in light of the nature, scope, complexity, and risks of its activities. Thus, for example, an institution that is actively involved in structuring and offering CSFTs that may create heightened legal or reputational risk for the institution should have a more formalized and detailed control framework than an institution that participates in these types of transactions less frequently. The internal controls and procedures discussed in this statement are not all-inclusive, and, in appropriate circumstances, an institution may find that other controls, policies, or procedures are appropriate in light of its particular CSFT activities.

Because many of the core elements of an effective control infrastructure are the same regardless of the business line involved, this statement draws heavily on controls and procedures that the agencies previously have found to be effective in assisting a financial institution to manage and control risks and identifies ways in which these controls and procedures can be effectively applied to elevated-risk CSFTs. Although this statement highlights some of the most significant risks associated with elevated-risk CSFTs, it is not intended to present a full exposition of all risks associated with these transactions. Financial institutions are encouraged to refer to other supervisory guidance prepared by the agencies for further information concerning market, credit, operational, legal, and reputational risks as well as internal audit and other appropriate internal controls.

This statement does not create any private rights of action and does not alter or expand the legal duties and obligations that a financial institution may have to a customer, its shareholders, or other third parties under applicable law. At the same time, adherence to the principles discussed in this statement would not necessarily insulate a financial institution from regulatory action or any liability the institution may have to third parties under applicable law.

Identification and Review of Elevated-Risk CSFTs

A financial institution that engages in CSFTs should maintain a set of formal, written, firmwide policies and procedures that are designed to allow the institution to identify, evaluate, assess, document, and control the full range of credit, market, operational, legal, and reputational risks associated with these transactions. These policies may be developed specifically for CSFTs, or included in the set of broader policies governing the institution generally. A financial institution operating in foreign jurisdictions may tailor its policies and procedures as appropriate to account for, and comply with, the applicable laws, regulations, and standards of those jurisdictions.[5]

A financial institution's policies and procedures should establish a clear framework for the review and approval of individual CSFTs. These policies and procedures should set forth the responsibilities of the personnel involved in the origination, structuring, trading, review, approval, documentation, verification, and execution of CSFTs. Financial institutions may find it helpful to incorporate the review of new CSFTs into their existing new-product policies. In this regard, a financial institution should define what constitutes a "new" complex structured finance product and establish a control process for the approval of such new products. In determining

5. In the case of U.S. branches and agencies of foreign banks, these policies, including management, review, and approval requirements, should be coordinated with the foreign bank's group-wide policies developed in accordance with the rules of the foreign bank's home-country supervisor and should be consistent with the foreign bank's overall corporate and management structure as well as its framework for risk management and internal controls.

whether a CSFT is new, a financial institution may consider a variety of factors, including whether it contains structural or pricing variations from existing products; whether the product is targeted at a new class of customers; whether it is designed to address a new need of customers; whether it raises significant new legal, compliance, or regulatory issues; and whether it or the manner in which it would be offered would materially deviate from standard market practices. An institution's policies should require new complex structured finance products to receive the approval of all relevant control areas that are independent of the profit center before the product is offered to customers.

Identifying Elevated-Risk CSFTs

As part of its transaction and new-product approval controls, a financial institution should establish and maintain policies, procedures, and systems to identify elevated-risk CSFTs. Because of the potential risks they present to the institution, transactions or new products identified as elevated-risk CSFTs should be subject to heightened reviews during the institution's transaction or new-product approval processes. Examples of transactions that an institution may determine warrant this additional scrutiny are those that (either individually or collectively) appear to the institution during the ordinary course of its transaction approval or new-product approval process to—

- lack economic substance or business purpose;
- be designed or used primarily for questionable accounting, regulatory, or tax objectives, particularly when the transactions are executed at year-end or at the end of a reporting period for the customer;
- raise concerns that the client will report or disclose the transaction in its public filings or financial statements in a manner that is materially misleading or inconsistent with the substance of the transaction or applicable regulatory or accounting requirements;
- involve circular transfers of risk (either between the financial institution and the customer or between the customer and other related parties) that lack economic substance or business purpose;
- involve oral or undocumented agreements that, when taken into account, would have a material impact on the regulatory, tax, or accounting treatment of the related transaction, or the client's disclosure obligations;[6]
- have material economic terms that are inconsistent with market norms (for example, deep "in the money" options or historic rate rollovers); or
- provide the financial institution with compensation that appears substantially disproportionate to the services provided or investment made by the financial institution or to the credit, market, or operational risk assumed by the institution.

The examples listed previously are provided for illustrative purposes only, and the policies and procedures established by financial institutions may differ in how they seek to identify elevated-risk CSFTs. The goal of each institution's policies and procedures, however, should remain the same: to identify those CSFTs that warrant additional scrutiny in the transaction or new-product approval process due to concerns regarding legal or reputational risks.

Financial institutions that structure or market, act as an advisor to a customer regarding, or otherwise play a substantial role in a transaction may have more information concerning the customer's business purpose for the transaction and any special accounting, tax, or financial disclosure issues raised by the transaction than institutions that play a more limited role. Thus, the ability of a financial institution to identify the risks associated with an elevated-risk CSFT may differ depending on its role.

Due Diligence, Approval, and Documentation Process for Elevated-Risk CSFTs

Having developed a process to identify elevated-risk CSFTs, a financial institution should implement policies and procedures to conduct a heightened level of due diligence for these transactions. The financial institution should design these policies and procedures to allow personnel at an appropriate level to understand and evaluate the potential legal or reputational risks presented by

6. This item is not intended to include traditional, nonbinding "comfort" letters or assurances provided to financial institutions in the loan process where, for example, the parent of a loan customer states that the customer (i.e., the parent's subsidiary) is an integral and important part of the parent's operations.

the transaction to the institution and to manage and address any heightened legal or reputational risks ultimately found to exist with the transaction.

Due diligence. If a CSFT is identified as an elevated-risk CSFT, the institution should carefully evaluate and take appropriate steps to address the risks presented by the transaction, with a particular focus on those issues identified as potentially creating heightened levels of legal or reputational risk for the institution. In general, a financial institution should conduct the level and amount of due diligence for an elevated-risk CSFT that is commensurate with the level of risks identified. A financial institution that structures or markets an elevated-risk CSFT to a customer, or that acts as an advisor to a customer or investors concerning an elevated-risk CSFT, may have additional responsibilities under the federal securities laws, the Internal Revenue Code, state fiduciary laws, or other laws or regulations and, thus, may have greater legal- and reputational-risk exposure with respect to an elevated-risk CSFT than a financial institution that acts only as a counterparty for the transaction. Accordingly, a financial institution may need to exercise a higher degree of care in conducting its due diligence when the institution structures or markets an elevated-risk CSFT or acts as an advisor concerning such a transaction than when the institution plays a more limited role in the transaction.

To appropriately understand and evaluate the potential legal and reputational risks associated with an elevated-risk CSFT that a financial institution has identified, the institution may find it useful or necessary to obtain additional information from the customer or to obtain specialized advice from qualified in-house or outside accounting, tax, legal, or other professionals. As with any transaction, an institution should obtain satisfactory responses to its material questions and concerns prior to consummation of a transaction.[7]

In conducting its due diligence for an elevated-risk CSFT, a financial institution should independently analyze the potential risks to the institution from both the transaction and the institution's overall relationship with the customer. Institutions should not conclude that a transaction identified as being an elevated-risk CSFT involves minimal or manageable risks solely because another financial institution will participate in the transaction or because of the size or sophistication of the customer or counterparty. Moreover, a financial institution should carefully consider whether it would be appropriate to rely on opinions or analyses prepared by or for the customer concerning any significant accounting, tax, or legal issues associated with an elevated-risk CSFT.

Approval process. A financial institution's policies and procedures should provide that CSFTs identified as having elevated legal or reputational risk are reviewed and approved by appropriate levels of control and management personnel. The designated approval process for such CSFTs should include representatives from the relevant business line(s) and/or client management, as well as from appropriate control areas that are independent of the business line(s) involved in the transaction. The personnel responsible for approving an elevated-risk CSFT on behalf of a financial institution should have sufficient experience, training, and stature within the organization to evaluate the legal and reputational risks, as well as the credit, market, and operational risks to the institution.

The institution's control framework should have procedures to deliver the necessary or appropriate information to the personnel responsible for reviewing or approving an elevated-risk CSFT to allow them to properly perform their duties. Such information may include, for example, the material terms of the transaction, a summary of the institution's relationship with the customer, and a discussion of the significant legal, reputational, credit, market, and operational risks presented by the transaction.

Some institutions have established a senior management committee that is designed to involve experienced business executives and senior representatives from all of the relevant control functions within the financial institution (including such groups as independent risk management, tax, accounting, policy, legal, compliance, and financial control) in the oversight and approval of those elevated-risk CSFTs that are identified by the institution's personnel as requiring senior management review and approval due to the potential risks associated with the transactions. While this type of management committee may not be appropriate for all financial institutions, a financial institution should establish processes that assist the institution in con-

7. Of course, financial institutions also should ensure that their own accounting for transactions complies with applicable accounting standards, consistently applied.

sistently managing the review and approval of elevated-risk CSFTs on a firm-wide basis.[8]

If, after evaluating an elevated-risk CSFT, the financial institution determines that its participation in the CSFT would create significant legal or reputational risks for the institution, the institution should take appropriate steps to address those risks. Such actions may include declining to participate in the transaction, or conditioning its participation upon the receipt of representations or assurances from the customer that reasonably address the heightened legal or reputational risks presented by the transaction. Any representations or assurances provided by a customer should be obtained before a transaction is executed and be received from, or approved by, an appropriate level of the customer's management. A financial institution should decline to participate in an elevated-risk CSFT if, after conducting appropriate due diligence and taking appropriate steps to address the risks from the transaction, the institution determines that the transaction presents unacceptable risk to the institution or would result in a violation of applicable laws, regulations, or accounting principles.

Documentation. The documentation that financial institutions use to support CSFTs is often highly customized for individual transactions and negotiated with the customer. Careful generation, collection, and retention of documents associated with elevated-risk CSFTs are important control mechanisms that may help an institution monitor and manage the legal, reputational, operational, market, and credit risks associated with the transactions. In addition, sound documentation practices may help reduce unwarranted exposure to the financial institution's reputation.

A financial institution should create and collect sufficient documentation to allow the institution to—

- document the material terms of the transaction;
- enforce the material obligations of the counterparties;
- confirm that the institution has provided the customer any disclosures concerning the transaction that the institution is otherwise required to provide; and
- verify that the institution's policies and procedures are being followed and allow the internal audit function to monitor compliance with those policies and procedures.

When an institution's policies and procedures require an elevated-risk CSFT to be submitted for approval to senior management, the institution should maintain the transaction-related documentation provided to senior management as well as other documentation, such as minutes of the relevant senior management committee, that reflect senior management's approval (or disapproval) of the transaction, any conditions imposed by senior management, and the factors considered in taking such action. The institution should retain documents created for elevated-risk CSFTs in accordance with its record retention policies and procedures as well as applicable statutes and regulations.

Other Risk-Management Principles for Elevated-Risk CSFTs

General business ethics. The board and senior management of a financial institution also should establish a "tone at the top" through both actions and formalized policies that sends a strong message throughout the financial institution about the importance of compliance with the law and overall good business ethics. The board and senior management should strive to create a firm-wide corporate culture that is sensitive to ethical or legal issues as well as the potential risks to the financial institution that may arise from unethical or illegal behavior. This kind of culture coupled with appropriate procedures should reinforce business-line ownership of risk identification and encourage personnel to move ethical or legal concerns regarding elevated-risk CSFTs to appropriate levels of management. In appropriate circumstances, financial institutions may also need to consider implementing mechanisms to protect personnel by permitting the confidential disclosure of concerns.[9] As in other areas of financial institution

8. The control processes that a financial institution establishes for CSFTs should take account of, and be consistent with, any informational barriers established by the institution to manage potential conflicts of interest, insider trading, or other concerns.

9. The agencies note that the Sarbanes-Oxley Act of 2002 requires companies listed on a national securities exchange or inter-dealer quotation system of a national securities association to establish procedures that enable employees to submit

management, compensation and incentive plans should be structured, in the context of elevated-risk CSFTs, so that they provide personnel with appropriate incentives to have due regard for the legal-, ethical-, and reputational-risk interests of the institution.

Reporting. A financial institution's policies and procedures should provide for the appropriate levels of management and the board of directors to receive sufficient information and reports concerning the institution's elevated-risk CSFTs to perform their oversight functions.

Monitoring compliance with internal policies and procedures. The events of recent years evidence the need for an effective oversight and review program for elevated-risk CSFTs. A financial institution's program should provide for periodic independent reviews of its CSFT activities to verify and monitor that its policies and controls relating to elevated-risk CSFTs are being implemented effectively and that elevated-risk CSFTs are accurately identified and have received proper approvals. These independent reviews should be performed by appropriately qualified audit, compliance, or other personnel in a manner consistent with the institution's overall framework for compliance monitoring, which should include consideration of issues such as the independence of reviewing personnel from the business line. Such monitoring may include more-frequent assessments of the risk arising from elevated-risk CSFTs, both individually and within the context of the overall customer relationship, and the results of this monitoring should be provided to an appropriate level of management in the financial institution.

Audit. The internal audit department of any financial institution is integral to its defense against fraud, unauthorized risk taking, and damage to the financial institution's reputation. The internal audit department of a financial institution should regularly audit the financial institution's adherence to its own control procedures relating to elevated-risk CSFTs, and further assess the adequacy of its policies and procedures related to elevated-risk CSFTs. Internal audit should periodically validate that business lines and individual employees are complying with the financial institution's standards for elevated-risk CSFTs and appropriately identifying any exceptions. This validation should include transaction testing for elevated-risk CSFTs.

Training. An institution should identify relevant personnel who may need specialized training regarding CSFTs to be able to effectively perform their oversight and review responsibilities. Appropriate training on the financial institution's policies and procedures for handling elevated-risk CSFTs is critical. Financial institution personnel involved in CSFTs should be familiar with the institution's policies and procedures concerning elevated-risk CSFTs, including the processes established by the institution for identification and approval of elevated-risk CSFTs and new complex structured finance products and for the elevation of concerns regarding transactions or products to appropriate levels of management. Financial institution personnel involved in CSFTs should be trained to identify and properly handle elevated-risk CSFTs that may result in a violation of law.

CONCLUSION

Structured finance products have become an essential and important part of the U.S. and international capital markets, and financial institutions have played an important role in the development of structured finance markets. In some instances, however, CSFTs have been used to misrepresent a customer's financial condition to investors and others, and financial institutions involved in these transactions have sustained significant legal and reputational harm. In light of the potential legal and reputational risks associated with CSFTs, a financial institution should have effective risk-management and internal control systems that are designed to allow the institution to identify elevated-risk CSFTs; to evaluate, manage, and address the risks arising from such transactions; and to conduct those activities in compliance with applicable law.

concerns regarding questionable accounting or auditing matters on a confidential, anonymous basis. (See 15 USC 78j-1(m).)

Bank management is responsible for controlling risk at a level deemed acceptable for the organization. An effective risk-management program begins with the identification of exposures that could disrupt the timely and accurate delivery of business services or result in unexpected financial claims on bank resources. Risk management also involves the implementation of cost-effective controls and the shifting, transfer, or assignment of risk to third parties through insurance coverage or other risk-transfer techniques. Although the design and sophistication of risk-management procedures varies from bank to bank, each institution's decision-making process should effectively identify; control; and, when or where appropriate, result in some transfer of risk. The risk-assessment program should be conducted annually to establish whether potential service disruptions and estimated risk-related financial costs and losses can be contained at levels deemed acceptable to bank management and the board of directors. Note that insurance can provide a bank with the resources to restore business operations and financial stability only *after* an unanticipated event has occurred, but a bank's own risk-management controls can prevent and minimize losses before they occur.

RISK-MANAGEMENT PROGRAM

A sound operational risk-management program requires the annual review of all existing business operations and a risk assessment of all proposed services. Identified risks should be analyzed to estimate their potential and probable levels of loss exposure. While the historical loss experience of the bank and other service providers may be helpful in quantifying loss exposure, technological and societal changes may result in exposure levels that differ from historical experience. Nevertheless, current exposure estimates should be derived from the bank's historical loss experience and augmented with industry experience. In addition, the bank's insurance broker or agent should be a source of advice.

Management must decide the most appropriate method for addressing a particular risk. Although many factors influence this decision, the purpose of risk management is to minimize the probability of losses and the net costs associated with them. In that context, cost is broadly defined to include—

- the direct and consequential cost of loss-prevention measures (controls), plus
- insurance premiums, plus
- losses sustained, including the consequential effects and expenses to reduce such losses, minus
- recoveries from third parties and indemnities from insurers on account of such losses, plus
- pertinent administrative costs.

Bank risks with potentially high or even catastrophic financial consequences should be eliminated or substantially mitigated whenever possible, even when the risk's frequency of occurrence is low. These risks can be eliminated by discontinuing operations where appropriate or by assigning the risk exposure to other parties using third-party service providers. When the exposure cannot be shifted to other parties or otherwise mitigated, the bank must protect itself with appropriate levels of insurance. Certain loss exposures may be deemed reasonable because their probability of frequency and severity of loss are low, the level of expected financial loss or service disruption is minimal, or the costs associated with the recovery of assets and restoration of services are low.

Bank management may decide to reduce insurance premiums and claims-processing costs by self-insuring for various types of losses, setting higher deductible levels, lowering the coverage limits for insurance purchased, and narrowing coverage terms and conditions. A financial organization's primary defenses against loss are adequate internal controls and procedures, which insurance is intended to complement, not replace. Thus, an overall appraisal of the organization's control environment is a significant consideration in determining the adequacy of the insurance program. To the extent that controls are lacking, the need for additional insurance coverage increases. These determinations should be based on the results of the risk assessment and be consistent with the limits established by the board of directors. Insurance decisions may also be influenced by the insurance broker's advice regarding current insurance market and premium trends.

Following September 2001, insurance companies reevaluated their position on providing coverage for acts of terrorism. As a result, terrorism coverage has become expensive or unavailable. The bank's "schedule of insurance" should note which policies contain exclusions, sublimits, or large deductibles for losses incurred as a result of terrorism.

When selecting insurance carriers, banks should consider the financial strength and claims-paying capacity of the insurance underwriter, as well as the robustness or strength of the supervisory regime to which the insurer is subject. This procedure is important for all significant policy-coverage lines. Rating agencies typically consider a number of insurers vulnerable, and some underwriters may have large environmental exposures but capped equity resources. Many large commercial enterprises acquire insurance coverage from foreign companies or from subsidiaries of U.S. insurers domiciled in the Caribbean or other countries. The quality of insurance supervision in many foreign countries may not meet the standards expected in the United States.

TYPES OF RISKS

Business risks generally fall into three categories: (1) physical property damage, (2) liability resulting from product failure or unintended employee performance, and (3) loss of key personnel. Common property risks are fires or natural disasters such as storms and earthquakes, but acts of violence or terrorism can also be included in this category. Risk-management programs for property damage should consider not only the protection and replacement of the physical plant, but also the effects of business interruptions, loss of business assets, and reconstruction of records.

Insurance programs increasingly cover the consequences of the second category, product failure or unintended employee performance. These risks include the injury or death of employees, customers, and others; official misconduct; and individual and class-action lawsuits alleging mistreatment or the violation of laws or regulations. All aspects of a bank's operation are susceptible to liability risks. While property-loss levels can be estimated with relative confidence, jury awards for personal injury or product liability, and the related litigation costs, often exceed expectations. In addition, it can be difficult to identify potential sources of liability exposure.

The third category, personnel risk, concerns those exposures associated with the loss of key personnel through death, disability, retirement, or resignation, as well as threats to all employees and third parties arising out of crimes such as armed robbery and extortion. The consequences of personnel loss are often more pronounced in small and medium-sized banks that do not have the financial resources to support a broad level of management.

INSURANCE PROGRAM

Program Objectives

A bank's insurance program should match the objectives of its management, the director-approved risk guidelines, and its individual risk profile. Insurance is primarily the transfer of the financial effect of losses and should be considered as only a part of the broader risk-management process. In that sense, it is imperative that management understands the costs and benefits of the bank's insurance program.

Due to the fluid nature of the insurance market and insurance products, there is no standard program or contract structure. Rather, many different insurance policies, coverages, endorsements, limits, deductibles, and payment plans fit together to form an insurance program. Based on the size and scope of a bank's operations, broader or narrower coverage, higher or lower limits, and separate policies may be purchased. Insurance programs should be customized to the risks that each bank faces. If a bank is particularly susceptible to a specific risk, purchasing additional insurance for that risk may be prudent.

A policy's deductible size and coverages, and the limits purchased, determine how much risk the bank has retained. Likewise, the payment plan of an insurance policy greatly influences the amount of risk transferred. An insurance policy alone does not represent significant risk transfer if the payment plan includes reimbursement to the insurance company for all losses, usually subject to a maximum. These reimbursement, loss-sensitive, or retrospectively rated plans can be viewed more as a risk-financing tool than as risk transfer. Management should understand and quantify the total ‘‘all-in’’ cost of these plans, as well as how these costs correspond with the risk guidelines approved by the directors.

Common Insurance-Policy Components and Concepts

There is a difference between ‘‘policy’’ and ‘‘coverage,’’ but the two terms are often used interchangeably. The term ‘‘policy’’ usually refers to the actual insurance contract, while the term ‘‘coverage’’ refers to the types of risks to which the policy is designed to respond. For example, a directors’ and officers’ policy may include employment-practices liability (EPL) coverage. However, the bank may also purchase a separate EPL policy

An ‘‘endorsement’’ is a modification to a policy. Endorsements can be either a simple change in wording from the original contract or a more complex addition or deletion of a coverage section. To expand on the example above, EPL coverage is often endorsed onto a directors’ and officers’ policy. When an endorsement adds a coverage to a policy, it is often called a ‘‘rider.’’

The ‘‘limit of insurance’’ is the dollar amount of insurance protection purchased. Each policy has a different limit, and some may have separate limits for separate coverages provided under the same policy. Policies usually include a ‘‘per-occurrence’’ and an ‘‘aggregate’’ limit. The per-occurrence limit is the most the insurer will pay under the policy for any one insured event, while the policy aggregate is the most the insurer will pay in total, regardless of the number and size of insurable events.

‘‘Deductibles’’ and ‘‘self-insured retentions (SIRs)’’ are the dollar amounts the bank must contribute to the loss before insurance applies.[1] They are effectively the same concept, with the difference being a deductible reduces the limits of insurance while a SIR does not. A deductible is included within or as part of the limits. A SIR is outside or in addition to the provided limits. For example, a $5 million policy limit with a $1 million deductible consists of $4 million of protection and the $1 million deductible. A $5 million policy limit with a $1 million SIR provides $5 million in protection after the $1 million dollar SIR is paid by the bank. As in any clause of an insurance contract, the terms can be negotiated so a deductible does not reduce the limits.

‘‘Occurrence’’ and ‘‘claims made’’ are two separate types of coverage bases of policies that differ as to the period protected, when claims are recognized, and when the policies are ‘‘triggered’’ or respond. Under an occurrence, or ‘‘loss-sustained,’’ form the amount and type of coverage (if any) for the loss event is based on the policy that was in force when the event took place or occurred, regardless of when a claim is submitted. Under a claims-made, or ‘‘discovery,’’ policy, the insurance policy in force when the loss event was discovered and reported to the insurance company would apply, regardless of when the event causing the claim occurred. Both types of policies have provisions regarding prompt claims-reporting to insurers. However, claims-made policies are usually stricter and their coverage may be compromised by failing to report claims in a timely manner.

Self-Insurance or Alternative Risk Transfer

There are numerous nontraditional insurance programs that larger, more complex banking organizations employ. These programs include, but are not limited to, captive insurance companies, individual or group self-insurance, risk-retention groups, and purchasing groups. These alternative risk-transfer (ART) programs are complex, and they should include common bank policies and procedures. For example, the bank should have access to individuals with insurance expertise. Outside consultants, qualified insurance brokers, and bank directors or management with insurance expertise are an integral part of a successful ART program. The ART program should also incorporate stop-loss provisions and reinsurance coverage to cap the organization’s exposure to severe claims or unexpected loss experience.

COMMON POLICIES AND COVERAGES

The following is not intended to be a compre-

1. An organization can maintain an unfunded reserve for loss-retention purposes.

hensive list of policies and coverages available, but rather a listing and description of those that banks most frequently purchase. The list is divided into three general types of insurance: liability, property, and life insurance. A fourth category is included for aircraft and aviation insurance, which consists of various types of property and liability coverage. While this last coverage category may be unnecessary for most banking organizations, for those institutions that do have exposure to risks associated with aircraft ownership, the risks may be exceptionally large.

Fidelity Insurance Bond

Liability insurance is sometimes called ‘‘third-party insurance’’ because three parties are involved in a liability loss: the insured, the insurance company, and the party (the claimant) who is injured or whose property is damaged by the insured. The insurance company pays the claimant on behalf of the insured if the insured is legally liable for the injury or damage. An insured’s legal liability for injury is often the result of a negligent act, but there are other sources of liability. Several examples of liability insurance are discussed below.

Fidelity bond coverage provides reimbursement for loss from employee dishonesty; robbery; burglary; theft; forgery; mysterious disappearance; and, in specified instances, damage to offices or fixtures of the insured. Coverage applies to all banking locations except automated teller machines, for which coverage must be specifically added. All banks should obtain fidelity bond coverage that is appropriate for their business needs.

The most widely used form of fidelity bond is the Financial Institution Bond (FIB), Standard Form No. 24 (formerly named the bankers’ blanket bond). Standard Form No. 24 is a claims-made, or discovery, form. The ‘‘basic’’ FIB has four insuring agreements or parts. Employee Dishonesty/Fidelity (Clause A) covers dishonest or fraudulent acts committed by employees. On-Premises (Clause B) covers losses from burglary, misplacement, or an unexplained disappearance that occurs on premises. In-Transit (Clause C) covers losses from burglary, misplacement, or an unexplained disappearance that occurs while the property is in transit. Counterfeit Currency (Clause F) covers losses from accepting counterfeit currency.

In addition to the basic four FIB insuring agreements, Forgery or Alteration (Clause D) and Securities (Clause E) may also appear on the standard form. (These coverages may not be a component of the most basic insurance program for a small bank.) Significant enhancements and additional coverages are often endorsed onto the FIB. Any misrepresentation, omission, concealment, or incorrect statement of material fact in the insurance application is grounds for recission of the fidelity bond by the underwriting insurance company.

When the bank under examination is a subsidiary of a bank holding company, and the holding company has purchased one fidelity bond to cover all affiliated banks, the examiner should determine that the policy is sufficient to cover the exposures of the subsidiary bank being examined. Examiners also should determine that any policy premiums the subsidiary bank pays to the parent holding company are not disproportionate to the bank’s benefits from the group policy and that such premiums are consistent with the fair-market requirements of section 23B of the Federal Reserve Act. Split-limit coverage may reduce protection if a loss involves the collusion of subsidiary bank employees or other affiliates of a bank holding company.

Clause A: Fidelity (Employee Dishonesty)

Clause A covers losses resulting directly from dishonest or fraudulent acts an officer or employee commits, either acting alone or in collusion with others. The employee must have had a manifest intent to cause a loss to the financial institution, and the employee or another person or entity must obtain financial benefit from the dishonest or fraudulent act. Officers, attorneys retained by the bank, persons provided by an employment contractor, and nonemployee data processors who are performing services for the insured are typically all considered ‘‘employees.’’ If any of the loss results from loans, that part of the loss is covered only if the employee was in collusion with other parties to the transaction and the employee received a minimum financial-benefit amount, as specified in the policy. (‘‘Financial benefit’’ does not include any employee benefits earned in the normal course of employment, including salaries, commissions, fees, bonuses, promotions, awards, profit-sharing plans, or pensions.) Clause A should not prevent the recovery of losses from employee dishonesty that are concealed by fictitious loans.

Clause B: On-Premises

Clause B covers losses of property (as defined in the bond) that occur on premises as a result of robbery, burglary, larceny, misplacement, theft, or a mysterious and unexplained disappearance. Under specified conditions, damage to offices and equipment may be covered under this clause, However, premises coverage should not be confused with standard fire or other types of property insurance.

Clause C: In-Transit

Clause C covers loss of property that is in transit. The property typically must be in the custody of (1) a natural person acting as a messenger for the insured, (2) a transportation company transporting the property in an armored motor vehicle, or (3) a transportation company transporting the property by means other than an armored motor vehicle. When an armored vehicle is not used by a transportation company, ‘‘property’’ is generally limited to records, certified securities, and negotiable instruments that are not payable to the bearer, are not endorsed, and have no restrictive endorsements. Some insuring agreements insure certain financial institution employees that carry cash.

Clause D: Forgery or Alteration

Clause D covers forgery, which is the signing of the name of another person or organization with the intent to deceive. Clause D also covers losses resulting from the alteration of any negotiable instrument. Evidences of debt, which the bank receives either over-the-counter or through clearings, are not usually covered. Fraudulent items received through an electronic funds transfer system are generally excluded.

Clause E: Securities

Clause E covers losses that result from a bank’s extending credit or assuming liability on the faith of original securities, documents, or written instruments that are forged, altered, lost, or stolen. These include but are not limited to a certificated security, a title, a deed or mortgage, a certificate of origin or title, an evidence of debt, a security agreement, an instruction to a Federal Reserve Bank, and a statement of uncertificated security of a Federal Reserve Bank. Coverage is included for certain counterfeit securities and instruments. The bank must have acted in good faith and had actual physical possession of the original instrument.

Clause F: Counterfeit Currency

Clause F provides coverage for losses resulting from the receipt of counterfeit money. The coverage is counterfeit money of the United States, Canada, or any other country where the insured maintains a branch office.

Common FIB Extensions, Riders, or Endorsements

Fidelity bond protection can be extended by purchasing additional coverage through extensions, riders, and endorsements. If a bank has significant risk exposures in certain areas, these additional protections should be considered. The most common of these protections are listed below.

Extortion/Threats to Persons or Property

The extortion/threats to persons or property rider insures against loss of property that is surrendered away from a banking office as the result of a threat to do bodily harm to a director, trustee, employee, or relative, or of threats to damage banking premises or property. While a bank may add this coverage with a rider to its FIB, many banks purchase a separate, more comprehensive policy or endorse this coverage onto the directors’ and officers’ policy.

Trading Losses

The trading-loss rider amends the FIB exclusion by providing coverage for trading losses resulting directly from employee dishonesty.

Automated Teller Machines

The automated teller machine (ATM) rider covers losses of money from, or damage to, an unattended ATM that results from robbery, burglary, or theft.

Electronic or Computer Systems

The electronic or computer-systems rider covers direct losses caused by fraudulent funds transfers originated through the bank's computer systems. The fraud may be caused by a dishonest employee, customer, or third party.

Unauthorized Signatures

The unauthorized-signature rider covers losses resulting from a bank's acceptance, cashing, or payment of any negotiable instrument or withdrawal order that bears an unauthorized signature. An "unauthorized signature" is not forged, but is the signature of an individual who is not an authorized signatory on the account.

Fraudulent Mortgages

The fraudulent-mortgages rider insures against loan losses that result from a bank's accepting or acting on mortgages or deeds of trust that have defective signatures. "Defective signatures" are those obtained through fraud or trickery or under false pretenses.

Counterfeit Checks

The counterfeit-check rider insures against loss from counterfeit checks and other negotiable instruments. The coverage applies whether or not the counterfeit instruments are forged.

Service Contractors

The service-contractor rider covers loss resulting from fraudulent or dishonest acts committed by a servicing contractor. A "servicing contractor" services real estate and home-improvement mortgages, as well as tax and insurance escrow accounts; manages real property; or provides other related services. The coverage extends to losses resulting from the contractor's failure to forward collected funds to the bank when the servicing contractor has committed to do so.

Money-Order Issuer's

With a money-order-issuer's rider, coverage is expanded to authorized third parties that issue registered checks or personal money orders on behalf of the insured.

Liability Insurance

Electronic and Computer Crimes

To broaden the electronic and computer-systems rider that is normally attached to the FIB, an additional electronic and computer-crime rider may be purchased. This rider is a "companion policy" that covers losses the bank may incur from having (1) transferred, paid, or delivered any funds or property; (2) established any credit; or (3) debited any account or given value as a direct result of fraudulent input of electronic data or computer instructions into the insured's computer. These losses may result from someone's unauthorized access to a terminal or the bank's communications lines, or from the fraudulent preparation of tapes or computer programs. Under this rider, coverage may include electronic funds transfer systems, the bank's proprietary systems, and voice instructions given over the telephone. Losses caused by software programmers and consultants, ATM systems, computer viruses, software piracy, computer extortion, and facsimiles may also be covered.

Excess Bank Employee Dishonesty Bond

The excess bank employee dishonesty bond adds limits over and above the FIB. Often an FIB cannot be purchased with limits that are large enough to satisfy the risk-transfer needs of larger banks. When this occurs, the bank may purchase an excess bond that would respond if a claim is larger than the per-occurrence limits on the FIB or if the aggregate limit of the FIB has been exhausted. The most common form of this coverage is the excess bank employee dishonesty blanket bond, Standard Form No. 28.

Combination Safe Depository

Combination safe depository insurance consists of two coverage sections that can be purchased together or separately. Coverage (A) applies to losses when the bank is legally obligated to pay for loss of a customer's property held in safe deposit boxes (including loss from damage or destruction). Coverage (B) generally covers loss, damage, or destruction of property in customers' safe deposit boxes, whether or not the bank is legally liable, when the loss results from an activity other than employee dishonesty, such as robbery or burglary.

Directors' and Officers' Liability

Directors' and officers' (D&O) liability insurance usually has three coverage parts: Side A, Side B, and Entity Securities Coverage (C). Side A covers the directors and officers individually for alleged wrongful acts. Side B reimburses the bank for money it has paid to or on behalf of its directors and officers to indemnify them for damages they may be liable for as a result of alleged wrongful acts. Entity Securities Coverage protects the corporation against securities claims. Subject to many exclusions and definitions, a ''wrongful act'' means any actual or alleged act, error, omission, misstatement, misleading statement, neglect, or breach of duty. D&O policies are primarily written on a claims-made basis. Larger banks will purchase excess D&O coverage. Like the FIB, there are numerous coverages or enhancements that can be endorsed onto a D&O policy.

Entity errors and omissions. The entity errors and omissions (E&O) insurance rider extends coverage to the financial institution as an entity for wrongful acts. A separate, more robust E&O policy may also be purchased. The separate policy is commonly referred to as bankers' professional liability.

Fiduciary liability and ERISA errors and omissions. Fiduciary liability (or fiduciary errors and omissions) extends insurance coverage for management of the bank's own employee pension or profit-sharing plans. A separate, more robust fiduciary policy may be purchased to expand further the coverage of the bank's management of its own plans. Without this additional special endorsement, neither the fiduciary errors and omissions nor the bank's directors' and officers' liability insurance will cover liability arising under the Employee Retirement Income Security Act of 1974 (ERISA). For protection against exposure arising from a breach of fiduciary duty under ERISA, a special ERISA errors and omissions endorsement is required (also called fiduciary or employee benefit plan liability). In addition to bank trust departments, banks whose only fiduciary responsibilities relate to their employee benefit plan should consider this coverage. A related specialized coverage called IRA/Keogh errors and omissions is also available.

For properties held or managed by a bank's trust department, a master or comprehensive policy is often obtained instead of individual policies. A master policy protects the trust-account properties from fire or other loss and insures the accounts and the bank against third-party liability in connection with the properties. The master policy does not usually cover claims by trust customers against the bank for negligence, errors, or violations resulting in loss to fiduciary accounts. However, separate fiduciary (or trust department) errors and omissions policies incorporate these areas.

Trust Errors and Omissions

Trust errors and omissions insurance provides coverage for wrongful acts while the bank is acting as trustee, guardian, conservator, or administrator. This is a claims-made policy that can be endorsed onto the D&O policy.

Employment-Practices Liability

Employment-practices liability (EPL) insurance provides coverage for an entity against employee claims of wrongful termination, discrimination, sexual harassment or ''wrongful employment acts.'' This is usually a claims-made policy that can be endorsed onto the D&O policy.

Bankers' Professional Liability

Bankers' professional liability (BPL-E&O) provides coverage for claims resulting from any actual or alleged wrongful acts, errors, or omissions bank employees commit in the performance of professional duties. Coverage can be broadened to include securities E&O, insurance agent E&O, brokerage service E&O, and notary E&O.

Mortgage Impairment

Mortgage-impairment insurance coverage protects the bank's interest, as mortgagee, from loss when contractually required insurance on real property held as collateral has inadvertently not been obtained. Upon discovery of the lack of required coverage, the bank has a limited time to either induce the borrower to obtain the required insurance or to place the insurance on its own.

Mortgage Errors and Omissions

Mortgage errors and omissions insurance, a broader version of mortgage-impairment coverage, provides coverage for direct damage and E&O losses to either the bank or the borrower. Mortgage E&O coverage also applies to the bank's mishandling of real estate taxes, life and disability insurance, and escrowed insurance premiums. Claims must result in a loss to the mortgaged property.

Commercial General Liability

Commercial general liability (CGL) insurance protects against claims of bodily injury or property damage for which the business may be liable and which may arise from the bank's premises, operations, and products. In addition to bodily injury and property damage, CGL can include liability coverage for various other offenses that might give rise to claims, such as libel, slander, false arrest, and advertising injury. A CGL policy can be underwritten on either an occurrence or a claims-made basis.

Workers' Compensation and Employers' Liability

Workers' compensation insurance covers injuries or deaths of employees caused by accidents in the course of employment. Workers' compensation insurance consists of two basic coverage parts: statutory benefits and employers' liability (EL). The two are mutually exclusive remedies to an employee injured on the job. EL protects a company from a lawsuit filed by an employee, while statutory benefits coverage provides medical care and long-term disability, death, or other benefits. State laws govern these provisions, so the provisions differ from state to state. The statutory coverage of workers' compensation is a no-fault system intended to benefit both the injured employee and the employer.

Automobile Liability and Physical Damage

Automobile liability insurance provides third-party liability protection for bodily injury or property damage resulting from accidents that involve the bank's vehicles. First-party coverage for damage to the vehicles is also provided. This coverage should be extended to include—

- nonowned and hired coverage, if employees use personal autos or rent autos while on bank business;
- coverage for autos that have been repossessed; and
- garage-keeper's liability, if the bank rents its parking facilities to customers or the public.

Umbrella and Excess Liability

Umbrella and excess liability insurance offers additional liability limits in excess of the coverage limits of any policy over which it ''attaches'' or becomes effective. Basic umbrella coverage attaches to CGL and automobile insurance and to the employers' liability section of workers' compensation policies. An excess liability policy attaches over an umbrella policy. More complex insurance programs may include both umbrella and excess liability policies that attach over the D&O, E&O, EPL, or other insurance.

Property Insurance

Several types of insurance coverage are available to help banks recover from property damage. Some of the more common types of property coverages are briefly described below.

Broad Form Property Insurance

Property insurance insures against the loss of or damage to real and personal property. The loss or damage may be caused by perils such as fire, theft, windstorm, hail, explosion, riot, aircraft, motor vehicles, vandalism, malicious mischief, riot and civil commotion, and smoke.

Fire

Fire insurance covers all losses directly attributed to fire, including damage from smoke or water and chemicals used to extinguish the fire. Additional fire damage for the building contents may be included, but often is written in combination with the policy on the building and permanent fixtures. Most fire insurance policies contain ''co-insurance'' clauses, meaning that insurance coverage must be maintained at a fixed proportion of the replacement value of the building. If a bank fails to maintain the required relationship of protection, all losses will be reimbursed at the ratio of the amount of the insurance carried to the amount required, applied to the value of the building at the time of the loss. When determining insurable value for fire insurance purposes, the basis typically is the cost of replacing the property with a similar kind or quality at the time of loss. Different types of values, however, may be included in policies, and care should be taken to ensure that the bank is calculating the correct value for its needs.

Business Personal Property

Traditionally known as ''contents'' insurance, business personal property insurance affords insurance protection coverage for the furniture, fixtures, equipment, machinery, merchandise, materials, and all other personal property owned by the bank and used in its business.

Blanket Coverage

Blanket insurance covers, in a single contract, either multiple types of property at a single location or one or more types of property at multiple locations.

Builder's Risk

Builder's-risk insurance is commercial property coverage specifically for buildings that are in the course of construction.

Business Interruption

Business-interruption insurance indemnifies the insured against losses arising from its inability to continue normal operations and functions of the business. Coverage is triggered by the total or partial suspension of business operations due to the loss of, loss of use of, or damage to all or part of the bank's buildings, plant machinery, equipment, or other personal property, when the loss is the result of a covered cause.

Contingent business-interruption insurance is also available to cover the bank's loss of earnings caused by a loss to another business that is one of its major suppliers or customers. This insurance is also known as ''business income from dependent properties.''

Crimes

Crime insurance covers money, securities, merchandise, and other property from various criminal causes of loss, such as burglary, robbery, theft, and employee dishonesty.

Data Processing

Data processing insurance coverage provides loss protection if data processing systems break down. This insurance also covers the additional expense incurred in making the system operational again.

Difference in Conditions

A difference-in-conditions (DIC) insurance contract is a separate coverage that expands or supplements property insurance that was written on a named-perils basis. A DIC policy will cover the property on an all-risk basis, subject to certain exclusions.

Ocean and Inland Marine

Ocean marine insurance covers ships and their cargo against such causes as fire, lightning, and ''perils of the seas.'' These include high winds, rough waters, running aground, and collision with other ships or objects.

Inland marine insurance was originally developed to provide coverage for losses to cargo transported over land. It now covers limited types of property in addition to goods in transit.

Valuable Papers and Destruction of Records

Valuable-papers and destruction-of-records insurance coverage is for the physical loss or damage to valuable papers and records of the insured. The coverage includes practically all types of printed documents or records except money.

Accounts Receivable

Accounts-receivable insurance covers losses that occur when an insured is unable to collect outstanding accounts because of damage to or destruction of the accounts-receivable records that was caused from a peril covered in the policy.

Cash Letters

Cash-letter insurance covers the costs for reproducing cash-letter items and items that remain uncollectible after a specified period of time. Generally, these policies do not cover losses due to dishonest acts of employees.

First-Class, Certified, and Registered Mail

The insurance coverage for first-class, certified, and registered mail provides protection on the shipment of property sent through the mail, as well as during transit by messenger or carrier to and from the post office. The insurance is principally used to cover registered mail in excess of the maximum $25,000 insurance provided by the U.S. Postal Service.

Commercial Multiple Peril

Commercial multiple peril insurance encompasses a range of insurance coverages, including property and liability. Small institutions may purchase this package policy when stand-alone polices are excessive or inefficient.

Life Insurance

Common types of life insurance policies purchased by banks are described below.

Key Person

When the death of a bank officer, or key person, would be of such consequence to the bank as to give it an insurable interest, key-person life insurance would insure the bank on the life of this individual.

Split-Dollar

In split-dollar life insurance, the purchaser of the policy pays at least part of the insurance premiums and is entitled to only a portion of the cash surrender value, death benefit, or both. See SR-93-37 (“Split-Dollar Life Insurance,” June 18, 1993) and its attachments for further discussion of the Federal Reserve’s position on these arrangements between bank holding companies and their subsidiary banks.

Bank-Owned

Bank-owned life insurance consists of tax-advantaged insurance policies that are purchased to cover the lives of bank officers and other highly compensated employees. The policies may be used as a funding mechanism for employee pension and benefit plans. The bank is the owner and beneficiary of the policy, and the cash value of the policy is considered an asset of the bank.

Aircraft or Aviation Insurance

Although aviation-liability exposures are frequently overlooked in the myriad of other financial institution exposures, they have tremendous potential for large catastrophic losses and must be addressed by senior risk-management executives at all financial institutions. Often hidden or obscure, aviation liability ranges from the more typical owned and nonowned liability and physical-damage exposures to the more exotic exposures from hangar-keepers, aviation products, and airport or heliport premises. In view of the specialized nature of aviation exposures, it is important that the bank deal with knowledgeable and experienced agents or brokers and underwriters in developing its aviation insurance program. While exposure categories overlap significantly, the following summary highlights the key areas of concern to most financial institutions.

Aviation Liability

Aviation liability insurance can be written to include aviation-products liability, all owned or nonowned exposures, and passenger liability. A bank's umbrella liability insurance program should also apply over the aviation policy's limit.

Nonowned Exposures

While many banks do not feel the need for aviation insurance because they do not own an aircraft, they may overlook liability exposures from nonowned aircraft and may, in fact, need this coverage. For example, an employee may use a personal aircraft on bank business, or lease or rent an aircraft to ferry customers or employees to a distant meeting. Financing or leasing an aircraft could create a nonowned exposure, even though the aircraft is not under bank control.

Most aviation-underwriting markets have programs available to meet the above exposures. However, additional exposures may require special coverage. Banks should consider the following situations:

- If the bank repairs and maintains the aircraft, it may incur a products-liability exposure after control is relinquished to others, such as when the aircraft is sold.
- If the bank finances aircraft, maintaining only a security interest, it becomes an owner when it repossesses the aircraft. In this case, there could be a definite need for both liability and physical-damage coverage. The coverage may be written at the time of repossession or negotiated in advance of the need for it. The bank should not attempt to continue coverage for its exposure under the borrower's policy.

All-Risk Physical Damage

To protect the bank's security interest in an aircraft hull, borrowers should be required to maintain full-value, all-risk physical-damage insurance (both ground-risk and in-flight coverage) in favor of the bank. However, a number of warranties in aircraft insurance policies could void the contract, so bankers are further advised to require that a borrower's hull insurance policy contain a breach-of-warranty endorsement to protect the bank if the borrower or owner violates provisions of the policy. The underwriter should agree to give the bank at least 30 days' advance notice of any change in the policy. Depending on the use of the aircraft, special consideration should be given to the territorial limits of coverage, as well as to confiscation protection. Since breach-of-warranty endorsements, like aircraft insurance policies, are far from standard, it is important that the bank understand and agree with the underwriter's language. It is particularly appropriate to review the consequences of potential recovery to the lien holder if the aircraft is damaged while a delinquency exists on the note.

Bank as Lessor

If the bank's security interest is that of the lessor, aviation liability insurance should be carried by the bank as lessor and also by the customer as lessee. In certain cases, it may be appropriate to require the lessee, through his or her underwriter, to provide the equivalent of the breach-of-warranty endorsement to the liability program and physical-damage coverage. The bank may also consider obtaining contingent lessor's liability.

Airport Premises and Hangar-Keepers

Airport-premises and hangar-keeper's insurance apply if the bank repossesses real estate on which an airport facility exists and continues to operate, or if the bank permits use of the facility pending further sale. In either case, the bank may assume liability exposures associated with the control tower, as well as airport-premises liability. Both the bank's comprehensive general liability and aviation liability programs should be reviewed for proper coverage.

If the bank owns or operates a hangar for its aircraft and attempts to share the burden of costs with others by renting aircraft space, it can pick up exposure to hangar-keeper's liability, unless the contract is properly worded. Appropriate consideration should be given to hold-harmless indemnification clauses, any regular or special insurance requirements, and waivers of subrogation.

Accidental Death and Dismemberment and Travel

Accidental death and dismemberment and travel insurance is another aspect of aviation insurance that banking institutions should consider. Many insurance programs for accidental death and dismemberment and corporate business travel accidents exclude coverage in corporate-owned, -leased, or -hired aircraft. Banks need to review the language of these policies carefully to be certain that they provide necessary and adequate coverages for the use of such aircraft.

RECORDKEEPING

The diversity of available insurance policies and their coverages emphasize the need for banks to maintain a concise, easily referenced schedule of their insurance coverage, referred to as the "schedule of insurance." These records should include the following information:

- insurance coverages provided, with major exclusions detailed
- the underwriter
- deductible amounts
- upper limits on policies
- terms of the policies
- dates that premiums are due
- premium amounts
- claim-reporting procedures

In preparation for policy renewal, the bank's risk manager and insurance broker organize much of the bank's relevant insurance data into a "submission." The submission may include—

- historical, current, and forecasted exposure information, such as sales, number and type of employees, property characteristics and values, and number and type of autos;
- loss and claim history by line of insurance, including detailed information on large claims, loss development, and litigation;
- information on company risk-management policies and financials; and
- specifications on desired coverages, terms and conditions, limits, deductibles, and payment plans.

The submission is delivered to the insurance company underwriter and forms the basis for determining premiums, rates, limits, and the program structure. The information may give the examiner a sense of why premiums and coverages change from year to year and whether purchased limits are sufficient.

Banks should retain the original policies and supporting documents for appropriate time periods. Records of losses should also be maintained, regardless of whether the bank was reimbursed. This information indicates areas where internal controls may need to be improved and is useful in measuring the level of risk exposure in a particular area.

1. To determine whether insurance is effectively integrated into the operational-risk-management program, and whether the insurance is appropriate, in light of the institution's internal-control environment.
2. To determine if insurance coverage adequately protects against significant or catastrophic loss.
3. To determine if recordkeeping practices are sufficient to enable effective risk and insurance management.
4. To ascertain if, and ensure that, the risk manager has initiated corrective action when policies, practices, procedures, or internal controls are deficient or when violations of banking laws and regulations have been noted.

1. If selected for implementation, complete or update the ''Bank Risk and Insurance Management'' section of the internal control questionnaire.
2. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examination procedures. From the examiner who is assigned to ''internal control,'' obtain a listing of any deficiencies noted in the latest review conducted by internal or external auditors and risk managers. Determine if appropriate corrections have been made.
3. Determine if the bank has designated a qualified risk manager, with expertise in insurance programs, to be responsible for loss control. If not, determine which officer handles the risk- and insurance-management function and whether external consultants are employed in designing the insurance program.
4. Obtain the bank's schedule of insurance policies in force and the renewal submissions. If the bank does not maintain a schedule, request that the bank complete a schedule of existing insurance coverage.
   a. Determine whether there have been any material changes in insurance coverage, limits, or deductibles since the last examination and the reasons for such changes. Do the changes reflect—
      - revised business strategies, the bank structure, operating processes, or technology systems that affect insurable risks, and
      - shifts to self-insurance or co-insurance or a change in insurance carriers?
   b. If there have been material changes, determine how they are being managed.
5. Using the bank-prepared summary of insurance coverage, determine that coverage conforms to the guidelines for maximum loss exposure, as established by the board of directors.
   a. Determine whether the use of insurance is in accordance with board-approved risk-management policies and guidelines.
   b. If the bank self-insures, determine what methods are used for this purpose; how the value of self-insurance is quantified; and how ''premiums'' are accounted for, funded, allocated, and tracked.
6. Determine whether insurance coverage provides adequate protection for the bank. The quality of internal controls and the audit function must be considered when making this assessment.
   a. Determine whether the bank manages its insurance coverage as an element of the operational-risk-management program.
   b. Determine whether the insurance program is managed on a corporate-wide basis or within each business unit.
   c. Identify any products, processes, or systems that the bank is not able to obtain insurance coverage for and determine how the associated risk is being managed.
   d. Determine whether the bank maintains a database of operational-loss events, the comprehensiveness of the database, and the claims history of operational losses.
   e. Review the due-diligence process used to assess the qualifications of providers of insurance coverage, including primary reinsurers.
7. If the bank's fidelity insurance has lapsed, determine that the appropriate Federal Reserve Bank has been notified.
8. Determine that the bank has adequate procedures to ensure that—
   a. reports of losses are filed with the bonding company pursuant to policy provisions,
   b. premiums are paid before policy expiration dates,
   c. policies are renewed without a lapse of coverage at expiration dates, and
   d. material changes in exposures are reported to the bank's insurance agent or broker and result in appropriate insurance-policy endorsements.

If the procedures are deficient, verify that reports have been filed as required and premiums have been paid.

9. Review any significant financial institution bond claims that were filed since the last examination to determine—

   a. any adverse effect on the bank's condition,
   b. whether the incident (or incidents) reflects any deficiencies with respect to internal controls and procedures, and
   c. whether management has taken appropriate steps to correct any deficiencies and made appropriate reports to the board of directors.
10. Prepare, in appropriate report form, and discuss with appropriate officers—
   a. recommended corrective action when policies, practices, procedures, or internal controls are deficient;
   b. recommended improvements in the risk-management program that relate to insurance;
   c. important areas in which insurance coverage is either nonexistent or inadequate in view of current circumstances; and
   d. any other deficiencies noted.
11. Update the workpapers with any information that will facilitate future examinations.

Review the bank's internal controls, policies, practices, and procedures for its own insurance coverage. The bank's risk-management system should be documented completely and concisely and should include, where appropriate, the risk-assessment matrix, a narrative description, flowcharts, the schedule of insurance coverage, policy forms, renewal submissions, and other pertinent information.

BANK RISK AND INSURANCE MANAGEMENT

1. Does the bank have established insurance guidelines that provide for—
   a. a reasonably frequent, and at least annual, determination of risks the bank assumes or transfers, including high-dollar and low-probability events?
   b. limits as to the amount of risk that may be retained or self-insured?
   c. periodic appraisals of major fixed assets to be insured?
   d. a credit or financial analysis of the insurance companies who have issued policies to the bank?
2. Does the bank have a risk manager who is responsible for assessing and developing controls to deal with the consolidated risks of the institution?
3. Is the bank's insurance program managed as an element of its overall operational-risk-management program; that is, are insurance coverages reviewed and coordinated by the person handling the operational-risk-management function?
4. Does the bank use the services of a professionally knowledgeable insurance agent, broker, direct writer, or consultant to assist in selecting and providing advice on alternative means of providing insurance coverage?
5. Does the bank's security officer coordinate his or her activities with the person responsible for handling the operational-risk-management function?
6. Does the bank maintain a concise, easily referenced schedule of existing insurance coverage?
7. Does the bank maintain records, by type of risk, to facilitate an analysis of the bank's experience in costs, claims, losses, and settlements under the various insurance policies in force?
8. Is a complete schedule of insurance coverage presented to the board of directors at least annually for review and approval? Does the schedule include the respective insurance premiums (net costs), claims, and loss experience, and is this information reviewed as part of this process?

CONCLUSION

1. Is the foregoing information an adequate basis for evaluating internal control; that is, there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
2. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

State member banks may purchase bank-owned life insurance (BOLI) as principal if such purchases are permitted for national banks and permitted under state law. The legal authority and guidance for acquiring permissible BOLI and for engaging in insurance activities is discussed within the following interagency statement. When such insurance purchases or insurance activities are not permissible for national banks, a determination of permissibility depends on a decision of the FDIC (1) that the investment or activity would not pose any significant risk to the insurance fund and (2) that the bank continues to comply with the required capital standards.

The bank supervisory agencies have concerns that some banks have committed a significant amount of capital to BOLI without having an adequate understanding or a proper assessment of the full array of risks it poses—especially risks that are difficult to measure, such as liquidity, transaction/operational, reputation, and compliance/legal risks. Banks are therefore expected to implement appropriate risk-management processes, including meaningful risk limits, before implementing or adding to a BOLI program. The following interagency guidance was developed for banks and savings associations (institutions) and examination staff to help ensure that risk-management practices for BOLI are consistent with safe and sound business practices. The interagency statement was issued on December 7, 2004.

INTERAGENCY STATEMENT ON THE PURCHASE AND RISK MANAGEMENT OF LIFE INSURANCE

This interagency statement[1] provides general guidance for banks and savings associations (institutions) regarding supervisory expectations for the purchase of and risk management for BOLI. Guidance is also provided for split-dollar arrangements and the use of life insurance as security for loans. The agencies are providing this guidance to help ensure that institutions' risk-management processes for BOLI are consistent with safe and sound banking practices. Among the safe and sound banking practices discussed in this statement are (1) the need for senior management and board oversight of BOLI, including both a thorough pre-purchase analysis of risks and rewards and post-purchase risk assessment and (2) the permissibility of BOLI purchases and holdings, as well as their risks and associated safety-and-soundness considerations. The statement's appendix [titled appendix A for this section of the manual] contains a discussion of insurance types and the purposes for which institutions commonly purchase life insurance, as well as a glossary of BOLI-related terminology [titled appendix B for this section].

The statement's guidance for the pre-purchase analysis of life insurance applies to all BOLI contracts entered into after December 7, 2004. The guidance concerning the ongoing risk management of BOLI subsequent to its purchase applies to all holdings of life insurance regardless of when purchased. Institutions that purchase life insurance after December 7, 2004, that are not in compliance with this guidance may be subject to supervisory action. Institutions that entered into BOLI contracts before this date will be evaluated according to each agency's pre-purchase guidance in effect at that time.

Compliance with the supervisory guidance in this statement regarding permissible uses for insurance (e.g., recovery of the costs of providing benefits) does not determine whether the policy satisfies state insurable interest requirements.

Legal Authority

National banks may purchase and hold certain types of life insurance under 12 USC 24 (Seventh), which provides that national banks may exercise ''all such incidental powers as shall be necessary to carry on the business of banking.'' Federal savings associations also may purchase and hold certain types of life insurance incidental to the express powers granted under the Home Owners' Loan Act. The OCC and OTS have delineated the scope of these authorities through various interpretations addressing the

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

permissible use of life insurance by national banks and federal savings associations.

Under these authorities, national banks and federal savings associations may purchase life insurance in connection with employee compensation and benefit plans, key-person insurance, insurance to recover the cost of providing pre- and post-retirement employee benefits, insurance on borrowers, and insurance taken as security for loans. The OCC and OTS may approve other uses on a case-by-case basis.

National banks and federal savings associations may *not* purchase life insurance—

- for speculation;
- to provide funds to acquire shares of stock from the estate of a major shareholder upon the shareholder's death, for the further purpose of controlling the distribution of ownership in the institution;
- as a means of providing estate-planning benefits for insiders, unless the benefit is a part of a reasonable compensation package; or
- to generate funds for normal operating expenses other than employee compensation and benefits.

National banks and federal savings associations may not hold life insurance in excess of their risk of loss or cost to be recovered. For example, once an individual no longer qualifies as a key person because of retirement, resignation, discharge, change of responsibilities, or for any other reason, the risk of loss has been eliminated. Therefore, national banks and federal savings associations may be required to surrender or otherwise dispose of key-person life insurance held on an individual who is no longer a key person. Typically, term or declining term insurance is the most appropriate form of life insurance for key-person protection.

National banks and federal savings associations may hold equity-linked variable life insurance policies (that is, insurance policies with a return tied to the performance of a portfolio of equity securities held in a separate account[2] of the insurance company) only for the purpose of economically hedging their equity-linked obligations under employee benefit plans. As discussed more fully in the section on ''Price Risk,'' for equity-linked variable life insurance holdings to be permissible, the national bank or federal savings association must demonstrate that—

- it has a specific, equity-linked obligation; and
- both at the inception of the hedge and on an ongoing basis, changes in the value of the equity-linked variable life insurance policy are highly correlated with changes in the value of the equity-linked obligation.

If a national bank or federal savings association does not meet these requirements, the equity-linked variable life insurance holdings are not permissible. The use of equity-linked variable life insurance holdings as a long-term hedge against general benefit costs is not permissible because the life insurance is not hedging a specific equity-linked liability and does not meet the ''highly correlated'' requirement.

As a general matter, the ability of state-chartered banks to purchase insurance (including equity-linked variable life insurance) is governed by state law. In some instances, state laws permit state-chartered banks to engage in activities (including making investments) that

2. A separate account is a design feature that is generally available to purchasers of whole life or universal life whereby the policyholder's cash surrender value is supported by assets segregated from the general assets of the carrier. Under such an arrangement, the policyholder neither owns the underlying separate account nor controls investment decisions (e.g., timing of investments or credit selection) in the underlying separate account that is created by the insurance carrier on its behalf. Nevertheless, the policyholder assumes all investment and price risk.

go beyond the authority of a national bank. The Federal Deposit Insurance Act (section 24) generally requires insured state-chartered banks to obtain the FDIC's consent before engaging as principal in activities (including making investments) that are not permissible for a national bank. Similarly, the Federal Deposit Insurance Act (section 28) generally requires a state-chartered savings association to obtain the FDIC's consent prior to engaging as principal in activities (including making investments) that are not permissible for a federal savings association. While insured state-chartered banks and state savings associations may seek the FDIC's consent to make purchases of life insurance that would not be within the authority of a national bank or federal savings association, such banks and savings associations should be aware that the FDIC will not grant permission to make life insurance purchases if the FDIC determines that doing so would present a significant risk to the deposit insurance fund or that engaging in such purchases is inconsistent with the purposes of federal deposit insurance.

Accounting Considerations

Institutions should follow generally accepted accounting principles (GAAP) applicable to life insurance for financial and regulatory reporting purposes. Financial Accounting Standards Board (FASB) Technical Bulletin No. 85-4, "Accounting for Purchases of Life Insurance" (TB 85-4), discusses how to account for holdings of life insurance. Under TB 85-4, only the amount that could be realized under an insurance contract as of the balance-sheet date (that is, the CSV reported to the institution by the carrier, less any applicable surrender charges not reflected by the insurance carrier in the reported CSV) is reported as an asset. The guidance set forth in TB 85-4 concerning the carrying value of insurance on the balance sheet is generally appropriate for all forms of BOLI.

An institution may purchase multiple permanent insurance policies from the same insurance carrier with each policy having its own surrender charges. In some cases, the insurance carrier will issue a rider or other contractual provision stating that it will waive the surrender charges if all of the policies are surrendered at the same time. Because it is not known at any balance-sheet date whether one or more of the policies will be surrendered before the deaths of those insured, the possibility that the institution will surrender all of these policies simultaneously and avoid the surrender charges is a gain contingency. Under FASB Statement No. 5, "Accounting for Contingencies," "[c]ontingencies that might result in gains usually are not reflected in the accounts since to do so might be to recognize revenue prior to its realization." Accordingly, an institution should report each of the insurance policies on its balance sheet at the policy's CSV reported by the insurance carrier, less any applicable surrender charges not reflected in the reported CSV, without regard to the existence of the rider.

In accordance with the instructions for Consolidated Reports of Condition and Income and Thrift Financial Reports, an institution should report the carrying value of its BOLI holdings as an "other asset" and the earnings on these holdings should be reported as "other noninterest income."

The agencies have seen a number of cases in which institutions have failed to account properly for a type of deferred compensation agreement, commonly referred to as a revenue-neutral plan or an indexed retirement plan. The accounting for such plans is separate and distinct from the accounting for BOLI. However, because many institutions buy BOLI to help offset the cost of providing such deferred compensation, the agencies have issued guidance addressing the accounting requirements for both deferred compensation agreements and BOLI. See the Interagency Advisory on Accounting for Deferred Compensation Agreements and Bank-Owned Life Insurance, dated February 11, 2004, for a complete description, including examples, of the appropriate accounting treatment.

Supervisory Guidance on BOLI

Before entering into a BOLI contract, institutions should have a comprehensive risk-management process for purchasing and holding BOLI. A prudent risk-management process includes—

- effective senior management and board oversight;
- comprehensive policies and procedures, including appropriate limits;

- a thorough pre-purchase analysis of BOLI products; and
- an effective ongoing system of risk assessment, management, monitoring, and internal control processes, including appropriate internal audit and compliance frameworks.

The risks associated with temporary (term) insurance are significantly less than those arising from holdings of permanent insurance. Accordingly, the risk-management process for temporary insurance may take this difference into account and need not be as extensive as the risk-management process for permanent insurance.

Senior Management and Board Oversight

The safe and sound use of BOLI depends on effective senior management and board oversight. Regardless of an institution's financial capacity and risk profile, the board must understand the complex risk characteristics of the institution's insurance holdings and the role this asset is intended to play in the institution's overall business strategy. Although the board may delegate decision-making authority related to purchases of BOLI to senior management, the board remains ultimately responsible for ensuring that the purchase and holding of BOLI is consistent with safe and sound banking practices.

An institution holding life insurance in a manner inconsistent with safe and sound banking practices is subject to supervisory action. Where ineffective controls over BOLI risks exist, or the exposure poses a safety-and-soundness concern, the appropriate agency may take supervisory action against the institution, including requiring the institution to divest affected policies, irrespective of potential tax consequences.

Policies and Procedures

Consistent with prudent risk-management practices, each institution should establish internal policies and procedures governing its BOLI holdings, including guidelines that limit the aggregate CSV of policies from any one insurance company as well as the aggregate CSV of policies from all insurance companies. When establishing these internal CSV limits, an institution should consider its legal lending limit, the capital concentration threshold, and any applicable state restrictions on BOLI holdings.[3] In this regard, given the liquidity, transaction/operational, reputation, and compliance/legal risks associated with BOLI, it is generally not prudent for an institution to hold BOLI with an aggregate CSV that exceeds 25 percent of the institution's capital as measured in accordance with the relevant agency's concentration guidelines.[4] Therefore, the agencies expect an institution that plans to acquire BOLI in an amount that results in an aggregate CSV in excess of 25 percent of capital, or any lower internal limit, to gain prior approval from its board of directors or the appropriate board committee. The agencies particularly expect management to justify that any increase in BOLI resulting in an aggregate CSV above 25 percent of capital does not constitute an imprudent capital concentration. An institution holding BOLI in an amount that approaches or exceeds the 25 percent of capital concentration threshold can expect examiners to more closely scrutinize the risk-management policies and controls associated with the BOLI assets and, where deficient, to require corrective action.

When seeking the board's approval to purchase or increase BOLI, management should inform the board members of the existence of this interagency statement, remind them of the illiquid nature of the insurance asset, advise them of the potential adverse financial impact of early surrender, and identify any other significant risks associated with BOLI. Such risks might include, but are not limited to, the costs associated with changing carriers in the event of a decline in the carrier's creditworthiness and the potential for noncompliance with state insurable interest requirements and federal tax law.

3. In July 1999, the OTS adopted a policy that savings associations may not invest more than 25 percent of their total capital in BOLI without first notifying and obtaining authorization from their OTS Regional Office. In order to maintain strong and effective communications with institutions under its supervision, the OTS retains this policy. The other agencies may also institute approval or notification requirements.

4. Each agency's definition of a concentration differs slightly. Institutions should refer to the definition provided by their supervisory agency when measuring the CSV of BOLI as a percentage of capital: OCC Bulletin 95-7 for national banks; FRB *Commercial Bank Examination Manual,* section 2050.1, for state member banks; FDIC *Manual of Examination Policies,* section 11.1, for insured state nonmember banks; and OTS *Thrift Activities Handbook,* section 211, for savings associations.

Pre-purchase Analysis

The objective of the pre-purchase analysis is to help ensure that the institution understands the risks, rewards, and unique characteristics of BOLI. The nature and extent of this analysis should be commensurate with the size and complexity of the potential BOLI purchases and should also take into account existing BOLI holdings. A mark of a well-managed institution is the maintenance of adequate records concerning its pre-purchase analyses, usually including documentation of the purpose and amount of insurance needed.

An effective pre-purchase analysis involves the following management actions:

Step 1—Identify the need for insurance and determine the economic benefits and appropriate insurance type. An institution should determine the need for insurance by identifying the specific risk of loss to which it is exposed or the specific costs to be recovered. It is not appropriate to purchase life insurance to recover a loss that the institution has already incurred. An institution's purchase of insurance to indemnify it against a specific risk of loss does not relieve it from other responsibilities related to managing that risk. The type of BOLI product, e.g., general[5] or separate account, and its features should be appropriate to meet the identified needs of the institution. The appendix [appendix A] contains a description of insurance types and design features.

An institution should analyze the cost and benefits of planned BOLI purchases. The analysis should include the anticipated performance of the BOLI policy and an assessment of how the purchase will accomplish the institution's objectives. Before purchasing BOLI, an institution should analyze projected policy values (CSV and death benefits) using multiple illustrations of these projections provided by the carrier, some of which incorporate the institution's own assumptions. An institution should consider using a range of interest-crediting rates and mortality-cost assumptions. In some cases, the net yield (after mortality costs) could be negative, particularly for separate-account products. The potential for unfavorable net yields underscores the importance of carefully evaluating BOLI costs and benefits across multiple scenarios, both currently and into the future.

Step 2—Quantify the amount of insurance appropriate for the institution's objectives. An institution should estimate the size of the employee benefit obligation or the risk of loss to be covered and ensure that the amount of BOLI purchased is not excessive in relation to this estimate and the associated product risks. When using BOLI to recover the cost of providing employee benefits, the estimated present value of the expected future cash flows from BOLI, less the costs of insurance, should not exceed the estimated present value of the expected after-tax employee benefit costs. In situations where an institution purchases BOLI on a group of eligible employees, it may estimate the size of the obligation or the risk of loss for the group on an aggregate basis and compare that to the aggregate amount of insurance to be purchased. This estimate should be based on reasonable financial and actuarial assumptions. State insurable interest laws may further restrict or limit the amount of insurance that may be purchased on a group of employees. Management must be able to support, with objective evidence, the reasonableness of all of the assumptions used in determining the appropriate amount of insurance coverage needed by the institution, including the rationale for its discount rates and cost projections.

Step 3—Assess the vendor's qualifications. When making a decision about vendors, an institution should consider its own knowledge of insurance risks, the vendor's qualifications, and the amount of resources the institution is willing to spend to administer and service the BOLI. Depending on the role of the vendor, the vendor's services can be extensive and may be critical to successful implementation and operation of a BOLI plan, particularly for the more complex separate-account products.

While it is possible to purchase insurance directly from insurance carriers, the vast majority of insurance purchases are made through vendors—either brokers, consultants, or agents. A vendor may design, negotiate, and administer the BOLI policy. An institution should ensure that it understands the product it is purchasing and that it selects a product that best meets its needs. Management, not just the vendor, must demonstrate a familiarity with the technical

5. A general account is a design feature that is generally available to purchasers of whole or universal life insurance whereby the general assets of the insurance company support the policyholder's CSV.

details of the institution's insurance assets, and be able to explain the reasons for and the risks associated with the product design features they have selected.

An institution that uses a vendor should make appropriate inquiries to satisfy itself about the vendor's ability to honor its long-term commitments, particularly when the vendor is expected to be associated with the institution's insurance program over an extended period of time. The institution should evaluate the adequacy of the vendor's services and its reputation, experience, financial soundness, and commitment to the BOLI product. Vendors typically earn a large portion of their commissions upon the sale of the product, yet they often retain long-term servicing responsibilities for their clients. The vendor's commitment to investing in the operational infrastructure necessary to support BOLI is a key consideration in vendor selection.

An institution should be aware that the vendor's financial benefit from the sale of insurance may provide the vendor with an incentive to emphasize the benefits of a BOLI purchase to the institution without a commensurate explanation of the associated risks. Therefore, reliance solely upon pre-packaged, vendor-supplied compliance information does *not* demonstrate prudence with respect to the purchase of insurance. An institution should not delegate its selection of product design features to its vendors. An institution that is unable to demonstrate a thorough understanding of BOLI products it has purchased and the associated risks may be subject to supervisory action.

Step 4—Review the characteristics of the available insurance products. There are a few basic types of life insurance products in the marketplace. These products, however, can be combined and modified in many different ways. The resulting final product can be quite complex. Furthermore, certain permanent insurance products have been designed specifically for banks. These products differ from other forms of corporate-owned life insurance (COLI) policies in that the policies designed for banks are generally structured without surrender or front-end sales charges in order to avoid having to report these charges as expenses when initially recording the carrying value. However, BOLI products may have lower net yields than COLI products due to the absence of these charges. An institution should review the characteristics of the various insurance products available, understand the products it is considering purchasing, and select those with the characteristics that best match the institution's objectives, needs, and risk tolerance.

Design features of permanent insurance policies determine (1) whether the policy is a general account, separate account, or hybrid product;[6] (2) whether the insurance contract is a modified endowment contract (MEC) that carries certain tax penalties if surrendered; and (3) the method used to credit earnings to the policy. Some implications of these design features are discussed in more detail in the ''Risk Management of BOLI'' section of this interagency statement.

When purchasing insurance on a key person or a borrower, management should consider whether the institution's need for the insurance might end before the insured person dies. An institution generally may not hold BOLI on a key person or a borrower once the key person leaves the institution or the borrower has either repaid the loan, or the loan has been charged off. Therefore, the maturity of the term or declining term insurance should be structured to match the expected tenure of the key person or the maturity of the loan, respectively. Permanent insurance generally is not an appropriate form of life insurance under these circumstances.

Step 5—Select the carrier. To achieve the tax benefits of insurance, institutions must hold BOLI policies until the death of the insured. Therefore, carrier selection is one of the most critical decisions in a BOLI purchase and one that can have long-term consequences. While a broker or consultant may assist the institution in evaluating carrier options, the institution alone retains the responsibility for carrier selection. Before purchasing life insurance, an institution should perform a credit analysis on the selected carrier(s) in a manner consistent with safe and sound banking practices for commercial lending. A more complete discussion of the credit-analysis standards is included in the ''Credit Risk'' section of this interagency statement.

Management should review the product design, pricing, and administrative services of proposed carriers and compare them with the institution's needs. Management should also review the carrier's commitment to the BOLI product, as well as its credit ratings, general reputation, experi-

6. A hybrid product combines features of both general- and separate-account products.

ence in the marketplace, and past performance. Carriers not committed to general-account BOLI products may have an incentive to lower the interest-crediting rate on BOLI over time, reducing the favorable economics of the product. The interest-crediting rate refers to the gross yield on the investment in the insurance policy, that is, the rate at which the cash value increases before considering any deductions for mortality cost, load charges, or other costs that are periodically charged against the policy's cash value. Insurance companies frequently disclose both a current interest-crediting rate and a guaranteed minimum interest-crediting rate. Institutions should be aware that the guaranteed minimum interest-crediting rate may be periodically reset in accordance with the terms of the insurance contract. As a result, the potential exists for a decline in the interest-crediting rate.

While institutions can exercise what is known as a 1035 exchange[7] option to change carriers, there are some practical constraints to using this option. First, the institution must have an insurable interest in each individual to be insured under the new carrier's policy. In a 1035 exchange, former employees of the institution may not be eligible for coverage under the new policy because state insurable interest laws may prohibit their eligibility. Second, the original carrier may impose an exchange fee specifically applicable to such 1035 exchanges.

Step 6—Determine the reasonableness of compensation provided to the insured employee if the insurance results in additional compensation. Insurance arrangements that are funded by the institution and that permit the insured officer, director, or employee to designate a beneficiary are a common way to provide additional compensation or other benefits to the insured. Split-dollar life insurance arrangements are often used for this purpose. Before an institution enters into a split-dollar arrangement or otherwise purchases insurance for the benefit of an officer, director, or employee, the institution should identify and quantify its compensation objective and ensure that the arrangement is consistent with that objective. The compensation provided by the split-dollar or other insurance arrangement should be combined with all other compensation provided to the insured to ensure that the insured's total compensation is not excessive. Excessive compensation is considered an unsafe and unsound banking practice. Guidelines for determining excessive compensation can be found in the Interagency Guidelines Establishing Standards for Safety and Soundness.[8]

Because shareholders and their family members who are not officers, directors, or employees of an institution do not provide goods or services to the institution, they should not receive compensation from the institution. This includes compensation in the form of split-dollar life insurance arrangements.

Prior to an institution's purchase of a life insurance policy to be used in a split-dollar life insurance arrangement, the institution and the insured should enter into a written agreement. Written agreements usually describe the rights of the institution, the insured individual, and any other parties (such as trusts or beneficiaries) to the policy's CSV and death benefits. It is important for an institution to be aware that ownership of the policy by the employee, a third party, or a trust (non-institution owner) may not adequately protect the institution's interest in the policy because the institution ordinarily will not have the sole right to borrow against the CSV or to liquidate the policy in the event that funds are needed to provide liquidity to the institution. Moreover, if a non-institution owner borrows heavily against the CSV, an institution's ability to recover its premium payments upon the death of the insured may be impaired.

At a minimum, an institution's economic interest in the policy should be equal to the premiums paid plus a reasonable rate of return, defined as a rate of return that is comparable to returns on investments of similar maturity and credit risk.

Split-dollar life insurance has complex tax and legal consequences. An institution considering entering into a split-dollar life insurance arrangement should consult qualified tax, legal, and insurance advisers.

Step 7—Analyze the associated risks and the ability to monitor and respond to those risks. An institution's pre-purchase analysis should include a thorough evaluation of all significant risks, as

7. A 1035 exchange is a tax-free replacement of an insurance policy for another insurance contract covering the same person in accordance with section 1035 of the Internal Revenue Code.

8. For national banks, appendix A to 12 CFR 30; for state member banks, appendix D-1 to 12 CFR 208; for insured state nonmember banks, appendix A to 12 CFR 364; for savings associations, appendix A to 12 CFR 570.

well as management's ability to identify, measure, monitor, and control those risks. An explanation of key risks (liquidity, transaction/operational, reputation, credit, interest rate, compliance/legal, and price) is included in the "Risk Management of BOLI" section of this interagency statement.

Step 8—Evaluate the alternatives. Regardless of the purpose of BOLI, a comprehensive pre-purchase analysis will include an analysis of available alternatives. Prior to acquiring BOLI, an institution should thoroughly analyze the risks and benefits, compared to alternative methods for recovering costs associated with the loss of key persons, providing pre- and post-retirement employee benefits, or providing additional employee compensation, as appropriate.

Step 9—Document the decision. A well-managed institution maintains adequate documentation supporting its comprehensive pre-purchase analysis, including an analysis of both the types and design of products purchased and the overall level of BOLI holdings.

Risk Management of BOLI

Risk assessment and risk management are vital components of an effective BOLI program. In addition to conducting a risk assessment as part of a thorough pre-purchase analysis, monitoring BOLI risks on an ongoing basis is important, especially for an institution whose aggregate BOLI holdings represent a capital concentration. Management of an institution should review the performance of the institution's insurance assets with its board of directors at least annually. More-frequent reviews are appropriate if there are significant anticipated changes to the BOLI program such as additional purchases, a decline in the financial condition of the insurance carrier(s), anticipated policy surrenders, or changes in tax laws or interpretations that could have an impact on the performance of BOLI. This risk-management review should include, but not necessarily be limited to:

- *Comprehensive assessment of the specific risks discussed in this section.*[9]
- *Identification of which employees are, or will be, insured (e.g., vice presidents and above, employees of a certain grade level).* For example, an institution that acquires another institution that owns BOLI may acquire insurance on individuals that it would not insure under its own standards. While the acquiring institution need not correct such exceptions, it is important to know that such exceptions exist.
- *Assessment of death benefit amounts relative to employee salaries.* Such information helps management to assess the reputation and insurable interest risks associated with disproportionately large death benefits.
- *Calculation of the percentage of insured persons still employed by the institution.* Larger institutions often find that their policies insure more former employees than current employees. This information can help the institution assess reputation risk.
- *Evaluation of the material changes to BOLI risk-management policies.*
- *Assessment of the effects of policy exchanges.* Exchanges typically are costly and it is a sound practice to review the costs and benefits of such actions.
- *Analysis of mortality performance and impact on income.* Material gains from death benefits can create reputation risks.
- *Evaluation of material findings from internal and external audits and independent risk-management reviews.*
- *Identification of the reason for, and tax implications of, any policy surrenders.* In some cases, institutions have surrendered BOLI policies and incurred tax liabilities and penalties. Formal assessment of the costs and benefits of a surrender is a useful component of sound corporate governance.
- *Peer analysis of BOLI holdings.* To address reputation risk, an institution should compare its BOLI holdings relative to capital to the holdings of its peers to assess whether it is an outlier.

Liquidity Risk

Liquidity risk is the risk to earnings and capital arising from an institution's inability to meet its obligations when they come due without incur-

9. All of the risks discussed in this section are applicable to permanent insurance. In contrast, because temporary insurance does not have a savings component or a CSV, it does not expose an institution to liquidity, interest-rate, or price risk. These risks need not be evaluated in the comprehensive assessment of the risks of temporary insurance.

ring unacceptable losses. Before purchasing permanent insurance, management should recognize the illiquid nature of the product and ensure that the institution has the long-term financial flexibility to hold the asset in accordance with its expected use. The inability to hold the life insurance until the death(s) of the insured(s) when the death benefits will be collected may compromise the success of the BOLI plan. An institution generally does not receive any cash flow from the insurance until the death benefit is paid. Depending upon the age of the insured population, it is possible that an institution that insures a small number of employees may not recognize any cash flow from the insurance for many years. The illiquid nature of insurance assets, combined with the difficulty of projecting liquidity needs far into the future, is a major reason an institution should keep its BOLI holdings below the agencies' concentration guidelines. Examiners will consider an institution's BOLI holdings when assessing liquidity and assigning the liquidity component rating.

The purchase of BOLI may negatively affect an institution's liquidity position, both because BOLI is one of the least liquid assets on an institution's balance sheet, and because institutions normally fund BOLI purchases through the sale of liquid assets (e.g., marketable securities). To access the CSV of BOLI, the institution must either surrender or borrow against the policy. In accordance with the policy contract and federal tax laws, the surrender of a policy may subject an institution to surrender charges, tax liabilities for previously untaxed increases in the CSV, and tax penalties. Borrowing against the CSV is disadvantageous in most cases due to limitations on the ability to deduct interest on the borrowing and other possible adverse tax consequences.

A BOLI product qualifying as a modified endowment contract (MEC) for tax purposes has particular liquidity disadvantages. If an institution surrenders a MEC, it will incur a tax liability on the increase in the policy's CSV from earnings on the policy since its inception and may incur an additional tax penalty for early surrender.

In order to avoid such additional tax penalties, an institution may opt to purchase a non-MEC contract. A non-MEC contract permits the policy owner to surrender the policy without incurring the additional tax penalty that, under certain circumstances, applies to MECs. Moreover, depending on the terms of the insurance contract, an institution generally may withdraw up to the basis (that is, the original amount invested) without creating a taxable event. However, a non-MEC policy increases in complexity if it is in the form of a separate account covered by a stable value protection (SVP) contract. An SVP contract protects the policy owner from declines in the value of the assets in the separate account arising from changes in interest rates, thereby mitigating price risk and earnings volatility. An SVP contract is most often used in connection with fixed-income investments. Institutions should recognize that SVP providers often place restrictions on the amount that may be withdrawn from the separate account, thereby reducing the liquidity of the BOLI asset. An institution considering the purchase of a non-MEC for its potential liquidity advantages compared to a MEC also should be aware of contractual provisions, such as 1035 exchange fees and "crawl-out" restrictions,[10] which may limit such advantages.

Transaction/Operational Risk

As it applies to BOLI, transaction/operational risk is the risk to earnings and capital arising from problems caused by the institution's failure to fully understand or to properly implement a transaction. Transaction/operational risk arises due to the variety and complexity of life insurance products, as well as tax and accounting treatments. To help mitigate this risk, management should have a thorough understanding of how the insurance product works and the variables that dictate the product's performance. The variables most likely to affect product performance are the policy's interest-crediting rate, mortality cost, and other expense charges.

Transaction/operational risk is also a function of the type and design features of a life insurance contract. With a general-account product, there are only two parties to the contract: the policy owner and the insurance carrier. With a separate-account product, the insurance carrier has a separate contract with an investment manager. There could also be an SVP provider with whom the carrier has a separate contract.

Transaction/operational risk may also arise as a result of the variety of negotiable features associated with a separate-account product.

10. A crawl-out restriction limits the amount of CSV eligible for a 1035 exchange or surrender over a period of time.

These include the investment options; the terms, conditions, and cost of SVP; and mortality options. Deferred acquisition costs (DAC) represent the insurance carrier's up-front costs associated with issuing an insurance policy, including taxes and commissions and fees paid to agents for selling the policy. The carrier charges the policyholder for these costs and capitalizes the DAC, including the prepayment of taxes in accordance with federal tax law. As the carrier recovers the DAC in accordance with applicable tax law, it credits the amount to the separate-account policyholder. Once it has been credited to the institution, the DAC is essentially a receivable from the carrier and, therefore, represents a general-account credit exposure.

Separate-account policies have additional transaction risks that can result from accounting requirements. Several institutions have had to restate their earnings because of contractual provisions in their policies that were ambiguous with respect to the amount of the CSV available upon surrender of the policy. Because BOLI must be carried at the amount that could be realized under the insurance contract as of the balance-sheet date, if any contractual provision related to costs, charges, or reserves creates uncertainty regarding the realization of a policy's full CSV, the agencies will require an institution to record the BOLI net of those amounts. As part of an effective pre-purchase analysis, an institution should thoroughly review and understand how the accounting rules will apply to the BOLI policy it is considering purchasing.

Tax and Insurable Interest Implications

Before the purchase of BOLI and periodically thereafter, management should also explicitly consider the financial impact (e.g., tax provisions and penalties) of surrendering a policy. Recent adverse press coverage of corporate-owned life insurance (COLI) should serve as a reminder to institutions that the current tax law framework, as it applies to BOLI, is always subject to legislative changes. A tax change that makes future BOLI cash flows subject to income tax, while perhaps deemed unlikely by many institutions, would have a negative impact on the economics of the BOLI holdings. An institution should recognize that earnings from BOLI could make it subject to the alternative minimum tax.

Institutions should also recognize that their actions, subsequent to purchase, could jeopardize the tax-advantaged status of their insurance holdings. The risk that a life insurance policy could be characterized by the Internal Revenue Service (IRS) as an actively managed investment is particularly relevant to separate-account policies. Many larger institutions prefer separate-account products because of perceived lower credit risk and greater transparency (that is, explicit disclosure of costs). Assets held by the insurance company on behalf of the policy owners in the separate account are intended to be beyond the reach of the insurance company's general creditors in the event of insolvency; however, the protected status of separate-account assets is generally untested in the courts. While the separate-account structure helps to mitigate an institution's credit exposure to the insurance carrier, the institution can have no "control" over investment decisions (e.g., timing of investments or credit selection) in the underlying account. Generally, allocating separate-account holdings across various divisions of an insurance company's portfolio does not raise concerns about "control," but other actions that a policy owner takes may be construed as investment control and could jeopardize the tax-advantaged status.

To benefit from the favorable tax treatment of insurance, a BOLI policy must be a valid insurance contract under applicable state law and must qualify under applicable federal law. Institutions must have an insurable interest in the covered employee, as set forth in applicable state laws. Furthermore, the favorable tax-equivalent yields of BOLI result only when an institution generates taxable income. Institutions that have no federal income tax liability receive only the nominal interest-crediting rate as a yield. In such an environment, BOLI loses much of its yield advantage relative to other investment alternatives.

Some institutions seem to have drawn comfort from assurances from insurance carriers that the carrier would waive lack of insurable interest as a defense against paying a claim. While the carrier may indeed make a payment, such payment may not necessarily go to the institution. Such assurances may not be sufficient to satisfy the IRS requirements for a valid insurance contract, nor do they eliminate potential claims from the estate of the insured that might seek to claim insurance proceeds on the basis that the institution lacked an insurable interest.

For example, some institutions have established out-of-state trusts to hold their BOLI assets. While such trusts may have legitimate uses, such as to gain access to an insurance carrier's product, in some cases the purpose is to avoid unfavorable insurable interest laws in the institution's home state and to domicile the policy in a state with more lenient requirements. In some cases, institutions have not made employees aware that they have taken out insurance on their lives.

A recent Fifth Circuit Court of Appeals ruling demonstrates the potential danger of this approach. A Texas employer used a Georgia trust to hold life insurance policies on its employees in Texas, and the trust agreement provided that the insurable interest law of Georgia should apply. In a lawsuit brought by the estate of a deceased employee, the court ignored this provision because the insured employee was not a party to the trust agreement. It then found that the insurable interest law of Texas applied and under that state's law, the employer did not have an insurable interest in the employee. The result was that the employer was not entitled to the insurance death benefits.[11] The outcome in this case suggests that institutions that have used, or are considering using, an out-of-state trust to take advantage of more-favorable insurable interest laws in another state should assess whether they could be vulnerable to a similar legal challenge.

Institutions should have appropriate legal review to help ensure compliance with applicable tax laws and state insurable interest requirements. Institutions that insure employees for excessive amounts may be engaging in impermissible speculation or unsafe and unsound banking practices. The agencies may require institutions to surrender such policies.

Reputation Risk

Reputation risk is the risk to earnings and capital arising from negative publicity regarding an institution's business practices. While this risk arises from virtually all bank products and services, reputation risk is particularly prevalent in BOLI because of the potential perception issues associated with an institution's owning or benefiting from life insurance on employees.

A well-managed institution will take steps to reduce the reputation risk that may arise as a result of its BOLI purchases, including maintaining appropriate documentation evidencing informed consent by the employee, prior to purchasing insurance. Some institutions assert that they make employees aware via employee handbooks, manuals, or newsletters of the possibility that the institution may acquire life insurance on them. Although such disclosure may satisfy state insurance requirements, any approach that does not require formal employee consent may significantly increase an institution's reputation risk.

Some institutions have begun to purchase separate-account, non-MEC product designs in order to address the liquidity concerns with MEC policies. One consequence of this product design choice, however, is that it has become increasingly common for institutions to insure a very large segment of their employee base, including non-officers. Because non-MEC designs have a higher ratio of death benefit to premium dollar invested, some institutions have, therefore, taken out very high death benefit policies on employees, including lower-level employees, further adding to reputation risk and highlighting the importance of obtaining explicit consent.

Credit Risk

Credit risk is the potential impact on earnings and capital arising from an obligor's failure to meet the terms of any contract with the institution or otherwise perform as agreed. All life insurance policyholders are exposed to credit risk. The credit quality of the insurance company and duration of the contract are key variables. With insurance, credit risk arises from the insurance carrier's contractual obligation to pay death benefits upon the death of the insured, and if applicable, from the carrier's obligation to pay the CSV (less any applicable surrender charges) upon the surrender of the policy.

Most BOLI products have very long-term (30- to 40-year) expected time frames for full collection of cash proceeds, i.e., the death benefit. For general-account policies, the CSV is an unsecured, long-term, and nonamortizing obligation of the insurance carrier. Institutions record and carry this claim against the insurance company as an asset.

11. Mayo v. Hartford Life Insurance Company, 354 F.3d 400 (5th Cir. 2004).

Before purchasing BOLI, an institution should conduct an independent financial analysis of the insurance company and continue to monitor its condition on an ongoing basis. The institution's credit-risk-management function should participate in the review and approval of insurance carriers. As with lending, the depth and frequency of credit analysis (both initially and on an ongoing basis) should be a function of the relative size and complexity of the transaction and the size of outstanding exposures. Among other things, an institution should consider its legal lending limit, concentration guidelines (generally defined as the aggregate of direct, indirect, and contingent obligations and exposures that exceed 25 percent of the institution's capital), and any applicable state restrictions on BOLI holdings when assessing its broader credit-risk exposure to insurance carriers. To measure credit exposures comprehensively, an institution should aggregate its exposures to individual insurance carriers, and the insurance industry as a whole, attributable to both BOLI policies and other credit relationships (e.g., loans and derivatives exposures).

There are product design features of a BOLI policy that can reduce credit risk. As noted earlier, an institution can purchase separate-account products, where the institution assumes the credit risk of the assets held in the separate account, rather than the direct credit risk of the carrier as would be the case in a general-account policy. With separate-account policies, the insurance carrier owns the assets, but maintains the assets beyond the reach of general creditors in the event of the insurer's insolvency. However, even with a separate-account policy, the policy owner incurs some general-account credit-risk exposure to the insurance carrier associated with the carrier's mortality and DAC reserves. Amounts equal to the mortality and DAC reserves are owed to the policyholder and represent general-account obligations of the insurance carrier. In addition, the difference, if any, between the CSV and the minimum guaranteed death benefit would be paid out of the insurance carrier's general account.

A separate-account policy may have a stable value protection (SVP) contract issued by the insurance carrier or by a third party that is intended to protect the policyholder from most declines in fair value of separate-account assets. In general, the provider of an SVP contract agrees to pay any shortfall between the fair value of the separate-account assets when the policy owner surrenders the policy and the cost basis of the separate account to the policy owner. Under most arrangements, the insurance carrier is not responsible for making a payment under the SVP contract if a third-party protection provider fails to make a required payment to it. The SVP contract thus represents an additional source of credit risk for a separate-account product. The policyholder's exposure under an SVP contract is to both the protection provider, which must make any required payment to the insurance carrier, and the carrier, which must remit the payment received from the protection provider to the institution. Because of this exposure, an institution should also evaluate the repayment capacity of the SVP provider.

State insurance regulation governing reserve requirements for insurance carriers, state guaranty funds, and reinsurance arrangements help to reduce direct credit risks from general-account exposures. Further, an institution can use a 1035 exchange to exit a deteriorating credit exposure, although most policies impose fees for the exchange. While credit risk for existing general- and separate-account policies may be low currently, the extremely long-term nature of a BOLI policy underscores the fact that credit risk remains an important risk associated with life insurance products. Strong current credit ratings offer no guarantee of strong credit ratings 20, 30, or 40 years into the future.

Interest-Rate Risk

Interest-rate risk is the risk to earnings and capital arising from movements in interest rates. Due to the interest-rate risk inherent in general-account products, it is particularly important that management fully understand how these products expose the policyholder to interest-rate risk before purchasing the policy. The interest-rate risk associated with these products is primarily a function of the maturities of the assets in the carrier's investment portfolio, which often range from four to eight years. When purchasing a general-account policy, an institution chooses one of a number of interest-crediting options (that is, the method by which the carrier will increase the policy's CSV). Using the "portfolio" crediting rate, the institution will earn a return based upon the existing yield of the carrier's portfolio each year. Using the "new money" crediting rate, the institution earns a return based upon yields available in the market at the time it purchases the policy.

Separate-account products may also expose the institution to interest-rate risk, depending on the types of assets held in the separate account. For example, if the separate-account assets consist solely of U.S. Treasury securities, the institution is exposed to interest-rate risk in the same way as holding U.S. Treasury securities directly in its investment portfolio. However, because the institution cannot control the separate-account assets, it is more difficult for the institution to control this risk. Accordingly, before purchasing a separate-account product, an institution's management should thoroughly review and understand the instruments governing the investment policy and management of the separate account. Management should understand the risk inherent within the separate account and ensure that the risk is appropriate for the institution. The institution also should establish monitoring and reporting systems that will enable management to monitor and respond to interest-rate fluctuations and their effect on separate-account assets.

Compliance/Legal Risk

Compliance/legal risk is the risk to earnings and capital arising from violations of, or nonconformance with, laws, rulings, regulations, prescribed practices, or ethical standards. Failure to comply with applicable laws, rulings, regulations, and prescribed practices could compromise the success of a BOLI program and result in fines or penalties imposed by regulatory authorities or loss of tax benefits. Among the legal and regulatory considerations that an institution should evaluate are compliance with state insurable interest laws, the Employee Retirement Income Security Act of 1974 (ERISA), Federal Reserve Regulations O and W (12 CFR 215 and 223, respectively), the Interagency Guidelines Establishing Standards for Safety and Soundness, the requirements set forth under the "Legal Authority" section of this document, and federal tax regulations applicable to BOLI.

Tax benefits are critical to the success of most BOLI plans. Accordingly, an institution owning separate-account BOLI must implement internal policies and procedures to ensure that it does not take any action that might be interpreted as exercising "control" over separate-account assets. This is especially important for privately placed policies in which the institution is the only policyholder associated with the separate-account assets.

When purchasing BOLI, institutions should be aware that the splitting of commissions between a vendor and the institution's own subsidiary or affiliate insurance agency presents compliance risk. The laws of most states prohibit the payment of inducements or rebates to a person as an incentive for that person to purchase insurance. These laws may also apply to the person receiving the payment. When an insurance vendor splits its commission with an institution's insurance agency that was not otherwise involved in the transaction, such a payment may constitute a prohibited inducement or rebate. Accordingly, an institution should assure itself that this practice is permissible under applicable state law and in compliance with Federal Reserve Regulation W before participating in any such arrangement. Moreover, payments to an affiliate that did not perform services for the institution could also raise other regulatory and supervisory issues.

Due to the significance of the compliance risk, institutions should seek the advice of counsel on these legal and regulatory issues.

Price Risk

Price risk is the risk to earnings and capital arising from changes in the value of portfolios of financial instruments. Accounting rules permit owners of insurance contracts to account for general-account products using an approach that is essentially based on cost plus accrued earnings. However, for separate-account products without SVP, the accounting would largely be based on the fair value of the assets held in the account because this value is the amount that could be realized from the separate account if the policy is surrendered. (See "Accounting Considerations" above.) Typically, the policyholder of separate-account products assumes all price risk associated with the investments within the separate account. Usually, the insurance carrier will provide neither a minimum CSV nor a guaranteed interest-crediting rate for separate-account products. Absent an SVP contract, the amount of price risk generally depends upon the type of assets held in the separate account.

Because the institution does not control the separate-account assets, it is more difficult for it to control the price risk of these assets than if they were directly owned. To address income-statement volatility, an institution may purchase an SVP contract for its separate-account policy. The SVP contract is designed to ensure that the amount that an institution could realize from its separate-account policy, in most circumstances, remains at or above the cost basis of the separate account to the policyholder. Institutions should understand, however, that SVP contracts protect against declines in value attributable to changes in interest rates; they do not cover default risk. Moreover, one purpose of the SVP contract is to reduce volatility in an institution's reported earnings. To realize any economic benefit of the SVP contract, an institution would have to surrender the policy. Since policy surrender is nearly always an uneconomic decision, the SVP contract provides, in a practical sense, accounting benefits only.

Before purchasing a separate-account life insurance product, management should thoroughly review and understand the instruments governing the investment policy and management of the separate account. Management should understand the risk inherent in the separate account and ensure that the risk is appropriate. If the institution does not purchase SVP, management should establish monitoring and reporting systems that will enable it to recognize and respond to price fluctuations in the fair value of separate-account assets.

Under limited circumstances it is legally permissible for an institution to purchase an equity-linked variable life insurance policy if the policy is an effective economic hedge against the institution's equity-linked obligations under employee benefit plans.[12] An effective economic hedge exists when changes in the economic value of the liability or other risk exposure being hedged are matched by counterbalancing changes in the value of the hedging instrument. Such a relationship would exist where the obligation under an institution's deferred compensation plan is based upon the value of a stock market index and the separate account contains a stock mutual fund that mirrors the performance of that index. Institutions need to be aware that this economic hedge may not qualify as a hedge for accounting purposes. Thus, the use of equity-linked variable life insurance policies to economically hedge equity-linked obligations may not have a neutral effect on an institution's reported earnings.

Unlike separate-account holdings of debt securities, SVP contracts on separate-account equity holdings are not common. The economic hedging criteria for equity-linked insurance products lessen the effect of price risk because changes in the amount of the institution's equity-linked liability are required to offset changes in the value of the separate-account assets. If the insurance cannot be characterized as an effective economic hedge, the presence of equity securities in a separate account is impermissible, and the agencies will require institutions to reallocate the assets unless retention of the policy is permitted under federal law.[13]

In addition to the general considerations discussed previously, which are applicable to any separate-account product, an institution should perform further analysis when purchasing a separate-account product involving equity securities. At a minimum, the institution should:

1. Compare the equity-linked liability being hedged (e.g., deferred compensation) and the equity securities in the separate account. Such an analysis considers the correlation between the liability and the equity securities, expected returns for the securities (including standard deviation of returns), and current and projected asset and liability balances.
2. Determine a target range for the hedge effectiveness ratio (e.g., 95 to 105 percent) and establish a method for measuring hedge effectiveness on an ongoing basis. The institution should establish a process for altering the program if hedge effectiveness drops below acceptable levels. Consideration should be given to the potential costs of program changes.
3. Establish a process for analyzing and reporting to management and the board the effect of the hedge on the institution's earnings and capital ratios. The analysis usually considers results both with and without the hedging transaction.

12. Insured state banks and state savings associations may make such purchases only if permitted to do so under applicable state law.

13. Insured state banks and state savings associations may request the FDIC's consent to retain the policies, but consent will not be granted if it is determined that retaining the policies presents a significant risk to the appropriate insurance fund.

Risk-Based Capital Treatment

If an institution owns a general-account insurance product, it should apply a 100 percent risk weight to its claim on the insurance company for risk-based capital purposes. A BOLI investment in a separate-account insurance product, however, may expose the institution to the market and credit risks associated with the pools of assets in the separate account. The assets in a pool may have different risk weights, similar to the assets held in a mutual fund in which an institution has invested. For risk-based capital purposes, if an institution can demonstrate that the BOLI separate-account policy meets the requirements below, it may choose to "look through" to the underlying assets to determine the risk weight.

Criteria for a Look-Through Approach

To qualify for the "look-through" approach, separate-account BOLI assets must be protected from the insurance company's general creditors in the event of the insurer's insolvency. An institution should document its assessment, based upon applicable state insurance laws and other relevant factors, that the separate-account assets would be protected from the carrier's general creditors. If the institution does not have sufficient information to determine that a BOLI separate-account policy qualifies for the look-through approach, the institution must apply the standard risk weight of 100 percent to this asset.

In addition, when an institution has a separate-account policy, the portion of the carrying value of the institution's insurance asset that represents general-account claims on the insurer, such as deferred acquisition costs (DAC) and mortality reserves that are realizable as of the balance-sheet date, and any portion of the carrying value attributable to an SVP contract, are not eligible for the look-through approach. These amounts should be risk-weighted at the 100 percent risk weight applicable to claims on the insurer or the SVP provider, as appropriate.

Look-Through Approaches

When risk-weighting a qualifying separate-account policy, an institution may apply the highest risk weight for an asset permitted in the separate account, as stated in the investment agreement, to the entire carrying value of the separate-account policy, except for any portions of the carrying value that are general-account claims or are attributable to SVP. In no case, however, may the risk weight for the carrying value of the policy (excluding any general-account and SVP portions) be less than 20 percent.

Alternatively, an institution may use a pro rata approach to risk-weighting the carrying value of a qualifying separate-account policy (excluding any general-account and SVP portions). The pro rata approach is based on the investment limits stated in the investment agreement for each class of assets that can be held in the separate account, with the constraint that the weighted average risk weight may not be less than 20 percent. If the sum of the permitted investments across market sectors in the investment agreement is greater than 100 percent, the institution must use the highest risk weight for the maximum amount permitted in that asset class, and then proceed to the next-highest risk weight until the permitted amounts equal 100 percent.

For example, if a separate-account investment agreement permits a maximum allocation of 60 percent for corporate bonds, 40 percent for U.S. government–sponsored enterprise debt securities, and 60 percent for U.S. Treasury securities, then the institution must risk-weight 60 percent of the carrying value of the separate-account investment (excluding any portion attributable to SVP) at the 100 percent risk weight applicable to corporate bonds and the remaining 40 percent at the 20 percent risk weight for U.S. government–sponsored enterprise debt securities. Because the sum of the permitted allocation for corporate bonds and government-sponsored enterprise debt securities totals 100 percent, the institution cannot use the zero percent risk weight for U.S. Treasury securities. However, if the permitted allocation for U.S. government–sponsored enterprise debt securities was 30 percent rather than 40 percent, the institution could risk-weight the remaining 10 percent of the carrying value of its investment at the zero percent risk weight for U.S. Treasuries.

Regardless of the look-through approach an institution employs, the weighted average risk weight for the separate-account policy (excluding any general-account and SVP portions) may not be less than 20 percent, even if all the assets in the separate account would otherwise qualify for a zero percent risk weight. Furthermore, the portion of the carrying value of the separate-account policy that represents general-account claims on the insurer, such as realizable DAC and mortality reserves, and any portion of the carrying value attributable to an SVP contract, should be risk-weighted at the risk weight applicable to the insurer or the SVP provider, as appropriate.

The following example demonstrates the appropriate risk-weight calculations for the pro rata approach, incorporating the components of a BOLI separate-account policy that includes general-account claims on the insurer as well as the investment allocations permitted for different asset classes in the separate-account investment agreement.

Example. The separate-account investment agreement requires the account to hold a minimum of 10 percent in U.S. Treasury obligations. It also imposes a maximum allocation of 50 percent in mortgage-backed securities issued by U.S. government–sponsored enterprises, and a maximum allocation of 50 percent in corporate bonds. Assume that the portion of the carrying value of the separate-account policy attributable to realizable DAC and mortality reserves equals $10 and that the portion attributable to the SVP totals $10.

Carrying value of separate-account policy	$100.00
Less: Portion attributable to DAC and mortality reserves	10.00
Portion attributable to SVP	10.00
Net carrying value of separate-account policy available for pro rata	$ 80.00
Risk-weight calculation:	
U.S. Treasury @ 10% x $80 = $8 x 0% RW	0.00
Corporate bonds @ 50% x $80 = $40 x 100% RW	$ 40.00
GSE MBS @ 40% x $80 = $32 x 20% RW	6.40
Separate-account risk-weighted assets subject to pro rata	$ 46.40
Add back: DAC and mortality reserves = $10 x 100% RW	$ 10.00
Add back: SVP = $10 x 100% RW	10.00
General-account and SVP risk-weighted assets	$ 20.00
Total BOLI-related risk-weighted assets	$ 66.40

Summary

The purchase of BOLI can be an effective way for institutions to manage exposures arising from commitments to provide employee compensation and pre- and post-retirement benefits. Consistent with safe and sound banking practices, institutions must understand the risks associated with this product and implement a risk-management process that provides for the identification and control of such risks. A sound pre-purchase analysis, meaningful ongoing monitoring program, reliable accounting process, and accurate assessment of risk-based capital requirements are all components of the type of risk-management process the agencies expect institutions to employ.

Where an institution has acquired BOLI in an amount that approaches or exceeds agency concentration levels, examiners will more closely scrutinize the components of the risk-management process and the institution's associated documentation. Where BOLI has been purchased in an impermissible manner, ineffective controls over BOLI risks exist, or a BOLI exposure poses a safety-and-soundness concern, the appropriate agency may take supervisory action, including requiring the institution to divest affected policies, irrespective of tax consequences.

Appendix A—Common Types of Life Insurance

Life insurance can be categorized into two broad types: temporary (also called ''term'') insurance and permanent insurance. There are numerous variations of these products. However, most life insurance policies fall within one (or a combination) of the following categories.

Temporary (Term) Insurance

Temporary (term) insurance provides life insurance protection for a specified time period. Death benefits are payable only if the insured dies during the specified period. If a loss does not occur during the specified term, the policy lapses and provides no further protection. Term insurance premiums do not have a savings component; thus, term insurance does not create cash surrender value (CSV).

Permanent Insurance

In contrast to term insurance, permanent insurance is intended to provide life insurance protection for the entire life of the insured, and its premium structure includes a savings component. Permanent insurance policy premiums typically have two components: the insurance component (e.g., mortality cost, administrative fees, and sales loads) and the savings component. Mortality cost represents the cost imposed on the policyholder by the insurance company to cover the amount of pure insurance protection for which the insurance company is at risk.

The savings component typically is referred to as CSV. The policyholder may use the CSV to make the minimum premium payments necessary to maintain the death benefit protection and may access the CSV by taking out loans or making partial surrenders. If permanent insurance is surrendered before death, surrender charges may be assessed against the CSV. Generally, surrender charges are assessed if the policy is surrendered within the first 10 to 15 years.

Two broad categories of permanent insurance are:

- *Whole life.* A traditional form of permanent insurance designed so that fixed premiums are paid for the entire life of the insured. Death benefit protection is provided for the entire life of the insured, assuming all premiums are paid.
- *Universal life.* A form of permanent insurance designed to provide flexibility in premium payments and death benefit protection. The policyholder can pay maximum premiums and maintain a very high CSV. Alternatively, the policyholder can make minimal payments in an amount just large enough to cover mortality and other insurance charges.

Purposes for Which Institutions Commonly Purchase Life Insurance

Key person. Institutions often purchase life insurance to protect against the loss of ''key persons'' whose services are essential to the continuing success of the institution and whose untimely death would be disruptive. For example, an institution may purchase insurance on the life of an employee or director whose death would be of such consequence to the institution as to give it an insurable interest in his or her life. The determination of whether an individual is a key person does not turn on that individual's status as an officer or director, but on the nature of the individual's economic contribution to the institution.

The first step in indemnifying an institution against the loss of a key person is to identify the key person. The next and possibly most difficult step is estimating the insurable value of the key person or the potential loss of income or other value that the institution may incur from the untimely death of that person.

Because the most appropriate method for determining the value of a key person is dependent upon individual circumstances, the agencies have not established a formula or a specific process for estimating the value of a key person. Instead, the agencies expect institutions to consider and analyze all relevant factors and use their judgment to make a decision about the value of key persons.

Key-person life insurance should not be used in place of, and does not diminish the need for, adequate management-succession planning. Indeed, if an institution has an adequate management-succession plan, its reliance on a key person should decline as the person gets closer to retirement.

Financing or cost recovery for benefit plans. Like other businesses, institutions often use life insurance as a financing or cost-recovery vehicle for pre- and post-retirement employee benefits, such as individual or group life insurance, health insurance, dental insurance, vision insurance, tuition reimbursement, deferred compensation, and pension benefits.

Permanent insurance is used for this purpose. In these arrangements, an institution insures the lives of directors or employees in whom it has an insurable interest to reimburse the institution for the cost of employee benefits. The group of insured individuals may be different from the group that receives benefits. The institution's obligation to provide employee benefits is separate and distinct from the purchase of the life insurance. The life insurance purchased by the institution remains an asset even after the employer's relationship with an insured employee is terminated. The employees who receive benefits, whether insured or not, have no ownership interest in the insurance (other than their general claim against the institution's assets arising from the institution's obligation to provide the stated employee benefits).

There are two common methods of financing employee benefits through the purchase of life insurance. The first is the cost-recovery method, which usually involves present-value analysis. Typically, the institution projects the amount of the expected benefits owed to employees and then discounts this amount to determine the present value of the benefits. Then, the institution purchases a sufficient amount of life insurance on the lives of certain employees so that the gain (present value of the life insurance proceeds less the premium payments) from the insurance proceeds reimburses the institution for the benefit payments. Under this method, the institution absorbs the cost of providing the employee benefits and the cost of purchasing the life insurance. The institution holds the life insurance and collects the death benefit to reimburse the institution for the cost of the employee benefits and the insurance.

The second method of financing employee benefits is known as cost offset. With this method, the institution projects the annual employee benefit expense associated with the benefit plan. Then, the institution purchases life insurance on the lives of certain employees. The amount earned on the CSV each year should not exceed the annual benefit expense.

Split-dollar life insurance arrangements. Institutions sometimes use split-dollar life insurance arrangements to provide retirement benefits and death benefits to certain employees as part of their compensation. Under split-dollar arrangements, the employer and the employee share the rights to the policy's CSV and death benefits. The employer and the employee may also share premium payments. If the employer pays the entire premium, the employee may need to recognize taxable income each year in accordance with federal income tax regulations.

Split-dollar arrangements may be structured in a number of ways. The two most common types of split-dollar arrangements are:

- *Endorsement split-dollar.* The employer owns the policy and controls all rights of ownership. The employer provides the employee an endorsement of the portion of the death benefit specified in the plan agreement with the employee. The employee may designate a beneficiary for the designated portion of the death benefit. Under this arrangement, the employer typically holds the policy until the employee's death. At that time, the employee's beneficiary receives the designated portion of the death benefits, and the employer receives the remainder of the death benefits.
- *Collateral-assignment split-dollar.* The employee owns the policy and controls all rights of ownership. Under these arrangements, the employer usually pays the entire premium or a substantial part of the premium. The employee assigns a collateral interest in the policy to the employer that is equal to the employer's interest in the policy. The employer's interest in the policy is set forth in the split-dollar agreement between the employer and the employee. Upon retirement, the employee may have an option to buy the employer's interest in the insurance policy. This transfer of the employer's interest to the employee is typically referred to as a ‘‘roll-out.’’ If a ‘‘roll-out’’ is not provided or exercised, the employer does not receive its interest in the policy until the employee's death.

Split-dollar life insurance is a very complex subject that can have unforeseen tax and legal consequences. Internal Revenue Service regulations issued in 2003[14] govern the taxation of

14. 68 *Fed. Reg.* 54336 (Sept. 17, 2003), chiefly codified at 26 CFR 1.61-22 and 1.7872-15.

split-dollar life insurance arrangements entered into or materially modified after September 17, 2003.[15] These rules provide less favorable tax treatment to split-dollar arrangements than existed previously. Institutions considering entering into a split-dollar life insurance arrangement should consult qualified tax, insurance, and legal advisers.

Life insurance on borrowers. State law generally recognizes that a lender has an insurable interest in the life of a borrower to the extent of the borrower's obligation to the lender. In some states, the lender's insurable interest may equal the borrower's obligation plus the cost of insurance and the time value of money. Institutions are permitted to protect themselves against the risk of loss from the death of a borrower. This protection may be provided through self-insurance, the purchase of debt-cancellation contracts, or by the purchase of life insurance policies on borrowers.

Institutions can take two approaches in purchasing life insurance on borrowers. First, an institution can purchase life insurance on an individual borrower for the purpose of protecting the institution specifically against loss arising from that borrower's death. Second, an institution may purchase life insurance on borrowers in a homogeneous group of loans employing a cost-recovery technique similar to that used in conjunction with employee benefit plans. Under this method, the institution insures the group of borrowers for the purpose of protecting the institution from loss arising from the death of any borrower in the homogeneous pool. Examples of homogeneous pools of loans include consumer loans that have distinctly similar characteristics, such as automobile loans, credit card loans, and residential real estate mortgages.

When purchasing insurance on an individual borrower, an institution should, given the facts and circumstances known at the time of the insurance purchase, make a reasonable effort to structure the insurance policy in a manner consistent with the expected repayment of the borrower's loan. To accomplish this, management should estimate the risk of loss over the life of the loan and match the anticipated insurance proceeds to the risk of loss. Generally, the risk of loss will be closely related to the outstanding principal of the debt. The insurance policy should be structured so that the expected insurance proceeds never substantially exceed the risk of loss.

When purchasing life insurance on borrowers in a homogeneous pool of loans, an institution's management should, given the facts and circumstances known at the time of the insurance purchase, make a reasonable effort to match the insurance proceeds on an aggregate basis to the total outstanding loan balances. If allowed by state law, institutions may match the insurance proceeds to the outstanding loan balances plus the cost of insurance on either a present-value or future-value basis. This relationship should be maintained throughout the duration of the program.

The purchase of life insurance on a borrower is not an appropriate mechanism for effecting a recovery on an obligation that has been charged off, or is expected to be charged off, for reasons other than the borrower's death. In the case of a charged-off loan, the purchase of life insurance on the borrower does not protect the institution from a risk of loss since the loss has already occurred. Therefore, the institution does not need to purchase insurance. Acquiring insurance that an institution does not need may subject the institution to unwarranted risks, which would be an unsafe and unsound banking practice. In the case of a loan that the institution expects to charge off for reasons other than the borrower's death, the risk of loss is so pronounced that the purchase of life insurance by the institution at that time would be purely speculative and an unsafe and unsound banking practice.

Internal Revenue Code section 264(f) disallows a portion of an institution's interest deduction for debt incurred to purchase life insurance on borrowers. Institutions considering the purchase of insurance on borrowers should consult their tax advisers to determine the economic viability of this strategy.

Life insurance as security for loans. Institutions sometimes take an interest in an existing life insurance policy as security for a loan. Institutions also make loans to individuals to purchase life insurance, taking a security interest in the policy, a practice known as "insurance-premium financing." As with any other type of lending, extensions of credit secured by life insurance should be made on terms that are consistent with safe and sound banking practices. For instance, the borrower should be obligated to repay the

15. Split-dollar arrangements entered into prior to September 17, 2003, and not materially modified thereafter may be treated differently.

loan according to an appropriate amortization schedule.

Generally, an institution may not rely on its security interest in a life insurance policy to extend credit on terms that excuse the borrower from making interest and principal payments during the life of the borrower with the result that the institution is repaid only when the policy matures upon the death of the insured. Lending on such terms is generally speculative and an unsafe and unsound banking practice.

Institutions may acquire ownership of life insurance policies for debts previously contracted (DPC) by invoking their security interest in a policy after a borrower defaults. Consistent with safety and soundness, institutions should use their best efforts to surrender or otherwise dispose of permanent life insurance acquired for DPC at the earliest reasonable opportunity.[16] In the case of temporary insurance acquired for DPC, retention until the next renewal date or the next premium date, whichever comes first, will be considered reasonable.

Appendix B—Glossary

Cash surrender value (CSV). The value available to the policyholder if the policy is surrendered. If no loans are outstanding, this amount is generally available in cash. If loans have been made, the amount available upon surrender is equal to the cash surrender value less the outstanding loan (including accrued interest).

Deferred acquisition costs (DAC). DAC represents the insurance carrier's up-front costs associated with issuing an insurance policy, including taxes and commissions and fees paid to agents for selling the policy. The carrier charges the policyholder for these costs. Carriers capitalize DAC and recover them in accordance with applicable tax law. As the carrier recovers DAC, it credits the amount to the policyholder.

Experience-rated pricing. A pricing method that bases prices for insurance products on the actual expenses and claims experience for the pool of individuals being insured.

General account. A design feature that is generally available to purchasers of whole or universal life insurance whereby the general assets of the insurance company support the policy's CSV.

Interest-crediting rate. The gross yield on the investment in the insurance policy, that is, the rate at which the cash value increases before considering any deductions for mortality cost, load charges, or other costs that are periodically charged against the policy's cash value.

There are a number of crediting rates, including "new money" and "portfolio." Using the "portfolio" crediting rate, the institution will earn a return based upon the existing yield of the insurance carrier's portfolio each year. Using the "new money" crediting rate, the institution will earn a return based upon yields available in the market at the time it purchases the policy.

Modified endowment contract (MEC). Type of policy that is defined in Internal Revenue Code section 7702A. A MEC generally involves the payment of a single premium at the inception of the contract; thus, it fails the so-called seven-pay test set forth in the statute. MECs are denied some of the favorable tax treatment usually accorded to life insurance. For example, most distributions, including loans, are treated as taxable income. An additional 10 percent penalty tax also is imposed on distributions in some circumstances. However, death benefits remain tax-free.

Mortality charge. The pure cost of the life insurance death benefit within a policy. It represents a cost to the purchaser and an income item to the carrier. Mortality charges retained by the insurance carrier are used to pay claims.

Mortality reserve. In separate-account products, the mortality reserve represents funds held by an insurance carrier outside of the separate account to provide for the payment of death benefits.

Non-MEC. An insurance contract that is not categorized as a MEC under Internal Revenue Code section 7702A.

Separate account. A separate account is a design feature that is generally available to purchasers of whole life or universal life whereby the policyholder's CSV is supported by assets segregated from the general assets of the carrier. Under such an arrangement, the policyholder

16. The OCC has generally directed national banks to surrender or divest permanent life insurance acquired for DPC within 90 days of obtaining control of the policy.

neither owns the underlying separate account nor controls investment decisions (e.g., timing of investments or credit selection) in the underlying separate account that is created by the insurance carrier on its behalf. Nevertheless, the policyholder assumes all investment and price risk.

Seven-pay test. The seven-pay test is a test set forth in Internal Revenue Code section 7702A that determines whether or not a life insurance product is a MEC for federal tax purposes.

Split-dollar life insurance. A split-dollar life insurance arrangement splits the policy's premium and policy benefits between two parties, usually an employer and employee. The two parties may share the premium costs while the policy is in effect, pursuant to a prearranged contractual agreement. At the death of the insured or the termination of the agreement, the parties split the policy benefits or proceeds in accordance with their agreement.

Stable value protection (SVP) contracts. In general, an SVP contract pays the policy owner of a separate account any shortfall between the fair value of the separate-account assets when the policy owner surrenders the policy and the cost basis of the separate account to the policy owner. The cost basis of the separate account typically would take into account the fair value of the assets in the account when the policy was initially purchased, the initial fair value of assets added to the account thereafter, interest credited to the account, the amount of certain redemptions and withdrawals from the account, and credit losses incurred on separate-account assets. Thus, SVP contracts mitigate price risk. SVP contracts are most often used in connection with fixed-income investments.

1035 exchange. A tax-free replacement of an insurance policy for another contract covering the same person(s) in accordance with section 1035 of the Internal Revenue Code.

Variable life insurance. Variable life insurance policies are investment-oriented life insurance policies that provide a return linked to an underlying portfolio of securities. The portfolio typically is a group of mutual funds chosen by the insurer and housed in a separate account, with the policyholder given some discretion in choosing among the available investment options.

Appendix C—Interagency Interpretations of the Interagency Statement on the Purchase and Risk Management of Life Insurance

The federal banking and thrift agencies developed responses to questions regarding the December 7, 2004, Interagency Statement on the Purchase and Risk Management of Life Insurance. A summary of these interpretations is included below to provide clarification on a wide variety of matters pertaining to financial reporting, credit-exposure limits, concentration limits, and the appropriate methodologies to use for calculating the amount of insurance an institution may purchase.

Legal Authority—State and Federal Law

As a general matter, the ability of state-chartered banks to purchase insurance (including equity-linked variable life insurance) is governed by state law. Section 24 of the Federal Deposit Insurance Act (the FDI Act) generally requires insured state-chartered banks to obtain the consent of the Federal Deposit Insurance Corporation (FDIC) before engaging as principal in activities (including making investments) that are not permissible for a national bank. Some state bank regulatory agencies have issued their own BOLI guidance or directives for their respective state-chartered institutions. A state-chartered institution should follow any BOLI guidance or directive issued by its state supervisory authority that is more restrictive than the interagency statement. Generally, if state law or policy is less restrictive than the interagency statement, a state-chartered institution should follow the interagency statement. If federal law is less restrictive than state law, a state-chartered institution should follow the state law.

Permissibility of Equity-Linked Securities in Separate-Account BOLI

The interagency statement states that national banks and federal savings associations may hold equity-linked variable life insurance policies (that is, insurance policies with a return tied to the performance of a portfolio of equity securities held in a separate account of the insurance company) only in very limited circumstances.

Similarly, state member banks may also hold equity-linked variable life insurance policies only in very limited circumstances. Because the range of instruments with equity-like characteristics varies significantly, the permissibility of each such instrument must be analyzed on a case-by-case basis. Furthermore, the agencies have significant concerns regarding whether an institution properly understands the complex risk profile that securities with "equity-like" characteristics often present. Some securities, even if legally permissible, may be inappropriate for the vast majority of financial institutions, whether held in an investment portfolio or a separate-account BOLI product. The agencies' April 1998 Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities provides guidance on the appropriateness of investments and risk-management expectations.

Senior Management and Board Oversight—Establishing BOLI Concentration Limits

Each institution should establish internal policies and procedures governing its BOLI holdings that limit the aggregate cash surrender value (CSV) of policies from any one insurance company as well as the aggregate CSV of policies from all insurance companies. The interagency statement is not intended to loosen the standards with respect to prior BOLI guidance. The agencies have rigorous expectations regarding the establishment of prudent limits and appropriate board and management oversight of the limit-setting process. Accordingly, exceptions will be subject to increased supervisory attention. The agencies continue to expect institutions to adopt per-carrier limits for BOLI, keeping in mind legal lending limits. Although the federal statutory and regulatory lending limits do not, as a general rule, impose a per-carrier legal constraint on BOLI because BOLI is not a loan, BOLI nevertheless does represent a long-term credit exposure. The agencies expect institutions to manage credit exposures in a prudent manner, irrespective of whether the exposure is subject to a statutory or regulatory limit. If an institution establishes an aggregate limit for BOLI based upon its applicable capital concentration threshold, it would seldom be prudent to have its per-carrier limit equal to the aggregate limit. Apart from credit considerations, it is also important to diversify BOLI exposures in order to control transaction risks that may be associated with an individual carrier's policies.

Per-Carrier Limits

Institutions should establish a per-carrier limit for separate-account policies. Diversification among carriers reduces transaction risks. Institutions should also explicitly consider whether it is appropriate to combine general- and separate-account exposures from the same carrier for purposes of measuring exposure against internal limits. The agencies believe that institutions, based upon their risk tolerance and understanding of insurance risks, should determine for themselves whether to combine such policies. In this regard, the agencies note that separate-account policies also present general-account credit exposures. For example, deferred acquisition costs (DAC) and mortality reserves associated with separate-account policies are general obligations of the insurance carrier. Moreover, when the death of an insured occurs, the difference between the death benefit amount and the cash surrender value comes from the carrier's general account. Finally, the actual credit exposure under a BOLI policy may be many times greater than the carrying value of the policy currently recorded on the institution's balance sheet, given the typical relationship between CSV and policy death benefits. Institutions should keep these factors in mind when evaluating whether and, if so, how to aggregate general- and separate-account exposures for purposes of monitoring compliance with internal limits.

Legal Limits and Concentrations

When establishing internal CSV limits, an institution should consider its legal lending limit, the capital concentration thresholds, and any applicable state restrictions on BOLI holdings. The following are the agencies' capital concentration definitions:

- The FDIC uses 25 percent of tier 1 capital to measure a capital concentration.
- The other agencies use tier 1 capital plus the allowance for loan and lease losses (ALLL).

A state-chartered institution should be guided by the more restrictive of the applicable state and federal limitations and thresholds. For example, if a state defines BOLI as an extension of credit subject to a statutory or regulatory lending limit, or otherwise imposes a per-carrier limit on BOLI, then institutions subject to that state's jurisdiction should ensure that their BOLI exposure to an individual carrier does not exceed the applicable state limit.

Permissibility of Holding Life Insurance on Former Employees and Former Key Persons

A well-managed institution adequately documents the purpose for which it is acquiring BOLI, as part of its pre-purchase analysis. When an institution purchases life insurance on a group of employees (whether it is a group policy or a series of individual policies) as a means to finance or recover the cost of employee benefits, and one or more of the insured employees is no longer employed by the bank, the insurance coverage may be retained by the institution provided—

- the application of the cost-recovery or cost-offset method (see ''Quantifying the Amount of Insurance Appropriate for the Institution's Objectives'' below) indicates that the amount of insurance held is not in excess of the amount required to recover or offset the cost of the institution's employee benefits,
- the policy is not specifically designated to cover only loss of income to the banking organization that may arise from the death of the employee,
- the coverage continues to qualify as an insurable interest under applicable state law, and
- the insurance asset continues to be a permissible holding under applicable state law for state-chartered institutions.

Additionally, if the policy no longer qualifies as insurance under the applicable state insurable-interest law, the policy may no longer be eligible for favorable tax treatment. These conditions apply to ''benefits BOLI'' despite the fact that the former employee was a ''key person.''

This is in contrast to true key-person insurance, in which the institution purchases life insurance on a key person in order to protect itself from financial loss in the event of that person's death. The interagency statement provides that a national bank or federal savings association may be required to surrender or otherwise dispose of key-person life insurance held on an individual who is no longer a key person because the institution will no longer suffer a financial loss from the death of that person. However, when an individual upon whom key-person life insurance has been held is no longer a key person, an institution may be able to recharacterize its objective for the insurance policy as recovery of the cost of providing employee benefits. In such cases, the institution must demonstrate, through appropriate analysis and quantification, that the insurance coverage satisfies the retention conditions, as set forth in the preceding paragraph. For a state-chartered institution, the recharacterization and retention of such key-person life insurance must be permissible under applicable state law. In circumstances where a national bank or federal savings association would be required to surrender or otherwise dispose of key-person life insurance, a state-chartered institution must also surrender or otherwise dispose of a key-person policy unless the retention of the policy is permitted under applicable state law and the institution obtains the FDIC's consent to continue to hold the policy under section 24 or section 28 of the FDI Act, as appropriate.

Quantifying the Amount of Insurance Appropriate for the Institution's Objectives

Institutions are responsible for ensuring that they do not purchase excessive amounts of insurance coverage on their employees relative to salaries paid and the costs of benefits to recover. Examiners will evaluate an institution's BOLI holdings and make a supervisory judgment as to whether insurance amounts on employees are so excessive as to constitute speculation or an unsafe or unsound practice on a case-by-case basis, as they do for other aspects of an institution's operations. Such an evaluation would be based on the totality of the circumstances.

Institutions may use either the cost-recovery or cost-offset method to quantify the amount of insurance permissible for purchase to finance or recover employee benefit costs. When using the cost-offset approach, an institution must ensure that the projected increase in CSV each year over the expected duration of the BOLI is less than or equal to the expected employee benefit expense for that year. When using the cost-recovery method, regardless of an institution's quantification method, management must be able to support, with objective evidence, the reasonableness of all assumptions used in determining the appropriate amount of insurance coverage needed, including the rationale for its discount rates (when the cost-recovery method is used) and cost projections.

Applicability of Prior Guidance for Split-Dollar Arrangements

The pre-purchase analysis guidance in the interagency statement applies to life insurance policies used in split-dollar arrangements that are acquired after December 7, 2004. The guidance concerning the ongoing risk management of life insurance after its purchase applies to life insurance policies, including those used in split-dollar arrangements, regardless of when acquired.

The FDIC's prior guidance on split-dollar arrangements, which was included in supervisory guidance on BOLI that was issued in 1993, has been superseded; until the issuance of the interagency statement, the FDIC had generally followed the Office of the Comptroller of the Currency's prior guidelines from 2000. Otherwise, the prior guidance issued by the agencies on split-dollar life insurance remains in effect. Each agency issued the interagency statement under its own bulletin, letter, or notice. For example, the Federal Reserve Board's issuance of the interagency statement is cross-referenced in SR-04-19, and the prior guidance on split-dollar life insurance arrangements is not superseded.

Accounting Considerations

An institution may purchase multiple permanent insurance policies from the same insurance carrier, with each policy having its own surrender charges. In some cases, the insurance carrier will issue a rider or other contractual provision stating that it will waive the surrender charges if all of the policies are surrendered at the same time. Because it is not known at any balance-sheet date whether one or more of the policies will be surrendered before the deaths of the insureds, the possibility that the institution will surrender all of these policies simultaneously and avoid the surrender charges is a gain contingency. This guidance should be applied to all insurance policies held by an institution regardless of when they were acquired. Therefore, an institution that has purchased BOLI is required to report the CSV on the bank's balance sheet net of the surrender charges (even if the policies have been in force for some time and the institution's auditors have not previously required reporting the CSV net of the surrender charges).

Based on the agencies' review of FASB Technical Bulletin No. 85-4, "Accounting for Purchases of Life Insurance" (TB 85-4), including its appendix, the agencies believe that TB 85-4 is intended to be applied on a policy-by-policy basis. It, therefore, does not permit the aggregation of multiple separate policies for balance-sheet-measurement purposes. Accordingly, the agencies do not intend to defer to institutions or their auditors on this issue. As of the balance-sheet date, an institution should determine the amount that could be realized under each separate insurance policy on a stand-alone basis without regard to the existence of other insurance policies or riders covering multiple policies. If a single insurance policy covers more than one individual, the realizable amount of the entire policy should be determined. A single insurance policy covering multiple individuals should not be subdivided into hypothetical separate policies for each covered individual, even if the carrier reports CSVs for each covered individual.

If a change in an institution's accounting for its holdings of life insurance is necessary for regulatory reporting purposes, the institution should follow Accounting Principles Board Opinion No. 20, "Accounting Changes"(APB 20).[17] APB 20 defines various types of accounting changes and addresses the reporting of corrections of errors in previously issued financial statements. APB 20 states that "[e]rrors in financial statements result from mathematical mistakes, mistakes in the application of accounting principles, or oversight or misuse of facts that existed at the time the financial statements were prepared."

17. Effective December 15, 2005, APB 20 will be replaced by FASB Statement No. 154, "Accounting Changes and Error Corrections—A replacement of APB Opinion No. 20 and FASB Statement No. 3."

For regulatory reporting purposes, an institution must determine whether the reason for a change in its accounting for its holdings of life insurance meets the APB 20 definition of an accounting error. If the reason for the change meets this definition and the amount is material, the error should be reported as a prior-period adjustment in the institution's regulatory reports. Otherwise, the effect of the correction of the error should be reported in current earnings. If the effect of the correction of the error is material, the institution should also consult with its primary federal regulatory agency to determine whether any previously filed regulatory reports should be amended. For the Call Report, the institution should report the amount of the adjustment in Schedule RI-A, item 2, ''Restatements due to corrections of material accounting errors and changes in accounting principles,'' with an explanation in Schedule RI-E, item 4. The effect of the correction of the error on income and expenses since the beginning of the period in which the correction of prior-period earnings is reported should be reflected in each affected income and expense account on a year-to-date basis in the Call Report Income Statement (Schedule RI), not as a direct adjustment to retained earnings.

Rate of Return to the Bank in Split-Dollar Insurance Arrangements

The agencies would consider the institution's economic interest in a split-dollar life insurance arrangement policy, at a minimum, to be a return of the premiums paid plus a reasonable rate of return. The agencies would generally consider a reasonable rate of return to be one that provides the bank a return that is commensurate with alternative investments having similar risk characteristics (including credit quality and term) at the time in which the bank enters into the split-dollar arrangement. The rate of return is to be calculated net of any payments made (or to be made) from insurance proceeds to the employee's beneficiaries.

The agencies look at the economic value of compensation arrangements when determining the reasonableness of split-dollar compensation, but the agencies do not rely solely on income tax rules for determining this economic value. Other factors that the agencies might consider include, but are not limited to, the benefit of a split-dollar arrangement to the employee as a percentage of salary and the expected length of time until the institution recovers its invested funds.

1. To determine the level and direction of risk that purchases and holdings of life insurance pose to the state member bank, and to recommend corrective action, as appropriate.
2. To perform—
   a. a risk assessment that summarizes the level of inherent risk by risk category, and
   b. an assessment of the adequacy of the board of directors' and management's oversight of the activity, including an assessment of the bank's internal control framework.
3. To ensure that the risk assessment considers a state member bank's purchase and risk management of its—
   a. broad bank-owned life insurance (BOLI) programs, in which life insurance is purchased on a group of employees to offset employee benefit programs and the bank is the beneficiary;
   b. split-dollar insurance arrangements for individual (usually senior-level) bank employees; and
   c. holdings of key-person insurance.
4. Recognizing that management may not be as familiar with insurance products as it is with more-traditional bank products, to adequately identify and assess the risks of BOLI, as well as the risk exposures that may arise from purchases and holdings of life insurance.[1]
5. To apply a forward-looking approach to the review of a bank's purchase and risk management of life insurance, recognizing that the bank may be exposed to increasing operational risks as a result of its large purchases or holdings of this product. These risks may arise from—
   a. separate-account assets that contain holdings of complex equity-linked notes and derivative products;
   b. the growing use of guaranteed minimum death benefits and other complex guarantee structures, which may increase the operational risk to banks purchasing significant amounts of life insurance; and
   c. the potential losses that could result from—
      - inadequate recordkeeping, which may be related to tracking the potentially large variety of contracts and agreements and the potentially large number of insured current and former employees covered by the contracts, and
      - a failure to ensure that contract agreements between the insurance company, the vendor(s), and the employees are properly executed and honored.

1. As noted in more depth in section 4042.1, the December 7, 2004, Interagency Statement on the Purchase and Risk Management of Life Insurance, these risks include operational, liquidity, credit, legal, and reputational risk. Operational risk arises in part from the vast array of new life insurance products and structures being offered and from the complexity of tax considerations related to the products, under various state insurable-interest and federal tax laws.

PRELIMINARY RISK ASSESSMENT

1. Consider the following, among other relevant criteria as appropriate, when determining whether to include the review of bank-owned life insurance (BOLI) in the examination scope:
   a. the volume, growth, and complexity of BOLI purchases and holdings
      - Consider the amount of the bank's BOLI holdings, measured by the total of their cash surrender values (CSVs) as a percentage of capital, and determine whether the resulting percentage is an asset concentration of capital. (For state member banks, the Federal Reserve has defined the capital base for determining this concentration threshold to be a percentage of tier 1 capital plus the allowance for loan and lease losses.) Determine whether the BOLI holdings have grown or declined significantly in recent years, when compared with the BOLI holdings of peer banks (consult the Federal Reserve System's intranet for applicable surveillance and monitoring data).
      - Obtain a breakout of the CSV of BOLI assets, as reported on the bank's balance sheet, including the amounts attributable to split-dollar insurance arrangements, general BOLI plans covering a group of employees to recover the cost of employee compensation and benefit programs, and the amount, if any, attributable to key-person insurance.
      - Obtain a listing of the amount of the bank's reimbursable premium payments under split-dollar life insurance arrangements and the amount receivable for these policies, which is to be booked as "other assets" on the bank's balance sheet.
      - Determine whether a portion of the CSV is in separate-account holdings of a life insurance company. If the bank has separate-account holdings, determine (1) the composition of the underlying separate-account assets and (2) if these assets constitute higher-risk investments, including equity-linked notes, mortgage-backed securities with significant interest-rate risk, or other investments entailing significant market risk.
      - Determine whether any of the life insurance policies are held in out-of-state trusts. If so, ascertain—
        — whether management and the board of directors can demonstrate that they have performed an independent legal analysis to ensure that the legal structure employed does not jeopardize the bank's insurable interest in the insurance policies or its access to the policy proceeds, as applicable; and
        — whether the trust arrangement inappropriately disadvantages the bank (for example, by permitting inappropriate investments or permitting the insured or the beneficiary to borrow against the policy holding in such a way that could jeopardize the bank's ability to recover amounts owed to it under the trust agreement).
   b. BOLI concentrations
      - Determine if there is a CSV concentration of life insurance to one carrier in excess of 25 percent that includes both separate-account and general-account BOLI holdings.
      - Determine if there are any market-risk concentrations within the underlying separate-account assets, including, for example, interest-sensitive fixed-income holdings.
      - Determine if there are any equity-linked notes or direct equity holdings in the separate accounts.
      - Determine if the bank holds any large-exposure life insurance policies on particular individuals. If so, determine if the policies are split-dollar arrangements and, if so—
        — whether the board or a board committee has evaluated the rea-

sonableness of the compensation as part of the employee's overall compensation package, and
— whether the board or a board committee has determined that the overall compensation is appropriate.

c. the appropriateness and recency of materials presented to the bank's board of directors concerning the bank's purchase and risk management of life insurance relative to its insurance purchases and holdings
d. the appropriateness and recency of audits and compliance reviews of the bank's purchases and risk management of life insurance
e. the overall financial condition of the bank, its supervisory rating, and any concerns or potential concerns about its liquidity

2. Depending upon the outcome of the preliminary risk assessment and other relevant factors, consider performing the following examination procedures.

OPERATIONAL-RISK ASSESSMENT

Senior Management and Board Oversight

1. Evaluate whether board and senior management oversight is effective and ensures that the bank's purchases and holdings of BOLI are consistent with safe and sound banking practices.
2. Determine whether the board of directors understands the complex risk characteristics of the bank's insurance holdings and the role of BOLI in the bank's overall business strategy.

Accounting Considerations

3. Determine if the bank's financial and regulatory reporting of its life insurance activities follows applicable generally accepted accounting principles (GAAP), including the following guidance:
   a. *Financial Accounting Standards Board (FASB) Technical Bulletin No. 85-4, "Accounting for Purchases of Life Insurance" (TB 85-4).* Only the amount that can be realized under an insurance contract as of the balance-sheet date (that is, the CSV reported to the bank by the insurance carrier, less any applicable surrender charges not reflected by the insurance carrier in the reported CSV) is reported as an asset. Since there is no right of offset, a BOLI investment is reported as an asset separately from any deferred compensation liability, provided that it was not purchased in connection with a tax-qualified plan.
   b. *Call Report instructions.* The bank is required to report the carrying value of its BOLI holdings (CSV net of applicable surrender charges) as a component of "other assets" and to report the earnings on these holdings as "other noninterest income."
4. Verify that the bank's deferred compensation agreements were accounted for using the guidance in the February 11, 2004, Interagency Advisory on Accounting for Deferred Compensation Agreements and Bank-Owned Life Insurance.
5. Verify that any accounts receivable that represent the bank's reimbursable life insurance premiums paid are recorded as unimpaired account receivables (for example, life insurance policies that are not impaired as a result of declining CSVs backing the obligations or employees borrowing against CSVs). (Impaired amounts should be expensed.)

Policies and Procedures

6. Assess the adequacy of the bank's policies and procedures governing its BOLI purchases and holdings, including its guidelines to limit the aggregate CSV of policies from one insurance company as well as limit the aggregate CSV of policies from all insurance companies.
7. Verify if the bank's board of directors or the board's designated committee approved BOLI purchases in excess of 25 percent of capital or in excess of any lower internal limit. (For state member banks, the Federal Reserve has defined the capital base for determining this concentration threshold to be a percentage of tier 1 capital plus the

allowance for loan and lease losses.)

8. Determine the reasonableness of the bank's internal limits and whether management and the board of directors have considered, before purchasing BOLI, the bank's legal lending limit, its applicable state and federal capital concentration threshold, and any other applicable state restrictions on BOLI.
9. For banks that may have other credit exposures to insurance companies, determine if the bank has considered the credit exposures arising from its BOLI purchases when assessing its overall credit exposure to a carrier and to the insurance industry.
10. Determine whether the bank's management has justified and analyzed the risks associated with a significant increase in the bank's BOLI holdings.
11. Determine if the bank has advised its board of directors of the existence of the December 7, 2004, Interagency Statement on the Purchase and Risk Management of Life Insurance and of the risks associated with BOLI.

Pre-Purchase Analysis

12. Ascertain whether the bank maintains adequate records of its pre-purchase analysis of BOLI.
13. Evaluate whether the bank's board of directors, or a designated board committee, and senior management understand the risks, rewards, and unique characteristics of BOLI.

Need for Insurance, Economic Benefits, and Appropriate Insurance Type

14. Determine whether the bank identified the specific risk of loss to which it is exposed or the specific costs to be recovered by the purchase of life insurance.
15. Determine whether the bank analyzed the costs and benefits of planned BOLI purchases.

Amount of Insurance Appropriate for the Institution's Objectives

16. Find out if the bank estimated the size of its employee benefit obligation or the risk of loss to be covered in order to ensure that the amount of BOLI purchased was not excessive in relation to this estimate and the associated product risks.
17. Determine whether management can support, with objective evidence, the reasonableness of all of the assumptions used in determining the appropriate amount of insurance coverage needed by the bank, including the rationale for its discount rates and cost projections.

Vendor Qualifications

18. Evaluate whether the bank's management assessed its own knowledge of insurance risks, the vendor's qualifications, the amount of resources the bank is willing to spend to administer and service the BOLI, and the vendor's ability to honor the long-term financial commitments associated with BOLI.

Characteristics of Available Insurance Products

19. Evaluate whether the bank's management has reviewed and understands the characteristics of the various life insurance products available and of the products it has acquired.
20. Ascertain if and how the bank's management reviewed and selected the life insurance product characteristics that best matched its objectives, needs, and risk tolerance. Ascertain whether management evaluated and documented, before the bank acquired BOLI, the risks of the variety and complexity of life insurance products considered, how the selected insurance product works, the variables that affect the product's performance, and the applicable tax and accounting treatments.
21. Determine whether the bank's management reviewed and documented its consideration of the types and design features of BOLI. Determine whether management reviewed and documented the negotiable features associated with a separate-account insurance product (for example, its investment options, terms, and conditions; the cost of stable value protection (SVP); deferred acquisition costs (DAC); and mortality options) and with any SVP provider that

may have been separately contracted by the insurance carrier.

22. Verify that the bank's management conducted a thorough review of life insurance policies before acquiring the policies. Ascertain if management determined how the accounting rules would apply to those policies and if it understood any ambiguous contract provisions, such as costs, charges, or reserves, that may affect the amount of a policy's CSV.

Tax and Insurable-Interest Implications

23. For the bank's pre-acquisition review of BOLI and its subsequent BOLI purchases, verify that the bank's management considered and documented its analysis of the financial impact of surrendering a policy (for example, any tax implications).
24. Verify that the bank's management obtained appropriate legal reviews. An appropriate legal review ensures that—
    a. the bank complies with applicable tax and state insurable-interest requirements, and
    b. the bank's insured amounts are *not* excessive (therefore, the bank is not involved in impermissible speculation or unsafe and unsound banking practices).

Carrier Selection

25. Find out if the bank (1) reviewed the BOLI product's design and pricing and the administrative services of the proposed carrier and (2) compared these services with those of other insurance carriers.
26. Ascertain whether the bank's management reviewed the selected carrier's ongoing long-term ability to commit to the BOLI product, as well as its credit ratings, general reputation, experience in the marketplace, and past performance.
27. Determine if the bank performed a credit analysis on the selected BOLI carriers and if the analysis was consistent with safe and sound banking practices for commercial lending.

Split-Dollar or Other Insurance Arrangements That Result in Additional Insured Employee Compensation

28. When a bank acquires insurance that permits a bank officer or employee to designate a beneficiary or provides the officer or employee with additional compensation, determine if the bank identified and quantified its total compensation objective. Determine if the bank ensured (1) that the acquired split-dollar life or other insurance arrangement was consistent with that objective, including when insurance compensation is combined with all other compensation being provided, and (2) that the total compensation was not excessive.
29. Verify that the bank and the insured have entered into a written agreement that specifically states the bank's rights, the insured individual's rights, and the rights of any other parties (trusts or beneficiaries) to the policy's CSV and death benefits.
30. Verify that the bank's shareholders and their family members (who are not bank officers, directors, or employees and who do not provide goods and services to the bank) do not receive compensation in the form of split-dollar life or other insurance coverage benefits.
31. Determine whether the bank's management has assessed the bank's ability to borrow against the CSV of its split-dollar life insurance policies, as well as the ability of other parties (whether an insured officer, employee, or noninstitution owner) to borrow against the policy CSV, without impairing the bank's financial interest in the policy proceeds. Determine also—
    a. if the bank can liquidate the policy in order to meet liquidity needs; or
    b. if the bank effects an early policy surrender (such as might occur if an employee terminates his or her employment), if the surrender would preclude the bank from recovering its premium payments and a market rate of return on the premiums invested.
32. Determine if and how management verified that the bank would be able to recover its premium payments plus a market rate of return on the premiums invested, after the payment of policy proceeds to the employee's beneficiary under the split-dollar arrangement.

Other Elements of Pre-Purchase Analysis

33. Ascertain whether the bank's management thoroughly evaluated all significant risks. Determine whether management has established procedures to identify, measure, monitor, and control those risks.
34. Find out if the bank, before acquiring BOLI, thoroughly analyzed its associated risks and benefits. As appropriate, determine whether the bank compared the risks of BOLI with those of alternative methods for recovering costs associated with the loss of key persons, providing pre- and post-retirement employee benefits, or providing additional employee compensation.

Post-Purchase Analysis

35. Find out if management reviewed at least annually the bank's life insurance purchases and holdings with the bank's board of directors.[1] Ascertain if the review included, at a minimum—
    a. a comprehensive assessment of the specific risks associated with the bank's permanent insurance acquisitions;
    b. an identification of the bank's employees who are or will be insured (for example, vice presidents and above, employees of a certain grade level, etc.);
    c. an assessment of death benefit amounts relative to employee salaries;
    d. a calculation of the percentage of insured persons still employed by the bank;
    e. an evaluation of the material changes to BOLI risk-management policies;
    f. an assessment of the effects of policy exchanges;
    g. an analysis of mortality performance and the impact on income;
    h. an evaluation of material findings from internal and external audits and independent risk-management reviews;
    i. an identification of the reason for, and the tax implications of, any policy surrenders; and
    j. a peer analysis of BOLI holdings.

1. More-frequent reviews should be conducted if significant changes to the BOLI program are anticipated, such as additional purchases, a decline in the financial condition of the insurance carrier(s), anticipated policy surrenders, or changes in tax laws or interpretations that could have an impact on the performance of BOLI.

LIQUIDITY-RISK ASSESSMENT

1. Find out if management, before the bank's purchase of permanent insurance, recognized the illiquid nature of the bank's acquisition of its permanent insurance products. Determine whether management ensured that the bank had the long-term financial flexibility to continue holding the insurance assets for their full term of expected use.
2. Determine if management, before the bank's purchase of permanent insurance, adequately considered the contractual arrangements and product types that limit product liquidity in order to best optimize the value of the bank's insurance assets and their possible future use as liquidity and funding sources. Contract provisions that should be considered include—
    a. 1035 exchange fees and ‘‘crawl-out restrictions,’’
    b. provisions that would result in the product's categorization for federal tax purposes as a modified endowment contract (MEC) or a non-MEC contract, and
    c. SVP contract provisions that may limit the bank's ability to surrender a policy early or that would increase the cost of an early surrender.

REPUTATION-RISK ASSESSMENT

1. Ascertain whether the bank has taken steps, including obtaining written consent from its insured officers and employees, to reduce its reputation risk that may result from BOLI purchases.
2. Determine if the bank maintains appropriate documentation evidencing that it obtained a formal written consent from its insured officers and employees.
3. Find out what segment of the employee base the bank has insured (i.e., officers or non-officers) and if the bank has taken out very high death benefit policies on employees, including lower-level employees.

CREDIT-RISK ASSESSMENT

1. Determine if the bank's management con-

ducted an independent financial analysis of the insurance carrier before the bank's purchase of a life insurance policy.
   a. Ascertain if management continues to monitor the life insurance company's condition on an ongoing basis.
   b. Verify that the bank's credit-risk management function participated in the review and approval of insurance carriers.
2. Determine whether the bank considered its legal lending limit, its credit concentration guidelines (the aggregate exposures to individual insurance carriers and the life insurance industry, including other bank credit relationships, such as credit exposures involving loans and derivatives), and any state restrictions on BOLI holdings.
3. Determine whether the bank's credit analysis of its BOLI holdings evaluated whether the policies to be acquired were either separate-account or general-account policies.
   a. Find out whether the separate-account policies included an SVP contract to protect the bank (as a policyholder) from declines in the fair value of separate-account assets.
   b. Ascertain if the bank evaluated the insurance carrier's separately contracted SVP provider's repayment capacity.

MARKET-RISK ASSESSMENT

1. Determine whether management fully understood (before the bank purchased its separate-account products)—
   a. how the life insurance products expose the bank to interest-rate risk;
   b. the instruments governing the investment policy, as well as how the separate account is managed;
   c. the inherent risk of a separate account; and
   d. whether the bank's risk from the purchase of separate-account products was appropriate.
2. For general-account products, ascertain if management understands the interest-crediting option the bank chose when purchasing the insurance policy.
3. Find out if the bank has established and if it maintains appropriate monitoring and reporting systems for interest-rate fluctuations and their effect on separate-account assets.
4. Find out if the bank has acquired an SVP contract for its separate-account policy in order to reduce income-statement volatility. (SVP contracts protect against declines in value attributable to changes in interest rates; they do not cover default risk.)
5. If the bank has not purchased an SVP contract, determine if management has established and maintained monitoring and reporting systems that will recognize and respond to price fluctuations in the fair value of separate-account assets.
6. If the bank has purchased an equity-linked variable life insurance policy, determine whether it is characterized as an effective economic hedge against the bank's equity-linked obligations under its employee benefit plans. (An effective hedge exists when changes in the economic value of the liability or other risk exposure being hedged are matched by counterbalancing changes in the value of the hedging instruments. The economic hedging criteria for equity-linked insurance products lessen the effect of price risk because changes in the amount of the equity-linked liability are required to offset changes in the value of the separate-account assets.)
7. If the bank is purchasing or has purchased a separate-account insurance product involving equity securities, determine if the bank's management has performed further analysis that—
   a. compares the equity-linked liability being hedged and the equity securities in the separate account,
   b. determines a target range for the hedge-effectiveness ratio and establishes a method for measuring ongoing hedge effectiveness, and
   c. establishes a process for analyzing and reporting to management and the board of directors the effect of the hedge on the bank's earnings and capital ratios (both with and without the hedging transaction).

COMPLIANCE/LEGAL-RISK ASSESSMENT

1. Determine whether the bank's compliance

and audit functions have evaluated its compliance with applicable state insurable-interest and federal tax laws in order to protect the bank's earnings and capital from the loss of tax benefits or from the imposition of fines or penalties by regulatory authorities for violations of, or noncompliance with, laws, rulings, regulations, prescribed practices, and ethical standards.

2. When the bank owns separate-account BOLI, determine whether the bank has implemented and maintains internal control policies and procedures that adequately ensure that it does not take any action that might be interpreted as exercising "control" over separate-account assets.
3. Determine whether the bank split commissions between a vendor and the bank's own subsidiary or affiliate insurance agency when purchasing life insurance. If so, determine whether the bank's compliance function has assessed the bank's compliance with state and federal securities and insurance laws regarding fee and commission arrangements.
4. Ascertain whether the bank seeks and documents the advice of legal counsel when determining legal and regulatory issues, requirements, and concerns related to its potential purchase or ownership of BOLI.
5. For a general-account insurance product, determine if the bank has assigned a standard risk weight of 100 percent to the general-account asset.
6. For a BOLI separate-account product (when the bank uses the look-through approach to assign risk weights according to the risk-based capital rules)—
   a. review the bank's documentation, and determine if the bank adequately verified that the separate-account BOLI assets are protected from the insurance company's general creditors in the event of the insurance company's insolvency;
   b. determine if the standard risk weight of 100 percent was assigned to the bank's BOLI assets when the bank's documentation is inadequate or does not exist;
   c. verify that a 100 percent risk weight has been assigned to (1) the portion of the bank's insurance asset that represents general-account claims on the insurer (such as DAC and mortality reserves that are realizable on the balance-sheet date) and (2) any portion of the carrying value attributable to an SVP contract (or if the SVP provider is not an insurance company, verify that the correct risk weight has been assigned for that obligor); and
   d. if the bank used a pro rata approach to risk-weighting the carrying value of a qualifying separate-account policy—
      - verify that the risk weight is applied to the separate account based on the most risky portfolio that could be held by the separate account (as stated in the investment agreement), except for any portions of the carrying value that are general-account claims attributable to either DAC or an SVP (which are generally risk-weighted at 100 percent);
      - verify that in no case may the assigned risk weight for the bank's entire separate-account holding be less than 20 percent; and
      - when the sum of the permitted investments across market sectors in the investment agreement is greater than 100 percent, determine if the bank assigned the highest risk weight for the maximum amount permitted in that asset class, and then applied the next-highest risk weights to the other asset classes until the aggregate of the permitted amounts equals 100 percent.

Examiners should use only those internal control questions that are appropriate, given the size, complexity, and growth of a bank's bank-owned life insurance (BOLI) holdings.

PRELIMINARY RISK ASSESSMENT

1. Have the steps for conducting a preliminary risk assessment been followed, as they are set forth in section 4042.3? Have other relevant factors been considered to determine if further examination review may be warranted, in accordance with risk-focused supervision guidelines?
2. What particular factors have been identified to warrant a review of the bank's purchases and risk management of life insurance?

OPERATIONAL-RISK ASSESSMENT

Senior Management and Board of Directors Oversight

1. Has senior management and the board of directors initiated and maintained effective oversight of the bank's BOLI by—
   a. performing a thorough pre-purchase analysis of its risks and rewards and a post-purchase risk assessment?
   b. determining the permissibility of the bank's BOLI purchases and holdings under both the applicable state and federal requirements (whichever requirements are more restrictive)?
   c. determining the types and kinds of risks that are associated with BOLI?
   d. ascertaining and reviewing the safety-and-soundness considerations associated with the bank's BOLI?
   e. understanding the complex risk characteristics of the bank's insurance holdings and what role BOLI is to play in the bank's overall business?
2. Does the bank have a comprehensive risk-management process for purchasing and holding BOLI?

Accounting Considerations

3. When accounting for its holdings of life insurance, did the bank follow the guidance in FASB's Technical Bulletin No. 85-4, "Accounting for Purchases of Life Insurance"? Are the bank's insurance policies reported on its balance sheet on the basis of each policy's cash surrender value (CSV), less any applicable surrender charges that are not reflected in the reported CSV?
4. On the bank's Call Report, did the bank's management —
   a. report the carrying value of its BOLI holdings as an "other asset"?
   b. report the earnings on the bank's holdings as "other noninterest income"?
   c. report the CSV separately, as required if the CSV amount exceeded the reporting threshold?
   d. expense only the noninvestment portion of the premium, in the case of bank-owned policies?
   e. expense the premium for employee-owned insurance purchased by the bank and record a receivable in "other assets" for any portion of the premium to be reimbursed to the bank under a contractual agreement?
5. Were the bank's deferred compensation agreements accounted for using the guidance in the February 11, 2004, Interagency Advisory on Accounting for Deferred Compensation Agreements and Bank-Owned Life Insurance?

Policies and Procedures

6. Does the bank have comprehensive policies and procedures, including guidelines, that limit the aggregate CSV of policies from any one insurance company, as well as the aggregate CSV of policies from all insurance companies?
   a. Does the board of directors or a designated board committee require senior management to provide adequate and appropriate justification for establishing or revising internal CSV limits on the amount of BOLI the bank holds? Does

this justification take into account the bank's legal lending limits, its capital and credit concentration threshold, and any applicable laws and regulations?

b. Is written justification required when the amount of the bank's BOLI holdings approaches or exceeds 25 percent of the bank's capital (tier 1 capital plus the allowance for loan and lease losses)? Does the board of directors or a board committee approve this justification?

Pre-Purchase Analysis

7. Did the bank's management perform a written pre-purchase analysis of its BOLI products?
8. Did management identify the bank's need for BOLI, the appropriate type of insurance to be acquired, and the economic benefits to be derived from the purchase of BOLI? Did this analysis accomplish the following:
   a. identify the specific risk of loss to be covered by the insurance, or the costs the insurance is supposed to cover?
   b. determine what type BOLI (for example, general- or separate-account) and what BOLI features are needed, before acquiring the product?
   c. evaluate the permissibility and market risk of any underlying separate-account asset holdings, if separate-account BOLI is held?
   d. analyze projected policy values (CSV and death benefits) using various interest-crediting rates and mortality cost assumptions?
   e. estimate the size of the employee benefit obligation or the risk of loss to be covered? Did management ensure that the amount of BOLI coverage was appropriate for the bank's objectives and that BOLI was not excessive in relation to this estimate and the associated product risks?
   f. review the range of assumptions? Was management able to justify the assumptions with objective evidence, and deem them reasonable in view of previous and expected market conditions?
   g. assess whether the present value of the BOLI's expected future cash flows (net of the costs of the insurance) is less than the estimated present value of the expected after-tax employee benefit costs, when the bank uses BOLI to recover the costs of providing employee benefits?
9. Did the bank's management —
   a. review and assess its own knowledge of insurance risks, the vendor's qualifications, and the amount of the bank's resources that will be needed to administer and service the BOLI?
   b. demonstrate its familiarity with the technical details of the bank's insurance assets, and is management able to explain the reasons for and the risks associated with the product design features that have been selected?
   c. make appropriate inquiries to determine whether the vendor has the financial ability to honor its long-term commitments over an extended period of time?
   d. assure itself of the vendor's commitment to investing in the operational infrastructure that is necessary to support the BOLI?
   e. undertake its own independent review and not rely solely on prepackaged, vendor-supplied compliance information (such reliance is a potential cause for supervisory action)?
   f. properly evaluate the characteristics of the available insurance products against the bank's objectives, needs, and risk tolerance?
   g. determine if the bank's need for insurance on key persons or on a borrower's loan resulted in a matching of the maturity of the term or declining term insurance to the key person's expected tenure or the maturity of the borrower's loan?
   h. conduct a review of the insurance carrier that included—
      - a credit analysis of the potential insurance carrier (the analysis should have been performed in a manner consistent with safe and sound banking practices for commercial lending)?
      - a review of the bank's needs and a comparison of those needs with the proposed carrier's product design, pricing, and administrative services?
      - a review of the insurance carrier's commitment to the BOLI product, as well as the carrier's general reputation, experience in the marketplace, and past performance?

i. determine whether the total amount of compensation and insurance to be provided to an employee is excessive, if the purchased BOLI will result in the payment of additional compensation?
j. analyze the associated significant credit risks and the bank's ability to monitor and respond to those risks?
k. as appropriate, analyze the risks and benefits of BOLI, compared with other available methods for recovering costs associated with the loss of key persons, providing pre- and post-retirement employee benefits, or providing additional employee compensation?
l. sufficiently document its comprehensive pre-purchase analysis (including its analysis of both the types and product designs of purchased BOLI and the bank's overall level of BOLI holdings)?

Post-Purchase Analysis

10. Do management and the board of directors annually review the performance of the bank's insurance assets? Does the annual review include—
    a. a comprehensive assessment of the specific risks associated with permanent insurance acquisitions?
    b. an identification of employees who are or will be insured (e.g., vice presidents and above, employees of a certain grade level)?
    c. an assessment of death benefit amounts relative to employee salaries?
    d. a calculation of the percentage of insured persons still employed by the institution?
    e. an evaluation of the material changes to BOLI risk-management policies?
    f. an assessment of the effects of policy exchanges?
    g. an analysis of mortality performance and the impact on income?
    h. an evaluation of material findings from internal and external audits and independent risk-management reviews?
    i. an identification of the reason for and the tax implications of any policy surrenders?
    j. a peer analysis of BOLI holdings?

Tax and Insurable-Interest Implications

11. Has the bank's management explicitly considered the financial impact (for example, the tax provisions and penalties) of surrendering a BOLI policy?
12. Does the bank's management have or has it obtained appropriate legal review to ensure that it will be in compliance with applicable tax and state insurable-interest requirements? Is management aware of the relevant tax features of the insurance assets, including whether the bank's purchase would—
    a. make the bank subject to the alternative minimum tax?
    b. jeopardize the tax-advantaged status of the bank's insurance holdings?
    c. qualify (under applicable state law) an insurable ownership interest in the BOLI policy covering the bank's officers or its employees (including any applicable state law pertaining to the insured's consent and the amounts of allowable insurance coverage for an employee)?
13. Did the bank establish an out-of-state trust to hold its BOLI assets, and, if so, has the bank adequately assessed its insurable interest, given the arrangement?

LIQUIDITY-RISK ASSESSMENT

1. Has the bank's management fully recognized and considered the illiquid nature of the BOLI to be acquired? (An institution's BOLI holdings should be considered when assessing liquidity and assigning the component rating for liquidity.)
2. Did management determine if the bank has the long-term financial flexibility to hold the insurance asset for the full term of its expected use?

REPUTATION-RISK ASSESSMENT

1. Has the bank's management implemented procedures to ensure that the bank maintains appropriate documentation that evidences employees' informed consent for the bank's purchase of insurance on their lives? Do these procedures ensure that the bank

obtains employees' explicit consent before purchasing the insurance?

2. Has the bank obtained insurance products that insure large segments of its employee base (including the bank's non-officers)? Do these policies provide very high death benefits on employees, possibly causing the bank to be exposed to increased reputation risk if explicit consent was not obtained from the employees?

CREDIT-RISK ASSESSMENT

1. Did the bank's management conduct an independent financial analysis of the insurance carrier before purchasing the life insurance policy?
   a. Does management continue to monitor the life insurance company's financial condition on an ongoing basis?
   b. Did the bank's credit-risk management function participate in the review and approval of insurance carriers?
2. When establishing exposure limits for aggregate BOLI holdings and exposures to individual carriers, did the bank's management consider—
   a. the bank's legal lending limit?
   b. the applicable state and federal credit concentration exposure guidelines?
   c. the aggregate CSV exposures as a percentage of the bank's capital?
3. Has the bank's credit-risk management process taken into account credit exposures arising from both BOLI holdings and other credit exposures (loans, derivatives, and other insurance products) when measuring exposures to individual carriers?
4. Did the bank's credit analysis of its BOLI holdings consider whether the policies to be acquired were separate-account or general-account policies?
   a. For the separate-account policies, did the credit review include a risk analysis of the underlying separate-account assets?
   b. For separate-account policies that include a stable value protection (SVP) contract, has the repayment capacity of the insurance carrier's separately contracted SVP providers been evaluated?

MARKET-RISK ASSESSMENT

1. Did management adequately assess the interest-rate risk exposure of BOLI before purchasing the products for separate-account and general-account assets?
2. Has the bank's management reviewed, and does it understand the instruments governing the separate-account investment policy and its management?
   a. Does the bank's management understand the risk inherent within the separate account?
   b. Has the bank's management determined if the risk is appropriate?
3. Have monitoring and reporting systems been established that will enable the bank's management to monitor, measure, and appropriately manage interest-rate risk exposure from BOLI holdings when assessing the bank's overall sensitivity to interest-rate risk?

COMPLIANCE/LEGAL-RISK ASSESSMENT

1. Has the bank's audit and/or compliance function reviewed the bank's legal and regulatory requirements as they pertain to life insurance holdings? Did the review consider—
   a. state insurable-interest laws?
   b. the Employee Retirement Income Security Act of 1974 (ERISA)?
   c. the Federal Reserve Board's Regulation W (12 CFR 223)?
   d. applicable federal prohibitions on insider loans, including the Federal Reserve Board's Regulation O, that may apply to split-dollar life insurance arrangements?
   e. the interagency guidelines for establishing standards for safety and soundness?[1]
   f. other state and federal regulations applicable to BOLI?
2. To ensure that the life insurance qualifies for its tax-advantaged status, has the bank's management implemented and maintained internal policies and procedures to ensure that "control" will not be exercised over any of the separate-account assets, espe-

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

cially those involving privately placed policies?

3. Does the bank's board of directors, its designated board committee, and its management seek the assistance of legal counsel when determining the legal and regulatory issues related to the acquisition and holding of life insurance policies?
4. Has management thoroughly reviewed, and does it understand, the instruments governing the investment policy and the management of a separate account, before purchasing a separate-account policy?
5. If the bank has not purchased SVP for a separate-account BOLI policy, has management established the appropriate monitoring and reporting systems that will enable it to recognize and respond to price fluctuations in the fair value of the separate-account assets?
6. When the bank considers or purchases a separate-account BOLI product involving equity securities, does it analyze the equity securities? Does this analysis—
   a. compare the specific equity-linked liability being hedged against the securities held in a separate account?
   b. establish a target ratio for hedge effectiveness, as well as a method for measuring hedge effectiveness on an ongoing basis?
   c. establish a process for analyzing and reporting to the board of directors, its designated committee, and senior management the effect of the hedge on the bank's earnings and capital ratios (this analysis should include a consideration of the results both with and without the hedging transaction)?
7. When reporting its risk-based capital, has the bank ensured that it accurately calculates and reports its risk-weighted assets for BOLI holdings according to the risk-based capital guidelines and the December 7, 2004, Interagency Statement on the Purchase and Risk Management of Life Insurance (see section 4042.1 and SR-04-19 and its attachment)?
   a. For a general-account insurance product, has the bank applied a standard risk weight of 100 percent to the general-account asset?
   b. When the bank has applied a look-through approach for separate-account holdings—
      - has management determined if BOLI assets would be protected from the insurance company's general creditors in the event of its insolvency? Has the bank documented its assessment that BOLI assets are protected?
      - has the portion of the carrying value of the separate-account policy (that reflects the amounts attributable to the insurer's DAC and mortality reserves, and any other portion that is attributable to the carrying value of an SVP contract) been risk-weighted using the 100 percent risk weight applicable to the insurer's general-account obligations? Or, if the SVP provider is not an insurance company, has the portion of the carrying value been risk-weighted as appropriate for that obligor?
8. When the bank has used a pro rata approach to risk-weighting the carrying value of a qualifying separate-account policy, did it use the appropriate procedures, as outlined in the December 7, 2004, Interagency Statement on the Purchase and Risk Management of Life Insurance (see section 4042.1 and SR-04-19 and its attachment)?
   a. Has the bank ensured that its assigned aggregate risk weight for all separate-account BOLI holdings will be 20 percent or more?
   b. When the sum of the permitted investments across market sectors in the investment agreement is greater than 100 percent, was the highest risk weight applied for the maximum amount permitted in that asset class, and was the next-highest risk weight then applied until the cumulative permitted amounts equal 100 percent?

Banking organizations have long been engaged in the sale of insurance products and annuities, although these activities historically have been subject to several restrictions. For example, until recently, national banks could sell most types of insurance, but only through an agency located in a small town. Bank holding companies also were permitted to engage in only limited insurance agency activities under the Bank Holding Company Act. State-chartered banks, on the other hand, generally have been permitted to engage in insurance sales activities as agent to the extent permitted by state law.

The Gramm-Leach-Bliley Act of 1999 (the GLB Act), however, authorized national banks and state-chartered member banks to sell all types of insurance products through a financial subsidiary. *The GLB Act generally did not change the powers of banks to sell insurance directly.* As a result of the GLB Act and marketplace developments, many banking organizations are increasing the range and volume of their insurance and annuities sales activities. To the extent permitted by applicable law, banking organizations may conduct insurance and annuity sales activities through a variety of structures and delivery channels, including ownership of an insurance underwriter or an insurance agency or broker, the employment by a bank of licensed agents, a joint marketing arrangement with a producer,[1] independent agents located at a bank's office, direct mail, telemarketing, and Internet marketing.

A banking organization may also conduct insurance or annuity sales activities through a managing general agent (MGA). An MGA is a wholesaler of insurance products and services to insurance agents. The MGA has a contractual agreement with an insurance carrier to assume functions for the carrier, which may include marketing, accounting, data processing, policy recordkeeping, and monitoring or processing claims. The MGA may rely on various local agents or agencies to sell the carrier's products. Most states require an MGA to be licensed.

OVERVIEW AND SCOPE

The following guidance pertains to state member banks that are either directly or indirectly engaged in the sale of insurance or annuity products. Examiner guidance on performing appropriate risk assessments of a state member bank's insurance and annuity sales activities is included.[2] Additionally, guidance is provided for examining a state member bank's compliance with the consumer protection rules relating to insurance and annuities sales activities that are contained in the Board's December 2000 revisions to Regulation H (subpart H) (12 CFR 208.81–86), "Consumer Protection in Sales of Insurance" (CPSI). Subpart H, which became effective on October 1, 2001, implements the consumer protection requirements of the GLB Act, which are codified at 12 USC 1831x. (See 65 *Fed. Reg.* 75841, December 4, 2000.) The regulation applies not only to the sale of insurance products or annuities by the bank, but also to activities of any person engaged in insurance product or annuity sales on behalf of the bank, as discussed in this guidance. The guidance is generally not applicable to debt-cancellation contracts and debt-suspension agreements, unless these products are considered to be insurance products by the state in which the sales activities are conducted.

The GLB Act permits state member banks that are not authorized by applicable state law to sell insurance directly to do so through a financial subsidiary.[3] A financial subsidiary engaged in insurance sales may be located wherever state

1. The term "producer" refers broadly to persons, partnerships, associations, limited liability corporations, etc., that hold a license to sell or solicit contracts of insurance to the public. Insurance agents and agencies are producers who, through a written contractual arrangement known as a direct appointment, represent one or more insurance underwriters. Independent agents and agencies are those producers that sell products underwritten by one or more insurance underwriters. Captive agents and agencies represent a specific underwriter and sell only its products. Brokers are producers that represent the purchaser of insurance and obtain bids from competing underwriters on behalf of their clients. State insurance laws and regulations often distinguish between an insurance agent and a broker; in practice, the terms are often used interchangeably.

2. The term "risk assessment" denotes the work product described in SR-97-24, "Risk-Focused Framework for Supervision of Large Complex Institutions," and entails an analysis of (1) the level of inherent risk by type of risk (operational, legal, market, liquidity, credit, and reputation risk) for a business line or business function, (2) the adequacy of management controls over that business line or business function, and (3) the direction of the risk (increasing, decreasing, or stable).

3. Rules pertaining to state member bank financial subsid-

law permits the establishment and operation of an insurance agency. Such subsidiaries, however, would be subject to state licensing and other requirements.

The Federal Reserve is responsible for evaluating the consolidated risk profile of a state member bank. This reponsibility includes determining the risks posed to the state member bank from the insurance and annuity sales activities it conducts directly or indirectly, as well as determining the effectiveness of the bank's risk-management systems. However, the GLB Act also established a regulatory framework that is designed to ensure that the Federal Reserve coordinates with, and relies to the extent possible on information from, the state insurance authorities when it is supervising the insurance activities a state member bank conducts through a functionally regulated subsidiary.

Consistent with the Federal Reserve's risk-focused framework for supervising banking organizations, resources allocated to the review of insurance sales activities should be commensurate with the significance of the activities and the risk they pose to the bank. The scope of the review depends on the significance of the activity to the state member bank and the extent to which the bank is directly involved in the activity. Examiner judgment is required to tailor the reviews, as appropriate, on the basis of the legal, organizational, and risk-management structure of the state member bank's insurance and annuity sales activities and on other relevant factors.[4]

SUPERVISORY APPROACH FOR THE REVIEW OF INSURANCE AND ANNUITY SALES ACTIVITIES

Supervisory Objective

The primary objective for the review of a state member bank's insurance and annuity sales activities is to determine the level and direction of risk such activities pose to the state member bank. The review includes insurance and annuity sales activities the state member bank conducts directly (by or in conjunction with a subsidiary or affiliate) or through a third-party arrangement. Primary risks that may arise from insurance sales activities include operational, legal, and reputational risk. If the state member bank does not adequately manage these risks, they could have an adverse impact on its earnings and capital. The examiner should produce (1) a risk assessment that summarizes the level of inherent risk to the state member bank by risk category and (2) an assessment of the adequacy of board of directors' and management oversight of the insurance and annuity sales activities, including their internal control framework. For those state member banks selling insurance or annuity products, or that enter into arrangements under which another party sells insurance or annuity products at the bank's offices or on behalf of the bank, a second objective of the review is to determine the bank's compliance with the consumer protection provisions of the GLB Act and the CPSI regulation.

State Regulation of Insurance Activities

Historically, insurance activities have primarily been regulated by the states. In 1945, Congress passed the McCarran-Ferguson Act, which granted states the power to regulate most aspects of the insurance business. The McCarran-Ferguson Act states that "no act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any state for the purpose of regulating the business of insurance, or which imposes a fee or tax upon such business, unless such Act specifically relates to the business of insurance" (15 USC 1012(b)).

State regulation of insurance producers is centered on the protection of the consumer and consists primarily of licensing and continuing education requirements for producers. A producer generally must obtain a license from each state in which it sells insurance and for each product sold. Each state in which a producer sells insurance has regulatory authority over the producer's activities in the state.

The GLB Act does include several provisions that are designed to keep states from (1) unfairly regulating a bank to prevent it from engaging in

iaries are found in the Board's Regulation H (12 CFR 208.71–77).

4. See SR-02-01, "Revisions to Bank Holding Company Supervision Procedures for Organizations with Total Consolidated Assets of $5 Billion or Less," and section 1000.1 for a discussion of the Federal Reserve's risk-focused examinations and the risk-focused supervision program for community banking organizations. See also SR-97-24.

authorized insurance activities or (2) otherwise discriminating against banks engaged in insurance activities. These provisions are complex and beyond the scope of this guidance. However, the GLB Act generally does not prohibit a state from requiring a bank or bank employee engaged in insurance sales, solicitation, or cross-marketing activities to be licensed within the state.

State insurance regulatory authorities do not conduct routine, periodic examinations of an insurance producer. A state examination of an insurance producer is generally conducted only on an ad hoc basis and is primarily based on the volume and severity of consumer complaints. The state examination may also be based in part on the producer's market share and on previous examination findings. Additionally, a review of a producer would typically not assess its financial condition.

A state's market conduct examination of *insurance sales practices* is focused at the insurance-underwriter level.[5] The insurance underwriter is generally held accountable for compliance with state insurance laws to protect the consumer from the unfair sales practices of any producer that markets the insurance underwriter's products. Market conduct examinations of an insurance underwriter may potentially uncover a concern about a particular producer, such as a bank-affiliated producer.[6] However, in the past, a state insurance regulatory authority has not typically examined a producer unless the producer is owned by the insurance underwriter.

Generally, market conduct examinations include reviews of the insurance underwriters' complaint handling, producer licensing, policyholder service, and marketing and sales practices. Typically, a state authority will direct a corrective action for insurance sales activity at the underwriter. The states generally have specific guidance for their market conduct examinations of life, health, and property/casualty[7] lines of business—guidance that corresponds to regulations related to advertising, misrepresentations, and disclosures for these different business lines. The reports of examination issued by the state insurance departments are usually available to the public.

Because the underwriter, not the producer, is liable to the insured, the failure of an insurance producer generally would not result in financial loss to consumers or state guarantee funds. Consequently, there are no regulatory capital requirements for insurance producers, nor do states require regulatory reporting of financial statement data on insurance producers. While the underwriter is ultimately liable to the insured, in some instances, a producer and its owner may be held liable for misrepresentations, as well as for violations of laws and regulations.

Functional Regulation

Under the GLB Act, banking supervisors' reviews of insurance or securities activities conducted in a bank's functionally regulated subsidiary are not to be extensions of more traditional bank-like supervision. Rather, to the extent possible, bank supervisors are to rely on the functional regulators to appropriately supervise the insurance and securities activities of a functionally regulated subsidiary. A functionally regulated subsidiary includes any subsidiary of a bank that (1) is engaged in insurance activities and subject to supervision by a state insurance regulator or (2) is registered as a broker-dealer with the Securities and Exchange Commission. The GLB Act does *not* limit the Federal Reserve's supervisory authority with respect to a *bank* or the insurance activities conducted by a bank. The functional regulators for insurance sales activities, including the activities of insurance producers, consist of the insurance departments in each of the 50 states, the District of Columbia, Puerto Rico, the U.S. Virgin Islands, American Samoa, and Guam.

5. Generally, market conduct reviews of *insurance underwriters* are conducted on an ad hoc basis, triggered primarily by the volume and severity of consumer complaints, and are based on the underwriter's market share or on previous examination findings. In some states, however, market conduct reviews of insurance underwriters are conducted on a periodic, three- to five-year schedule.

6. The terms "insurance underwriter," "insurer," "insurance carrier," and "insurance company" are industry terms that apply similarly to the party to an insurance arrangement who undertakes to indemnify for losses, that is, the party that assumes the principal risk under the contract.

7. Property insurance indemnifies a person who has an interest in a physical property for loss of the property or the loss of its income-producing abilities. Casualty insurance is primarily concerned with the legal liability for losses caused by injury to persons or damage to the property of others. It may also include such diverse forms of insurance as crime insurance, boiler and machinery insurance, and aviation insurance. Many casualty insurers also underwrite surety bonds.

The GLB Act places certain limits on the ability of the Federal Reserve to examine, obtain reports from, or take enforcement action against a functionally regulated nondepository subsidiary of a state member bank. For purposes of these limitations, a subsidiary licensed by a state insurance department to conduct insurance sales activities is considered functionally regulated only with respect to its insurance activities and any activities incidental to these activities.[8]

The GLB Act indicates that the Federal Reserve must rely, to the fullest extent possible, on information obtained by the appropriate state insurance authority of a nondepository insurance agency subsidiary of a state member bank. In addition, the Federal Reserve may examine a functionally regulated subsidiary of a state member bank only in the following situations:

- The Federal Reserve has reasonable cause to believe that the subsidiary is engaged in activities that pose a material risk to an affiliated depository institution, as determined by the responsible Reserve Bank and Board staff.
- After reviewing relevant information (including information obtained from the appropriate functional regulator), it is determined that an examination is necessary to adequately understand and assess the banking organization's systems for monitoring and controlling the financial and operational risks that may pose a threat to the safety and soundness of an affiliated depository institution.
- On the basis of reports and other available information (including information obtained from the appropriate functional regulator), there is reasonable cause to believe that the subsidiary is not in compliance with a federal law that the Federal Reserve has specific jurisdiction to enforce with respect to the subsidiary (including limits relating to transactions with affiliated depository institutions), and the Federal Reserve cannot assess such compliance by examining the state member bank or other affiliated depository institution.

Other similar restrictions limit the ability of the Federal Reserve to obtain a report directly from, or take enforcement action against, a functionally regulated nonbank subsidiary of a state member bank. These GLB Act limitations do *not* apply to a state member bank even if the state member bank is itself licensed by a state insurance regulatory authority to conduct insurance sales activities.

Staff who are conducting reviews of state member bank insurance or annuity sales activities should be thoroughly familiar with SR-00-13, which provides guidance on reviews of functionally regulated state member bank subsidiaries. Reserve Bank staff may conduct an examination of a functionally regulated subsidiary, or request a specialized report from a functionally regulated subsidiary, only after obtaining approvals from the appropriate staff of the Board's Division of Banking Supervision and Regulation.

When preparing or updating the risk assessment of a state member bank's insurance or annuity sales activities, Federal Reserve staff, when appropriate, should coordinate their activities with the appropriate state insurance authorities. The Federal Reserve's supervision of state member banks engaged in insurance sales activities is not intended to replace or duplicate the regulation of insurance activities by the appropriate state insurance authorities.

Information Sharing with the Functional Regulator

The Federal Reserve and the National Association of Insurance Commissioners (NAIC) approved a model memorandum of understanding (MOU) on the sharing of confidential information between the Federal Reserve and individual state insurance departments.[9] The Board also approved the delegation of authority to the Board's general counsel to execute agreements with individual states, based on this MOU. Examiners should follow required Board administrative procedures before sharing any confidential information with a state insurance regulator. (These procedures generally require Federal Reserve staff to identify and forward to Board staff for review any confidential information that may be appropriate to share with the applicable

8. For example, if a state member bank subsidiary engages in mortgage lending and is also licensed as an insurance agency, it would be considered a functionally regulated subsidiary only to the extent of its insurance sales activities.

9. The NAIC is the organization of insurance regulators from the 50 states, the District of Columbia, and the four U. S. territories. The NAIC provides a forum for the development of uniform policy among the states and territories. The NAIC is not a governmental or regulatory body.

state insurance regulator concerning insurance sales activities conducted by state member banks.) The Board's Division of Consumer and Community Affairs CP Letter 2001-11 outlines the procedures for sharing consumer complaint information with state insurance regulators.

STATUTORY AND REGULATORY REQUIREMENTS AND POLICY GUIDANCE

Privacy Rule and the Fair Credit Reporting Act

State member banks that sell insurance to consumers must comply with the privacy provisions under title V of the GLB Act (12 USC 6801–6809), as implemented by the Board's Regulation P (12 CFR 216) (the privacy rule). Functionally regulated state member bank nonbank insurance agency subsidiaries are not covered by the Federal Reserve's privacy rule; however, they must comply with the privacy regulations (if any) issued by their relevant state insurance regulator.

The privacy rule regulates a state member bank's treatment of nonpublic personal information about a "consumer," an individual who obtains a financial product or service (such as insurance) from the institution for personal, family, or household purposes. The privacy rule generally requires a bank to provide a notice to each of its customers that describes its privacy policies and practices no later than when the bank establishes a business relationship with the customer. The privacy rule also generally prohibits a bank from disclosing any nonpublic personal information about a consumer to any nonaffiliated third party, unless the bank first provides to the consumer a privacy notice and a reasonable opportunity to prevent (or "opt out" of) the disclosure, and the consumer does not opt out. The privacy rule permits a financial institution to provide a joint notice with one or more of its affiliates or other financial institutions, as identified in the privacy notice itself, provided that the notice is accurate with respect to the institution and the other institutions.

While the privacy rule applies to the sharing of nonpublic personal information by a bank with nonaffiliated third parties, the sharing of certain consumer information with affiliates or nonaffiliates may be subject to the Fair Credit Reporting Act (FCRA) as well. For example, under the FCRA, if a bank wants to share with its insurance subsidiary information from a credit report or from a consumer application for credit (such as the consumer's assets, income, or marital status), the bank must first notify the consumer about the intended sharing and give the consumer an opportunity to opt out. The same rules would apply to an insurance company that wants to share information from credit reports or from applications for insurance with an affiliate or a third party.

Anti-Tying Prohibitions

Federal law (section 106(b) of the BHC Act Amendments of 1970 (12 USC 1972(b))) generally prohibits a bank from requiring that a customer purchase a product or service from the bank or an affiliate as a prerequisite to obtaining another product or service (or a discount on the other product or service) from the bank. This prohibition applies whether the customer is retail or institutional, or whether the transaction is on bank premises or off premises. For example, a state member bank may not require that a customer purchase insurance from the bank or a subsidiary or affiliate of the bank in order to obtain a loan from the bank (or a reduced interest rate on the loan).[10]

Policy Statement on Income from Sale of Credit Life Insurance

The Federal Reserve Board's Policy Statement on Income from Sale of Credit Life Insurance (see the *Federal Reserve Regulatory Service* at 3-1556) sets forth the principles and standards that apply to a bank's sales of credit life insurance and the limitations that apply to the receipt of income from those sales by certain individuals and entities associated with the bank. See also the examination procedures related to this policy statement in section 2130.3.

10. See section 2040.1 and "Tie-In Considerations of the BHC Act," section 3500.0, of the *Bank Holding Company Supervision Manual.*

RISK-MANAGEMENT PROGRAM

Elements of a Sound Insurance or Annuity Sales Program

A state member bank engaged in insurance or annuity sales activities should—

- conduct insurance sales programs in a safe and sound manner;
- have appropriate written policies and procedures in place that are commensurate with the volume and complexity of its insurance sales activities;
- obtain its board of directors' approval of the scope of the insurance and annuity sales program and of written policies and procedures for the program;
- effectively oversee the sales program activities, including third-party arrangements;
- have an effective, independent internal audit and compliance program;
- appropriately train and supervise the employees conducting insurance and annuity sales activities;
- take reasonable precautions to ensure that disclosures to customers for insurance and annuity sales and solicitations are complete and accurate and are in compliance with applicable laws and regulations;
- ensure compliance with all applicable federal, state, or other jurisdiction regulations, including compliance with sections 23A and 23B of the Federal Reserve Act as that act applies to affiliate transactions; and
- have controls in place to ensure accurate and timely financial reporting.

Every state member bank conducting insurance or annuity sales activities should have appropriate, board-approved policies, procedures, and controls in place to monitor and ensure that it complies with both federal and state regulatory requirements. Consistent with the principle of functional regulation, the Federal Reserve will rely primarily on the appropriate state insurance authorities to monitor and enforce compliance with applicable state insurance laws and regulations, including state consumer protection laws and regulations governing insurance sales.

Sales Practices and Handling of Customer Complaints

Every state member bank engaged in insurance or annuity sales activities should have board-approved policies and procedures for handling customer complaints related to these sales. The customer complaint process should provide for the recording and tracking of all complaints and require periodic reviews of complaints by compliance personnel. A state member bank's board of directors and senior management should also review complaints if the complaints involve significant compliance issues that may pose a risk to the state member bank.

Third-Party Arrangements

State member banks, to the extent permitted by applicable law, may enter into agreements with third parties, including unaffiliated agents or agencies, to sell insurance or annuities or provide expertise and services that otherwise would have to be developed in-house. Many banks hire third parties to assist in establishing an insurance program or to train their own insurance staff. A bank may also find it advantageous to offer more specialized insurance products through a third-party arrangement.

A state member bank's management should conduct a comprehensive review of an unaffiliated third party before entering into any arrangement to conduct insurance or annuity sales with the third party. The review should include an assessment of the third party's financial condition, management experience, reputation, and ability to fulfill its contractual obligations to the state member bank, which includes compliance with applicable consumer protection laws and regulations.

The state member bank's board of directors or its designated committee should approve any agreements with third parties. Agreements should outline the duties and responsibilities of each party; describe the third-party activities permitted on the institution's premises; address the sharing or use of confidential customer information; and define the terms for use of the state member bank's office space, equipment, and personnel. If an arrangement includes dual employees (for example, bank employees who are also employed by an independent third party), the agreement must provide for written employment contracts that specify the duties of these employees and their compensation arrangements.

In addition, a third-party agreement should specify that the third party will comply with all applicable laws and regulations and will conduct its activities in a manner consistent with the CPSI regulation, if applicable. The agreement should authorize the banking organization to monitor the third party's compliance with its agreement, as well as authorize the bank to have access to third-party records considered necessary to evaluate compliance. A state member bank that contracts with a functionally regulated third party should obtain from and review, as appropriate, any relevant, publicly available regulatory reports of examination of the third party.[11] Finally, the agreement should provide for indemnification of the institution by the unaffiliated third party for any losses caused by the conduct of the third party's employees in connection with its sales activities.

The state member bank is responsible for ensuring that any third party or dual employee selling insurance at or on behalf of the bank is appropriately trained either by the bank or the third party with respect to compliance with the minimum disclosures and other requirements of the CPSI regulation and applicable state regulations. The banking organization should obtain and review copies of third-party training and compliance materials to monitor the third party's performance of its disclosure and training obligations.

Designation, Training, and Supervision of Personnel

A state member bank hiring personnel to sell insurance or annuities should investigate the backgrounds of the prospective employees. When a candidate for employment has previous insurance industry experience, the state member bank should have procedures to determine whether the individual has been the subject of any disciplinary actions by state insurance regulators.[12]

The state member bank should require its own insurance or annuity sales personnel or third-party sales personnel selling at or on behalf of the bank to receive appropriate training and licensing. Training should cover appropriate policies and procedures for the bank's sales of insurance and annuity products. Personnel who are referring potential or established customers to a licensed insurance producer should also be trained to ensure that referrals are made in conformance with the CPSI regulation, if applicable. The training should also include procedures and guidance to ensure that an unlicensed or referring individual cannot be deemed to be acting as an insurance agent that is subject to licensing requirements.

When insurance or annuities are sold by a state member bank or third parties at an office of, or on behalf of, the organization, the institution should have policies and procedures to designate, by title or name, the individuals responsible for supervising insurance sales activities, as well as for supervising the referral activities of bank employees not authorized to sell these products. A state member bank also should designate supervisory personnel responsible for monitoring compliance with any third-party agreement, as well as with the CPSI regulation, if applicable.

Compliance

State member banks should have policies and procedures to ensure that insurance or annuity sales activities are conducted in compliance with applicable laws and regulations (including the CPSI regulation for sales conducted by or on behalf of the state member bank) and the institution's internal policies and procedures. Compliance procedures should identify any potential conflicts of interest and how such conflicts should be addressed. For example, sales-compensation programs should be conducted in a manner that would not expose the bank to undue legal or reputation risks. The compliance procedures should also provide for a system to monitor customer complaints and their resolution. Where applicable, compliance procedures also should call for verification that third-party sales are being conducted in a manner consistent with the governing agreement with the banking organization.

The compliance function should be conducted independently of the insurance and annuity prod-

11. The reports of examination issued by state insurance regulators are generally public documents. Many states do not conduct periodic examinations of insurance sales activities.

12. Information from the states on the issuance and termination of producer licenses and on producers' compliance with continuing education requirements is available from the NAIC database known as the National Insurance Producer Registry (NIPR).

uct sales and management activities. Compliance personnel should determine the scope and frequency of their reviews, and findings of compliance reviews should be reported directly to the state member bank's board of directors or to its designated board committee.

RISK ASSESSMENT OF INSURANCE AND ANNUITY SALES ACTIVITIES

A risk assessment of insurance activities may be accomplished in the course of conducting a regularly scheduled state member bank examination or as a targeted review. The purpose of preparing the risk assessment is to determine the level and direction of risk to the bank arising from its insurance and annuity sales activities. Risks to state member banks engaged in insurance and annuity sales programs consist primarily of legal, reputational, and operational risk, all of which may lead to financial loss. After completing the risk assessment, if material concerns remain, the Board's Division of Banking Supervision and Regulation staff should be consulted for further guidance.

Legal and reputational risk may arise from a variety of sources, such as fraud; noncompliance with statutory or regulatory requirements, including those pertaining to the handling of premiums collected on behalf of the underwriter; claims processing; insurance and annuity sales practices; and the handling of ''errors and omissions'' claims.[13] Other sources of legal and reputational risk may arise from failing to safeguard nonpublic customer information, a high volume of customer complaints, or public regulatory sanctions against a producer.

Legal and reputational risks may also arise from an agent's obligation to provide a customer with products that are suited to the customer's particular needs and are priced and sold in accordance with state regulations. Additionally, an agent or agency may be liable for failing to carry out the appropriate paperwork to bind a policy that it has sold to a customer, or for making an error in binding the policy. State insurance departments generally are permitted by law to suspend or revoke a producer's license and assess monetary penalties against a producer if warranted.

Operational risk may arise from errors in processing sales-related information or from a lack of appropriate controls over systems or staff responsible for carrying out the insurance or annuity sales activities. Additionally, state member banks that have recently commenced insurance or annuity sales activities, or that are expanding their insurance or annuity sales business, also are exposed to risk arising from inadequate strategic and financial planning associated with the activities, which could result in financial loss. Examiners should be attuned to risks that may arise from inadequate controls over insurance activities, a rapid expansion of the insurance or annuity sales programs offered by the state member bank, the introduction of new products or delivery channels, and legal and regulatory developments.

Operational risk may arise from inadequate premium-payment procedures and trust-account-balance administration by an agency. When the insurance agency bills the insured, the agent must comply with requirements for forwarding the payments to the insurer and for safekeeping the funds. Inadequate internal controls over this activity may result in the inappropriate use of these funds by the agent or agency. The state member bank should ensure that appropriate controls are in place to verify that all funds that are owed to the insurer or the insured are identified in the trust account and that the account is in balance.

When conducting a risk assessment, the examiner should first obtain relevant information to determine the existence and scale of insurance or annuity sales activity. Such information is available in the state member bank's Uniform Bank Performance Report (UBPR) and in other System reports on insurance activities. Relevant reports, including applicable balance sheets and income statements for the insurance and annuity sales activities, may also be obtained from the state member bank. When preparing a risk assessment for an insurance or annuity sales activity that is conducted by a functionally regulated nonbank subsidiary of a state member bank, examiners should rely, to the fullest extent possible, on information available from the state member bank and the appropriate state insurance regulator for the subsidiary. If information that is needed to assess the risk cannot be obtained from the state member bank or the

13. Errors and omissions insurance indemnifies the insured against loss sustained because of an error or oversight by the insured. For instance, an insurance agency generally purchases this type of coverage to protect itself against such things as failing to issue a policy.

applicable functional regulator, the examiner should consult with the appropriate designated Board staff. Requests should not be made directly to a functionally regulated nonbank insurance and annuity sales subsidiary of a state member bank without first obtaining approval from the appropriate Board staff.

CONSUMER PROTECTION IN SALES OF INSURANCE RULES

Overview of the CPSI Regulation

The CPSI regulation is applicable to all insured depository institutions.[14] The regulation, however, generally does not apply to nonbank affiliates or subsidiaries of a state member bank unless the company engages in the retail sale of insurance products or annuities at an office of, or on behalf of, an insured depository institution. Interpretations of the regulation issued by the federal banking agencies are found in appendix A of this section. Federal Reserve examiners are responsible for reviewing state member banks' compliance with the regulation.

The regulation applies to the retail sale of insurance products and annuities by banks or by any other person at an office of a bank, or acting on behalf of a bank. For purposes of the CPSI regulation, ''office'' means the premises of the bank where retail deposits are accepted. The regulation applies only to the retail sale of insurance or annuity products—that is, when the insurance is sold or marketed to an individual primarily for personal, family, or household purposes.

Misrepresentations Prohibited

The regulation prohibits a bank or other covered person from engaging in any practice or using any advertisement at any office of, or on behalf of, the bank or a subsidiary of the bank if the practice or advertisement could mislead any person or otherwise cause a reasonable person to erroneously believe—

- that the insurance product or annuity is backed by the federal government or the bank or is insured by the Federal Deposit Insurance Corporation (FDIC);
- that an insurance product or annuity does not have investment risk, including the potential that principal may be lost and the product may decline in value, when in fact the product or annuity does have such risks; or
- in the case of a bank or subsidiary of the bank at which insurance products or annuities are sold or offered for sale, that (1) the bank may condition approval of an extension of credit to a consumer by the bank or subsidiary on the purchase of an insurance product or annuity from the bank or a subsidiary of the bank, and (2) the consumer is not free to purchase the insurance product or annuity from another source.

The regulation also incorporates the anti-tying provisions of section 106(b) of the Bank Holding Company Act Amendments of 1970 (12 USC 1972). Additionally, banks are prohibited from selling life or health insurance products if the status of the applicant or insured as a victim of domestic violence or as a provider of services to domestic violence victims is considered as a factor in decision making on the product, except as expressly authorized by state law.

Insurance Disclosures

The CPSI regulation also requires that a bank or a person selling insurance at an office of, or on behalf of, a bank make the following affirmative disclosures (to the extent accurate), both orally and in writing, before the completion of the initial sale of an insurance product or an annuity to a consumer. However, sales by mail or, if the consumer consents, via electronic media (such as the Internet) do not require oral disclosure.

- The insurance product or annuity is not a deposit or other obligation of, or guaranteed by, the bank or an affiliate of the bank.
- The insurance product or annuity is not insured by the FDIC or any other U.S. government agency, the bank, or (if applicable) an affiliate of the bank.
- The insurance product or annuity, if applicable, has investment risk, including the possible loss of value.

14. The CPSI regulation applies to all federally insured depository institutions, including all federally chartered U.S. branches and state-chartered insured U.S. branches of foreign banking organizations.

For telephone sales, written disclosures must be mailed within three business days. The above disclosures must be included in advertisements and promotional materials for insurance products and annuities, unless the advertisements or promotional materials are of a general nature and describe or list the nature of services or products offered by the bank. Disclosures must be conspicuous and readily understandable.

Credit Disclosures

When an application for credit is made in connection with the solicitation, offer, or sale of an insurance product or annuity, the consumer must be notified that the bank may not condition the extension of credit on either (1) the consumer's purchase of an insurance product or annuity from the bank or any of its affiliates or (2) the consumer's agreement not to obtain, or a prohibition on the consumer from obtaining, an insurance product or annuity from an unaffiliated entity. These disclosures must be made both orally and in writing; however, applications taken by mail or, if the consumer consents, via electronic media, do not require oral disclosure. For telephone applications, the written disclosure must be mailed within three business days. The disclosures must be conspicuous and readily understandable.

Consumer Acknowledgment

The bank must obtain written or electronic acknowledgments of the consumer's receipt of the disclosures described above at the time they are made or at the completion of the initial purchase. For telephone sales, the bank must receive an oral acknowledgment and make a reasonable effort to obtain a subsequent written or electronic acknowledgment.

Location

Insurance and annuity sales activities must take place, to the extent practicable, in an area physically segregated from one where retail deposits are routinely accepted from the general public (such as teller windows). The bank must clearly identify and delineate areas where insurance and annuity sales activities occur.

Referrals

Any person who accepts deposits from the public in an area where deposits are routinely accepted may refer a consumer to a qualified person who sells insurance products or annuities only if the person making the referral receives no more than a one-time, nominal fee of a fixed dollar amount for the referral. The amount of the referral fee may *not* depend on whether a sale results from the referral.

Qualifications

A bank may not permit any person to sell or offer insurance products or annuities at its office or on its behalf, unless that person is at all times properly qualified and licensed under applicable state law for the specific products being sold or recommended.

Relationship of the CPSI Regulation to State Regulation

The GLB Act contains a legal framework for determining the effect of the CPSI regulation on state laws governing the sale of insurance, including state consumer protection standards. In general, if a state has legal requirements that are inconsistent with, or contrary to, the CPSI regulation, initially the federal regulation does not apply in the state. However, the federal banking agencies may, after consulting with the state involved, decide to preempt any inconsistent or contrary state laws if the agencies find that the CPSI regulation provides greater protections than the state laws. It is not expected that there will be significant conflict between state and federal laws in this area. If the consumer protection laws of a particular state appear to be inconsistent with and less stringent (that is, provide less consumer protection) than the CPSI regulation, examiners should inform the staff of the Board's Division of Banking Supervision and Regulation.

Relationship to Federal Reserve Guidance on the Sale of Nondeposit Investment Products

When a bank sells insurance products or annuities that also are securities (such as variable life insurance annuities), it must conform with the applicable Federal Reserve and interagency guidance pertaining to a bank's retail sales of nondeposit investment products (NDIPs).[15] If the CPSI regulation and the guidance pertaining to NDIPs conflict, the CPSI regulation prevails.

Examining a State Member Bank for Compliance with the CPSI Regulation

Examinations for compliance with the CPSI regulation should be conducted consistent with the risk-focused supervisory approach when a state member bank sells insurance products or annuities directly, or when a third party sells insurance or annuities at or on behalf of, a state member bank. To the extent practicable, the examiner should conduct the review at the state member bank. In certain instances, however, the examiner's review at the state member bank may identify potential supervisory concerns about the state member bank's compliance with the CPSI regulation as it pertains to insurance or annuities sales conducted by a functionally regulated nonbank affiliate or subsidiary of the state member bank that is selling insurance products or annuities at or on behalf of the state member bank.

If the examiner determines that an on-site review of a functionally regulated nonbank affiliate or subsidiary of the state member bank is appropriate to adequately assess the state member bank's compliance with the CPSI regulation, the examiner should discuss the situation with staff of the Board's Division of Banking Supervision and Regulation. The approval of the Division of Banking Supervision and Regulation's officer that is responsible for the supervisory policy and examination guidance pertaining to insurance and annuity sales activities should be obtained before examining or requesting any information directly from a functionally regulated nonbank affiliate or subsidiary of the state member bank that is selling insurance or annuity products at or on behalf of the state member bank.

The examination guidelines described in section 4043.3 apply to retail sales, solicitations, advertisements, or offers of insurance products and annuities by any state member bank or any other person that is engaged in such activities at an office of the bank or on behalf of the state member bank. For purposes of the CPSI regulation, activities "on behalf of a state member bank" include activities in which a person, whether at an office of the bank or at another location, sells, solicits, advertises, or offers an insurance product or annuity and in which at least one of the following applies:

- The person represents to a consumer that the sale, solicitation, advertisement, or offer of any insurance product or annuity is by or on behalf of the bank.
- The bank refers a consumer to a seller of insurance products or annuities, and the bank has a contractual arrangement to receive commissions or fees derived from the sale of an insurance product or annuity resulting from the bank's referral.
- Documents evidencing the sale, solicitation, advertising, or offer of an insurance product or annuity identify or refer to the bank.

15. Interagency Statement on Retail Sales of Nondeposit Investment Products, February 17, 1994. See SR-94-11.

APPENDIX A—JOINT INTERPRETATIONS OF THE CONSUMER PROTECTION IN SALES OF INSURANCE REGULATION

In response to a banking association's inquiries, the federal banking agencies jointly issued interpretations regarding the Consumer Protection in Sales of Insurance (CPSI) regulation.[1] A joint statement, issued on August 17, 2001, contains responses to a set of questions relating to disclosure and acknowledgment, the scope of applicability of the regulation, and compliance. Additionally, a February 28, 2003, joint statement responded to a request to clarify whether the disclosure requirements apply to renewals of pre-existing insurance policies sold before October 1, 2001, the effective date of the regulation. The issues raised and the banking agencies' responses are summarized below.

1. These letters, issued jointly by the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision, may be accessed on these agencies' web sites.

Disclosures

Credit Disclosures

A bank or other person who engages in insurance sales activities at an office of, or on behalf of, a bank (‘‘a covered person’’) must make the credit disclosures set forth in the regulation if a consumer is solicited to purchase insurance while the consumer’s loan application is pending. A consumer’s application for credit is still ‘‘pending’’ for purposes of the regulation if the depository institution has approved the consumer’s loan application but not yet notified the consumer. Until the consumer is notified of the loan approval, the covered person must provide the credit disclosures if the consumer is solicited, offered, or sold insurance.

Disclosures for Sales by Mail and Telephone

The regulation requires a covered person to provide oral disclosures and to obtain an oral acknowledgment of these disclosures when sales activities are conducted by telephone. This requirement applies regardless of whether the consumer will also receive and acknowledge written disclosures in person, through the mail, or electronically.

Use of Short-Form Insurance Disclosures

There is no short form for the credit disclosures. A depository institution, however, may use the short-form insurance disclosures set forth below in visual media (such as television broadcasting, ATM screens, billboards, signs, posters, and written advertisements and promotional materials):

- NOT A DEPOSIT
- NOT FDIC-INSURED
- NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY
- NOT GUARANTEED BY THE BANK
- MAY GO DOWN IN VALUE

Acknowledgment of Disclosures

Reasonable efforts to obtain written acknowledgment. The banking agencies have not prescribed any steps that must be taken for a depository institution’s efforts to obtain a written acknowledgment to be deemed ‘‘reasonable’’ in a transaction conducted by telephone. Examples of reasonable efforts, however, include—

- providing the consumer with a return-addressed envelope or similar means to facilitate the consumer’s return of the written acknowledgment,
- making a follow-up phone call or contact,
- sending a second mailing, or
- similar actions.

The covered person should (1) maintain documentation that the written disclosures and the request for written acknowledgment of those disclosures were mailed to the consumer and (2) should record his or her efforts to obtain the signed acknowledgment. The ‘‘reasonable efforts’’ policy exception for telephone sales does not apply to other types of transactions, such as mail solicitations, in which a covered person must obtain from the consumer a written (in electronic or paper form) acknowledgment.

Appropriate form or format for acknowledgment provided electronically. Electronic acknowledgments are not required to be in a specific format but must be consistent with the provisions of the CPSI regulation applicable to consumer acknowledgments. That is, the electronic acknowledgment must establish that the consumer has acknowledged receipt of the credit and insurance disclosures, as applicable.

Retention of acknowledgments by an insurance company. If an insurance company provides the disclosures and obtains the acknowledgment on behalf of a depository institution, the insurance company may retain the acknowledgment. The depository institution is responsible for ensuring that sales made ‘‘on behalf of’’ the depository institution are in compliance with the CPSI regulation. An insurance company may maintain documentation showing compliance with the CPSI regulation, but the depository institution should have access to such records and the records should be readily available for review by examiners.

Form of written acknowledgment. There is no prescribed form for the written acknowledgment. The regulation requires, however, that a covered person obtain the consumer's acknowledgment of receipt of the complete insurance and credit disclosures.

Timing of acknowledgment receipt. A covered person must obtain the consumer's acknowledgment either at the time a consumer receives disclosures or at the time of the initial purchase of an insurance product.

Oral acknowledgment of oral disclosure. The CPSI regulation does not prescribe any specific wording for an oral acknowledgment. However, if a covered person has made the insurance and credit disclosures orally, an affirmative response to the question "Do you acknowledge that you received this disclosure?" is acceptable.

Scope of the CPSI Regulation

Applicability to Private Mortgage Insurance

Depending on the nature of a depository institution's involvement in an insurance sales transaction, the CPSI regulation may cover sales of private mortgage insurance. If the depository institution itself purchases the insurance to protect its interest in mortgage loans it has issued and merely passes the costs of the insurance on to the mortgage borrowers, the transaction is not covered by the regulation. If, however, a consumer has the option of purchasing the private mortgage insurance and (1) the depository institution offers the private mortgage insurance to a consumer or (2) any other person offers the private mortgage insurance to a consumer at an office of a depository institution, or on behalf of a depository institution, the transaction would be covered by the regulation.

Applicability to Federal Crop Insurance

The CPSI regulation does not apply to federal crop insurance that is sold for commercial or business purposes. However, if the crop insurance is purchased by an individual primarily for family, personal, or household purposes, it would be covered.

Solicitations and Applications Distributed Before, but Returned After, the Effective Date of the CPSI Regulation

Direct-mail solicitations and "take-one" applications that are distributed on or after October 1, 2001, must comply with the CPSI regulation. If a consumer seeks to purchase insurance after the effective date of the regulation in response to a solicitation or advertisement that was distributed *before* that date, the depository institution would be in compliance with the regulation if the institution provides the consumer, before the initial sale, with the disclosures required by the regulation. These disclosures must be both written and oral, except that oral disclosures are not required if the consumer mails in the application.

Renewals of Insurance

Renewals of insurance are not subject to the disclosure requirements (see "Disclosures" above) but are subject to other requirements of the CPSI regulation. A "renewal" of insurance means continuation of coverage involving the same type of insurance for a consumer as issued by the same carrier. A renewal need not be on the same terms and conditions as the original policy, provided that the renewal does not involve a different type of insurance and the consumer has previously received the disclosures required by the regulation at the time of the initial sale. An upgrade in coverage at a time when a policy is not up for renewal would be treated as a renewal, provided that the solicitation and sale of the upgrade does not involve a different type of insurance and the consumer has previously received the disclosures required by the regulation at the initial sale.

Disclosures Required with Renewals of Insurance Coverage

The banking agencies' interpretations clarified that the CPSI regulation does not *mandate* disclosures for renewals of policies sold before October 1, 2001. Accordingly, the regulation does not require the disclosures to be furnished at the time of renewal of a policy, including a pre-existing policy. However, renewals are subject to the other provisions of the regulation. Moreover, the banking agencies would expect that, consistent with applicable safety-and-soundness requirements, depository institutions would take reasonable steps to avoid customer confusion in connection with renewals of preexisting policies.

''On-Behalf-of'' Test and Use of Corporate Name or Logo

Under the CPSI regulation, an affiliate of a bank is not considered to be acting ''on behalf of'' a bank simply because the affiliate's marketing or other materials use a corporate name or logo that is common to the bank and the affiliate. In general, this exclusion applies even if a bank and its parent holding company have a similar, but not identical, name. For example, if the names of all of the affiliates of a bank holding company share the words ''First National,'' an affiliate would not be considered to be engaged in an activity ''on behalf of'' an affiliated bank simply by using the terms ''First National'' as part of a corporate logo or identity. The affiliate would, however, be considered to be acting ''on behalf of'' an affiliated bank if the name of the bank (for example, ''First National Bank'') appears in a document as the seller, solicitor, advertiser, or offeror of insurance. A transaction also would be covered if it occurs on the premises of a depository institution or if one of the other prongs of the ''on-behalf-of'' test is met.

Compliance

Appropriate Documentation of an Oral Disclosure or Oral Acknowledgment

There is no specific documentation requirement for oral disclosures or acknowledgments. However, other applicable regulatory reporting standards would apply. Appropriate documentation of an oral disclosure would clearly show that the covered person made the credit and insurance disclosures to a consumer. Similarly, appropriate documentation of an oral acknowledgment would clearly show that the consumer acknowledged receiving the credit and insurance disclosures. For example, a tape recording of the conversation (where permitted by applicable laws) in which the covered person made the oral disclosures and received the oral acknowledgment would be acceptable. Another example would be a contemporaneous checklist completed by the covered person to indicate that he or she made the oral disclosures and received the oral acknowledgment. A contemporaneous note to the consumer's file would also be adequate. The documentation should be maintained in the consumer's file so that it is accessible to examiners.

Setting for Insurance Sales

A depository institution must identify the areas where insurance sales occur and must clearly delineate and distinguish those areas from areas where the depository institution's retail deposit-taking activities occur. Although the banking agencies did not define how depository institutions could ''clearly delineate and distinguish'' insurance areas, signage or other means may be used.

APPENDIX B—GLOSSARY

For additional definitions of insurance terms, see section 4040.1.

Accident and health insurance. A type of coverage that pays benefits in case of sickness, accidental injury, or accidental death. This coverage may provide for loss of income when the insured is disabled and provides reimbursement for medical expenses when the insured is ill. The insurance can provide for debt payment if it is taken out in conjunction with a loan. (See *Credit life insurance.*)

Actuary. A professional whose function is to calculate statistically various estimates for the field of insurance, including the estimated risk of loss on an insurable interest and the appropriate level for premiums and reserves.

Admitted insurer. An insurance company licensed by a state insurance department to underwrite insurance products in that state.

Agency contract (or agreement). An agreement that establishes the contractual relationship between an agent and an insurer.

Agent. A licensed insurance company representative under contract to one or more insurance companies. Depending on the line of insurance represented, an agent's power may include soliciting, advertising, and selling insurance; collecting premiums; claims processing; and effecting insurance coverage on behalf of an insurance underwriter. Agents are generally compensated by commissions on policies sold, although some may receive salaries.

- *Captive or exclusive agent.* An agent who represents a single insurer.
- *General agent.* An agent who is contractually awarded a specific geographic territory for an individual insurance company. They are responsible for building their own agency and usually represent only one insurer. Unlike exclusive agents, who usually receive a salary in addition to commissions, general agents are typically compensated on a commission basis only.
- *Independent agent.* An agent who is under contractual agreements with at least two different insurers. Typically, all of the independent agent's compensation originates from commissions.

Aggregate excess-of-loss reinsurance. A form of ''excess-of-loss'' reinsurance that indemnifies the ceding company against the amount by which all of the ceding company's losses incurred during a specific period (usually 12 months) exceed either (1) a predetermined dollar amount or (2) a percentage of the company's subject premiums. This type of contract is also commonly referred to as *stop-loss reinsurance* or *excess-of-loss ratio reinsurance.*

Allied lines. Various insurance coverages for additional types of losses and against losses by additional perils. The coverages are closely associated with and usually sold with fire insurance. Examples include coverage against loss by perils other than fire, coverage for sprinkler-leakage damage, and business-interruption coverage.

Annuity. A contract that provides for a series of payments payable over an individual's life span or other term, on the basis of an initial lump-sum contribution or series of payments made by the annuitant into the annuity during the accumulation phase of the contract.

- *Fixed-annuity contracts* provide for payments to annuitants at fixed, guaranteed minimum rates of interests.
- *Variable-annuity contracts* provide for payments based on the performance of annuity investments. Variable-annuity contracts are usually sold based on a series of payments and offer a range of investment or funding options, such as stocks, bonds, and money market fund investments. The annuity principal and the investment return are not guaranteed as they depend on the performance of the underlying funding option.

Annuity payments may commence with the execution of the annuity contract (*immediate annuity*) or may be deferred until some future date (*deferred annuity*).

Assigned risk. A risk that is not usually acceptable to insurers and is therefore assigned to a group of insurers who are required to share in the premium income and losses, in accordance with state requirements, in order for the insurer to sell insurance in the state.

Assignment. The legal transfer of one person's interest in an insurance policy to another person or business.

Bank-owned life insurance (BOLI). Life insurance purchased and owned by a bank to fund its exposure arising from employee compensation and benefit programs. In a typical BOLI program, a bank insures a group of employees; pays the life insurance policy premiums; owns the cash values of the policies, which are booked on the bank's balance sheet as ''other assets''; and is the beneficiary of the policies upon the death of any insured employee or former employee. (See SR-04-19 and section 4042.1.)

Beneficiary. The person or entity named in an insurance policy as the recipient of insurance proceeds upon the policyholder's death or when an endorsement matures. A revocable beneficiary can be changed by the policyholder at any time. An irrevocable beneficiary can be changed by the policyholder only with the written permission of the beneficiary.

Binder. A written or oral agreement, typically issued by an insurer, agent, or broker for property and casualty insurance, to indicate acceptance of a person's application for insurance and to provide interim coverage pending the insurance company's issuance of a binding policy.

Blanket bond. Coverage for an employer for loss incurred as a result of employee dishonesty.

Boiler and machinery insurance. Insurance against the sudden and accidental breakdown of boilers, machinery, and electrical equipment, including coverage for damage to the equipment and property damage, including the property of others. Coverage can be extended to cover consequential losses, including loss from interruption of business.

Broker. A person who represents the insurance buyer in the purchase of insurance. Brokers do not have the power to bind an insurance company to an insurance contract. Once a contract is accepted, the broker is compensated for the transaction through a commission from the insurance company. An individual may be licensed as both a broker and an agent.

Bulk reinsurance. A transaction sometimes defined by statute as any quota-share, surplus aid, or portfolio reinsurance agreement through which an insurer assumes all or a substantial portion of the liability of the reinsured company.

Captive insurer. An insurance company established by a parent firm to insure or reinsure its own risks or the risks of affiliated companies. A captive may also underwrite insurable risks of unaffiliated companies, typically the risks of its customers or employees. For example, a bank may form a captive insurance company to underwrite its own directors' and officers' risks or to underwrite credit life or private mortgage insurance (third-party risks) related to its lending activities.

Cash surrender value of life insurance. The amount of cash available to a life insurance policyholder upon the voluntary termination of a life insurance policy before it becomes payable by death or maturity.

Casualty insurance. Coverage for the liability arising from third-party claims against the insured for negligent acts or omissions causing bodily injury or property damage.

Cede. To transfer to a reinsurer all or part of the insurance or reinsurance risk underwritten by an insurance company.

Ceding commission. The fee paid to a reinsurance company for assuming the risk of a primary insurance company.

Ceding company (also cedant, reinsured, reassured). The insurer that transfers all or part of the insurance or reinsurance risk it has underwritten to another insurer or reinsurer via a reinsurance agreement.

Cession. The amount of insurance risk transferred to the reinsurer by the ceding company.

Churning. The illegal practice wherein a customer is persuaded to unnecessarily cancel one insurance policy in favor of buying a purportedly superior policy, often using the cash surrender value of the existing policy to pay the early premiums of the new policy. In such a transaction, the salesperson benefits from the additional commission awarded for booking a new policy.

Claim. A request for payment of a loss under the terms of a policy. Claims are payable in the manner suited to the insured risk. Life, property, casualty, health, and liability claims generally are paid in a lump sum after the loss is incurred. Disability and loss-of-time claims are paid periodically during the period of disability or through a discounted lump-sum payment.

Coinsurance. A provision in property and casualty insurance that requires the insured to maintain a specified amount of insurance based on the value of the property insured. Coinsurance clauses are also found in health insurance and require the insured to share a percentage of the loss.

Combination-plan reinsurance. A reinsurance agreement that combines the excess-of-loss and the quota-share forms of coverage within one contract, with the reinsurance premium established as a fixed percentage of the ceding company's subject premium. After deducting the excess recovery on any one loss for one risk, the reinsurer indemnifies the ceding company on the basis of a fixed quota-share percentage. If a loss does not exceed the excess-of-loss retention level, only the quota-share coverage applies.

Commission. The remuneration paid by insurance carriers to insurance agents and brokers for the sale of insurance and annuity products.

Comprehensive personal liability insurance. A type of insurance that reimburses the policyholder if he or she becomes liable to pay money for damage or injury he or she has caused to others. This coverage does not include automobile liability but does include almost every activity of the policyholder, except business operations.

Contractholder. The person, entity, or group to whom an annuity is issued.

Credit for reinsurance. A statutory accounting procedure, set forth under state insurance regulations, that permits a ceding company to treat amounts due from reinsurers as assets, or as offsets to liabilities, on the basis of the reinsurer's status.

Credit life insurance. A term insurance product issued on the life of a debtor that is tied to repayment of a specific loan or indebtedness. Proceeds of a credit life insurance policy are used to extinguish remaining indebtedness at the time of the borrower's death. The term is applied broadly to other forms of credit-related insurance that provide for debt satisfaction in the event of a borrower's disability, accident or illness, and unemployment. Credit life insurance has historically been among the most common bank insurance products.

Credit score. A number that is based on an analysis of an individual's credit history and that insurers may consider as an indicator of risk for purposes of underwriting insurance. Where not prohibited by state law, insurers may consider a person's credit history when underwriting personal lines.

Debt-cancellation contract/debt-suspension agreement. A loan term or contract between a lender and borrower whereby, for a fee, the lender agrees to cancel or suspend payment on the borrower's loan in the event of the borrowers's death, serious injury, unemployment, or other specified events. The Office of the Comptroller of the Currency considers these products to be banking products. State law determines whether these products are bank or insurance products for state-chartered banks and insurance companies.

Deductible. The amount a policyholder agrees to pay toward the total amount of insurance loss. The deductible may apply to each claim for a loss occurrence, such as each automobile accident, or to all claims made during a specified period, as with health insurance.

Directors and officers liability insurance. Liability insurance covering a corporation's obligation to reimburse its directors or officers for claims made against them for alleged wrongful acts. It also provides direct coverage for company directors and officers themselves in instances when corporate indemnification is not available.

Direct premiums written. Premiums received by an underwriter for all policies written during a given time period by the insurer, excluding those received through reinsurance assumed.

Direct writer. An insurance company that deals directly with the insured through a salaried representative, as opposed to those insurers that use agents. This term also refers to insurers that operate through exclusive agents. In reinsurance, a direct writer is the company that originally underwrites the insurance policies ceded.

Disability income insurance. An insurance product that provides income payment to the insured when his or her income is interrupted or terminated because of illness or accident.

Endowment insurance. A type of life insurance contract under which the insured receives the face value of the policy if he or she survives the endowment period. Otherwise, the beneficiary receives the face value of the policy upon the death of the insured.

Errors and omissions (E&O) liability insurance. Professional liability insurance that covers negligent acts or omissions resulting in loss. Insurance agents are continually exposed to the claim that inadequate or inappropriate coverage was recommended, resulting in a lack of coverage for losses incurred. The agent or the carrier may be responsible for coverage for legitimate claims.

Excess-of-loss reinsurance. A form of reinsurance whereby an insurer pays the amount of each claim for each risk up to a limit determined in advance, and the reinsurer pays the amount of the claim above that limit up to a specific sum. It includes various types of reinsurance, such as catastrophe reinsurance, per-risk reinsurance, per-occurrence reinsurance, and aggregate excess-of-loss reinsurance.

Excess-per-risk reinsurance. A form of excess-of-loss reinsurance that, subject to a specified limit, indemnifies the ceding company against the amount of loss in excess of a specified retention for each risk involved in each occurrence.

Excess and surplus lines. Property/casualty coverage that is unavailable from insurers licensed by the state (admitted insurers) and must be purchased from a nonadmitted underwriter.

Exposure. The aggregate of all policyholder limits of liability arising from policies written.

Face amount. The amount stated on the face of the insurance policy to be paid, depending on the type of coverage, upon death or maturity. It does not include dividend additions or additional amounts payable under accidental death or other special provisions.

Facultative reinsurance. Reinsurance of individual risks by offer and acceptance wherein the reinsurer retains the faculty to accept or reject each risk offered by the ceding company.

Facultative treaty. A reinsurance contract under which the ceding company has the option to cede and the reinsurer has the option to accept or decline classified risks of a specific business line. The contract merely reflects how individual facultative reinsurance shall be handled.

Financial guarantee insurance. Financial guarantee insurance is provided for a wide array of financial risks. Typically, coverage is provided for the fulfillment of a specific financial obligation originated in a business transaction. The insurer, in effect, is lending the debtor its own credit rating to enhance the debtor's creditworthiness.

Financial strength rating. Opinion as to an insurance company's ability to meet its senior policyholder obligations and claims. For many years, the principal rating agency for property and casualty insurers and life insurers has been A.M. Best. Other rating agencies, such as Fitch, Moody's, Standard and Poor's, and Weiss, also rate insurers.

Fixed annuity. See *Annuity.*

Flood insurance. A special insurance policy to protect against the risk of loss or damage to property caused by flooding. Regular homeowners' policies do not pay for damages caused by flooding.

General liability insurance. A broad commercial policy that covers all business liability exposures, such as product liability, completed operations, premises and operations, independent contractors, and other exposures that are not specifically excluded.

Gross premiums written. Total premiums for insurance written during a given period, before deduction for reinsurance ceded.

Group insurance. Insurance coverage typically issued to an employer under a master policy for the benefit of employees. The insurer usually does not condition coverage of the people that make up the group upon satisfactory medical examinations or other requirements. The individual members of the group hold certificates as evidence of their insurance.

Health insurance. An insurance product that provides benefits for medical expenses incurred as a result of sickness or accident, as well as income payments to replace lost income when the insured is unable to work because of illness, accident, or disability. This product may be in the form of traditional indemnity insurance or managed-care plans and may be underwritten on an individual or group basis.

Incurred but not reported (IBNR). The loss-reserve value established by insurance and reinsurance companies in recognition of their liability for future payments on losses that have occurred but have not yet been reported to them. This definition is often erroneously expanded to include adverse loss development on reported claims. The term *incurred but not enough reported (IBNER)* is being increasingly used to reflect more accurately the adverse development on inadequately reserved reported claims.

Inland marine insurance. A broad field of insurance that covers cargo being shipped by air, truck, or rail. It includes coverage for most property involved in transporting cargo as well as for bridges, tunnels, and communications systems.

Key person life insurance. Life insurance designed to cover the key employees of an employer. It may be written on a group- or an individual-policy basis.

Lapse. The termination or discontinuance of a policy resulting from the insured's failure to pay the premium due.

Liability insurance. Protects policyholders from financial loss due to liability resulting from injuries to other persons or damage to their property.

Lines. A term used in insurance to denote insurance business lines, as in ''commercial lines'' and ''personal lines.''

Long-term care insurance. Health insurance designed to supplement the cost of nursing home care or other care facilities in the event of a long-term illness or permanent disability or incapacity.

Managing general agent. A managing general agent (MGA) is a wholesaler of insurance products and services to insurance agents. An MGA receives contractual authority from an insurer to assume many of the insurance company's functions. The MGA may provide insurance products to the public through local insurance agents as well as provide services to an insurance company, including marketing, accounting, data processing, policy maintenance, and claims-monitoring and -processing services. Many insurance companies prefer the MGA distribution and management system for their insurance products because it avoids the high cost of establishing branch offices. Most states require that an MGA be licensed.

Manuscript policy. A policy written to include specific coverage or conditions not provided in a standard policy.

Morbidity. The incidence and severity of illness and disease in a defined class of insured persons.

Mortality. The rate at which members of a group die in a specified period of time or die from a specific illness.

Mortgage guarantee insurance. A product that insures lenders against nonpayment by borrowers. The policies are issued for a specified time period. Lenders who finance more than 80 percent of the property's fair value generally require such insurance.

Mortgage insurance. Life insurance that pays the balance of a mortgage even if the borrower dies. Coverage typically is in the form of term life insurance, with the coverage declining as the debt is paid off.

Multiperil insurance. An insurance contract providing coverage against many perils, usually combining liability and physical damage coverage.

Net premiums written. The amount of gross premiums written, after deduction for premiums ceded to reinsurers.

Ninety-day loss rule. A state requirement for an insurer to establish a loss provision for reinsurance recoverables over 90 days past due.

Obligatory treaty. A reinsurance contract under which business must be ceded in accordance with contract terms and must be accepted by the reinsurer.

Policyholder. The person or entity who owns an insurance policy. This is usually the insured person, but it may also be a relative of the insured, a partnership, or a corporation.

Premium. The payment, or one of the periodic payments, a policyholder agrees to make for insurance coverage.

Private mortgage insurance (PMI). Coverage for a mortgage lender against losses due to a collateral shortfall on a defaulted residential real estate loan. Most banks require borrowers to take out a PMI policy if a downpayment of less than 20 percent of a home's value is made at the time the loan is originated. PMI does not directly benefit a borrower, although its existence provides the opportunity to purchase a home to many people who otherwise would not qualify for a loan.

Producer. A person licensed to sell, solicit, or negotiate insurance.

Professional designations and organizations. Three of the most common insurance professional designations are chartered life underwriter (CLU), chartered property casualty underwriter (CPCU), and chartered financial consultant (ChFC). Insurance agents also join professional organizations such as the American Society of Chartered Life Underwriters, the International Association of Financial Planning, the National Association of Life Underwriters, the National Association of Health Underwriters, the American Council of Life Insurance, the Life Insurance Marketing and Research Association, the Life Underwriter Training Council, and the Million Dollar Round Table.

Pro rata reinsurance. A generic term describing all forms of "quota-share" and "surplus reinsurance," in which the reinsurer shares a pro rata portion of the losses and premiums of the ceding company.

Property insurance. Coverage for physical damage or destruction of real property (buildings, fixtures, and permanently attached equipment) and personal property (movable items that are not attached to land) that occurs during the policy period as a result of, for example, fire, windstorm, explosion, or vandalism.

Protected cell. A structure available to captive insurers underwriting risks of unaffiliated companies whereby the assets associated with the self-insurance program of one organization are segregated to provide legal-recourse protection from creditors of protected cells providing insurance coverage to other organizations.

Quota-share reinsurance. A form of pro rata reinsurance indemnifying the ceding company for a fixed percent of loss on each risk covered in the contract in consideration of the same percentage of the premium paid to the ceding company.

Rebating. Directly or indirectly giving or offering to give any portion of the premium or any other consideration to an insurance buyer as an inducement to purchase or renew the insurance. Rebates are forbidden under most state insurance codes.

Reinsurance. Insurance placed by an underwriter (the ceding company or reinsured) in another company to transfer or reduce the amount of the risk assumed under the original insurance policy (or group of policies).

Reinsurance premium. The consideration paid by a ceding company to a reinsurer for the coverage provided by the reinsurer.

Residual market. Also known as the shared market, it covers applications for insurance that were rejected by underwriters in the voluntary market that is covered by agency direct-marketing systems, perhaps because of high loss experience by the insured party. The residual market includes government insurance programs, specialty pools, and shared market mechanisms such as assigned-risk plans.

Retrocession. A reinsurance transaction whereby a reinsurer (the retrocedant) cedes all or part of the reinsurance risks it has assumed to another reinsurer (the retrocessionaire).

Retrospective rating. An insurance plan in which the current year's premium is based on the insured's own loss experience for that same period, subject to a maximum and minimum.

Rider. A written attachment, also known as an endorsement, to an insurance policy that changes the original policy to meet specific requirements, such as increasing or decreasing benefits or providing coverage for specific property items beyond that provided for under the insurance company's standard contract terms.

Self-insured retention (SIR). The percentage of a risk or potential loss assumed by an insured, whether in the form of a deductible, self-insurance, or no insurance at all.

Separate accounts. Certain life insurance assets and related liabilities that are segregated and maintained to meet specific investment objectives of contract holders, particularly those assets and liabilities associated with pension plans and variable products offered by life insurers, wherein the customer and not the insurer retains most of the investment and interest-rate risk.

Split-dollar life insurance. An arrangement that typically involves an agreement between an employer and an employee whereby the premium payment, cash values, policy ownership, and death benefits may be split. There are many variations of split-dollar arrangements, including arrangements in which a trust is created to facilitate estate planning. Split-dollar life insurance is designed to serve as a supplemental benefit to a particular company executive. The arrangement typically involves the payment of the insurance premium by the employer, with the death benefit accruing to the employee.

Subrogation. An insurance carrier may reserve the ‘‘right of subrogation’’ in the event of a loss. This means that the company may choose to take action to recover the amount of a claim paid to a covered insured if a third party caused the loss. After expenses, the amount recovered must be divided proportionately with the insured to cover any deductible for which the insured was responsible.

Term life insurance. An insurance product that provides, for a specified period of time, death coverage only. Typically, it has no savings component and, therefore, no cash value. Because term insurance provides only mortality protection, it generally provides the most coverage per premium dollar. Most term life insurance policies are renewable for one or more time periods up to a stipulated maximum age; however, premiums generally increase with the age of the policyholder.

Title insurance. Insurance that protects banks and mortgagees against unknown encumbrances against real estate by indemnifying the mortgagor and property owner in the event that clear ownership of the property is clouded by the discovery of faults in the title. Title insurance policies may be issued to either the mortgagor or the mortgagee or both. Title insurance is written largely only by companies specializing in this class of insurance.

Treaty reinsurance. A reinsurance contract under which the reinsured company agrees to cede, and the reinsurer agrees to assume, risks of a particular class or classes of business.

Twisting. In insurance, twisting involves making misrepresentations to a policyholder to induce the policyholder to terminate one policy and take out another policy with another company, when it is not to the insured’s benefit. Twisting is a violation of the Unfair Trade Practices Act. Twisting is similar to the ‘‘churning’’ concept in securities sales, and it results in increased commissions for the inducing agent.

Umbrella liability insurance. This type of liability insurance provides excess liability protection over the ‘‘underlying’’ liability insurance coverage to supplement underlying policies that have been reduced or exhausted by loss.

Underwriting. The process by which a company determines whether it can accept an application for insurance and by which it may charge an appropriate premium for those applications selected. For example, the underwriting process for life insurance classifies applicants by identifying such characteristics as age, sex, health, and occupation.

Unearned reinsurance premium. The part of the reinsurance premium that is applicable to the unexpired portion of the policies reinsured.

Universal life insurance. A form of permanent insurance designed to provide flexibility in premium payments and death benefit protection. The policyholder can pay maximum premiums and maintain a high cash surrender value. Alternatively, the policyholder can make minimal payments in an amount only large enough to cover mortality and other expense charges.

Variable annuity. See *Annuity.*

Variable life insurance. A form of whole life, or universal life, insurance in which the policyholder’s cash value is invested in ‘‘separate accounts’’ of the insurer. These accounts are segregated from the insurance carrier’s other asset holdings. Such separate account investments are generally not available to a carrier’s general creditors in the event of the carrier’s insolvency. The policyholder assumes the investment and price risk. Because variable life policies have investment features, life insurance agents selling these policies must be registered representatives of a broker-dealer licensed by the Financial Industry Regulatory Authority and registered with the Securities and Exchange Commission.

Vendors’ single-interest insurance. A form of force-placed insurance that is typically purchased by the bank to protect against loss or damage to loan collateral in which the bank has a security interest. The bank passes its expense for this insurance on to the consumer who has either refused or is unable to obtain property insurance.

Viatical settlement. The cashing in of a life insurance policy at a discount from face amount by policyholders who are often terminally ill and need the money for medical care. The purchaser becomes the policyholder as well as the beneficiary and assumes the premium payments of the policy.

Whole life insurance. A fixed-rate insurance product, with premiums and death benefits guaranteed over the duration of the policy. There is a cash value (essentially a savings account) that accrues to the policyholder tax deferred. A policyholder receives the cash value in lieu of death benefits if the policy matures or lapses before the insured's death. A policyholder also may borrow against the policy's accumulated cash value or use it to pay future premiums. For most whole life insurance policies, premiums are constant for the life of the insured's contract.

Insurance Sales Activities and Consumer Protection in Sales of Insurance

Examination Objectives

Effective date November 2003

Section 4043.2

1. To understand the volume and complexity of the state member bank's insurance or annuity program and insurance sales strategy.
2. To assess the financial results of the insurance and annuity sales activity compared with planned results.
3. To determine if the state member bank's insurance and annuity sales activities are effectively integrated into the risk-management, audit, and compliance functions and if the control environment is adequate.
4. To assess the adequacy of the state member bank's controls to ensure compliance with the applicable state and federal laws and regulations.
5. To assess the state member bank's level and direction of operational, legal, and reputational risks from the insurance or annuity sales activity.

The following objectives apply if insurance products or annuities are sold by a bank or another person at an office of, or on behalf of, the bank.

6. To assess the adequacy of the state member bank's oversight program for ensuring compliance with the Consumer Protection in Sales of Insurance (CPSI) regulation. (See section 4043.1.)
7. To assess the effectiveness of the state member bank's audit and compliance programs for the CPSI regulation.
8. To assess the state member bank's current compliance with the CPSI regulation.
9. To obtain commitments for corrective action when the state member bank is in violation of the CPSI regulation or when applicable policies, procedures, practices, or management oversight to protect against violations is deficient.

RISK ASSESSMENT OF INSURANCE AND ANNUITY SALES ACTIVITIES

The examiner should consider the following procedures, as appropriate, when conducting a risk assessment to determine the level and direction of risk exposure to the state member bank that is attributable to insurance or annuity sales activity. If there are specific areas of concern, the examiner should focus primarily on those areas.

1. *Scope of activities and strategies.* Assess the significance and complexity of the insurance or annuity sales program.
   a. Obtain a general overview of the scope of the state member bank's insurance or annuity sales activities and any anticipated or recent change in or expansion of such activities.
   b. Determine the state member bank's strategy for insurance or annuity sales, including strategies for cross-selling and referrals of insurance and banking products. Determine the institution's experience with any cross-marketing programs for both insurance business generated by the bank and bank business generated by insurance producers.
   c. Obtain two years' worth of income statements, balance sheets, and budget documents for the agency's activities. Compare the expected budget items with their actual results.
   d. Determine the volume and type of insurance or annuity products and services sold or solicited.
   e. Determine what other related services the state member bank provides in connection with its insurance or annuity sales activities, such as providing risk-management services to clients seeking advice on appropriate insurance coverages, claims processing, and other activities.
2. *Insurance sales products and concentrations.*
   a. Determine the composition of sales—
      - by line of business, such as property/casualty insurance, life insurance including annuities, and health insurance;
      - by the proportion of sales to commercial and retail customers; and
      - by the portion of sales that is credit related, such as credit life and credit health insurance.
   b. Determine any sales concentrations to particular entities, industries, or bank customers.
   c. Note any concentrations to large commercial accounts.
   d. Determine what insurance services are provided to the bank, its employees, and bank affiliates.
3. *Legal-entity and risk-management structure for insurance or annuity sales.*
   a. Obtain an organizational chart for the legal-entity and risk-management structure for the insurance or annuity sales activities.
   b. Determine—
      - whether the insurance or annuity sales activity is conducted in an affiliated producer, by the bank itself, through another distribution arrangement, or by a combination of these arrangements;
      - the names of any affiliated insurance agencies and the states where the affiliated insurance agencies are licensed;
      - the locations outside of the United States where insurance or annuities are sold or solicited; and
      - if any subsidiary agency operates as a financial subsidiary under the Gramm-Leach-Bliley Act.
   c. Determine if the insurance or annuity producer is acting as a managing general agent (MGA).[1] If so, determine—
      - the scope of the MGA activities;
      - the state member bank management's

1. MGAs do not assume underwriting risk. Through contractual arrangements with an insurer, MGAs have the authority to write policies on behalf of the insurer in certain instances, thereby binding the insurer to the policy. Certain minimum provisions governing MGA agreements are delineated in the applicable National Association of Insurance Commissioners (NAIC) model law.

assessment of the risk associated with the MGA activity; and
- what risk controls are in place to protect the state member bank from potential loss that may arise from the MGA's activities, such as loss arising from legal liability.

4. *Strategic and financial plans.* Assess management controls over the insurance and annuity sales activities.
   a. Ascertain the state member bank management's strategic and financial plans and goals for the insurance or annuity sales activity.
   b. Review the state member bank's due-diligence process for acquiring and pricing agencies, if applicable.
   c. Review the state member bank's financial budgets and forecasts for the activity, particularly plans for new products, marketing strategies and marketing arrangements, and the rate of actual and expected growth for the activity.
   d. Determine the cause for significant deviations from the plan.
   e. Determine if any agency acquired by the state member bank is providing the expected return on investment and if the agency's revenues are covering the debt servicing associated with the purchase, if applicable.
5. *Review of board and committee records and reports.*
   a. Review the reports of any significant state member bank oversight committees, including relevant board of directors and board committee minutes and risk-management reports.
   b. Determine if the board of directors, a board committee, or senior management of the state member bank reviews reports pertaining to consumer complaints and complaint resolution, information pertaining to litigation and associated losses, and performance compared with the organization's plan for the insurance and annuity sales activities.
6. *Policies and procedures.*
   a. Determine—
      - the adequacy of the state member bank's policies and procedures for conducting and monitoring insurance or annuity sales activities, including those policies designed to ensure adherence with federal and state laws and regulations pertaining to consumer protection;
      - whether there are appropriate policies and procedures for the handling of customer funds collected on behalf of the underwriter; accurate and timely financial reporting; complaint monitoring and resolution; effective system security and disaster-recovery plans; and policy-exception tracking and reporting; and
      - if the board of directors or its designated committee has formally approved the policies.
   b. Obtain a detailed balance sheet for agency subsidiaries, and determine if the assets held by insurance or annuity agency subsidiaries of the state member bank are all bank-eligible investments.
   c. Determine the independence of the state member bank's audit program applicable to the insurance and annuity sales activity. Determine if the audit program's scope, frequency, and resources are commensurate with the insurance or annuity sales activities conducted.
   d. Determine how the state member bank selects insurance underwriters with whom to do business, as well as how the state member bank monitors the continuing performance of the underwriters.
   e. Determine the adequacy of the oversight of the bank's board of directors over the insurance management team's qualifications, the training and licensing of personnel, and general compliance with state insurance regulations.
   f. Review the internal controls of the state member bank related to third-party arrangements, including arrangements for sales, processing, and auditing of insurance or annuity sales activities.
7. *Claims, litigation, and functional regulatory supervision.* Assess legal and reputational risk.
   a. Identify any significant litigation against the state member bank arising from its insurance or annuity sales activity and the likely impact of the litigation on the state member bank.
   b. Obtain the insurance agency's errors and omissions claims records for the past several years, including a listing of claims it has made and the amount of claims, the

claim status, and the amount of claim payments.

c. Review the state member bank's policies and procedures for tracking and resolving claims. Determine if they appear adequate and if they are adhered to.

d. Determine if the applicable functional regulator has any outstanding supervisory issues with the insurance agency.

8. *Consumer complaints.*

a. Determine if bank managagement has policies and procedures in place to assess whether consumer complaints received are likely to expose the state member bank to regulatory action, litigation, reputational damage, or other significant risk.

b. Obtain applicable consumer complaint files, and evaluate internal control procedures to ensure the complaints are being adequately addressed.

9. *Audit and compliance functions.*

a. Determine the date of the most recent review of the insurance or annuity sales activities by the audit and compliance functions.

b. Determine the adequacy of the state member bank's management policies and procedures for ensuring that any deficiencies noted in such reviews are corrected, and ascertain whether any such deficiencies are being adequately addressed.[2]

10. *Insurance underwriter oversight of agent/agency activities.*

a. Determine if there are adequate policies and procedures to review and resolve any issues or concerns raised by an insurance underwriter regarding the producers used by, or affiliated with, the state member bank.[3]

b. Determine whether any of the insurance underwriters conducted a periodic review of the producers that they engaged to sell insurance.

11. *State supervisory insurance authorities.*

a. During discussions with state member bank management, determine whether state insurance regulators have raised any issues or concerns in correspondence or reports.

b. Consult with the state insurance regulators, as appropriate, to determine any significant supervisory issues, actions, or investigations. (For multistate agencies, contacts with states may be prioritized on the basis of the location of the agency's head office or by a determination of the significance of sales by state. Both financial examinations and market conduct examinations conducted by the state insurance departments are targeted at insurance underwriters, not agencies. Therefore, information available from the states pertaining to agencies may be very limited.)

12. *Operational risk assessment.* Ascertain from the state member bank's management whether there are—

a. any significant operational problems or concerns relating to insurance or annuity sales activities;

b. policies and procedures in place to ensure accurate and timely reporting to the state member bank's management of insurance or annuity sales activity plans, financial results, and significant consumer complaints or lawsuits or compliance issues, such as errors and omissions claims;[4]

c. appropriate policies and procedures at the state member bank to ensure accurate reporting of insurance or annuity sales activity on Federal Reserve regulatory reports (Determine from applicable Board or Reserve Bank contacts if there are any outstanding issues with respect to potential reporting errors on submitted Federal Reserve reports, bank call reports, or other applicable reports. If so, seek resolution of the issues.); and

d. adequate disaster-recovery plans and procedures to protect the state member bank

2. Enforcement of the privacy provisions of the Gramm-Leach-Bliley Act as they relate to state member banks is the responsibility of the Board's Division of Consumer and Community Affairs. However, enforcement of the privacy provisions of the GLB Act with respect to the insurance activities of nondepository subsidiaries of a state member bank is the responsibility of the state insurance regulators.

3. Insurance underwriters generally have procedures to determine whether individual producers affiliated with agencies are selling the underwriters' products in conformance with applicable laws and regulations. The findings and conclusions of these reviews should be available to the state member bank's management.

4. Errors and omissions insurance should be in place to protect the state member bank against loss sustained because of an error or oversight, such as failure to issue an insurance policy. A tracking system to monitor errors and omission claims should be in place and monitored by the state member bank, as appropriate. See section 4040.1, "Management of Insurable Risks."

from loss of data related to insurance or annuity sales activities.

CONSUMER PROTECTION IN SALES OF INSURANCE REGULATION

The following procedures should be risk-focused in accordance with the Federal Reserve's risk-focused framework for supervising banking organizations. The procedures should be carried out as necessary to adequately assess the state member bank's compliance with the Consumer Protection in Sales of Insurance (CPSI) regulation.

1. Determine the role of the state member bank's board of directors and management in ensuring compliance with the CPSI regulation and applicable state consumer regulations.
2. Evaluate the management information system (MIS) reports the state member bank's board or designated committee rely on to monitor compliance with the consumer regulations and to track complaints and complaint resolution.
3. Review the state member bank's policies and procedures to ensure they are consistent with the CPSI regulation, and conduct transaction testing, as necessary, in the following areas.[5]
   a. disclosures, advertising, and promotional materials
   b. consumer acknowledgments
   c. physical separation from areas of deposit-taking activities
   d. qualifications and licensing for insurance personnel
   e. compliance programs and internal audits
   f. hiring, training, and supervision of insurance or annuity sales personnel employed directly by the bank, or of third parties selling insurance or annuity products at a state member bank office or on behalf of the state member bank
   g. compensation practices and training for personnel making referrals
4. If a third party sells insurance or annuities at the state member bank's offices, or on behalf of the bank, review the state member bank's policies and procedures for ensuring that the third party complies with the CPSI regulation and other relevant policies and procedures of the bank.
5. Review the bank's process for identifying and resolving consumer complaints related to the sale of insurance products and annuities.
6. Obtain and review the record of consumer complaints related to the CPSI regulation. (These records are available from the Board's Division of Consumer and Community Affairs database. See CP letter 2001-11.)
7. Include examination findings, as appropriate, in the commercial bank examination report or in other communications to the bank, as appropriate, that pertain to safety-and-soundness reviews of the bank.

5. If the examiner determines that transaction testing of a functionally regulated nonbank affiliate of the state member bank is appropriate in order to determine the state member bank's compliance with the CPSI regulation, the examiner should first consult with and obtain approval from appropriate staff of the Board's Division of Banking Supervision and Regulation.

RISK ASSESSMENT OF INSURANCE AND ANNUITY SALES ACTIVITIES

Program Management

1. Does the state member bank have a comprehensive program to ensure that its insurance and annuity sales activities are conducted in a safe and sound manner?
2. Does the state member bank have appropriate written policies and procedures commensurate with the volume and complexity of the insurance or annuity sales activities?
3. Has bank management obtained the approval of the bank's board of directors for the program scope and the associated policies and procedures?
4. Have reasonable precautions been taken to ensure that disclosures to customers for insurance or annuity sales and solicitations are complete and accurate, and are in compliance with applicable laws and regulations?
5. Does the state member bank effectively oversee the insurance or annuity sales activities, including those involving third parties?
6. Does the state member bank have an effective independent internal audit and compliance program in place to monitor retail sales of insurance or annuity products?
7. Does the bank appropriately train and supervise employees conducting insurance or annuity sales activities?

Management Information Systems

8. Does the state member bank's insurance program management plan establish the appropriate management information systems (MIS) necessary for the board of directors to properly oversee the bank's insurance or annuity sales activities?
9. Does MIS provide sufficient information to allow for the evaluation and measurement of the effect of actions taken to identify, track, and resolve any issues relative to compliance with the Consumer Protection in Sales of Insurance (CPSI) regulation?
10. Does MIS include sales volumes and trends, profitability, policy exceptions and associated controls, customer complaints, and other information providing evidence of compliance with laws and established policies?

Compliance Programs and Internal Audits

11. Are there policies and procedures in place to ensure that insurance or annuity sales activities are conducted in compliance with applicable laws and regulations?
12. Do compliance procedures identify potential conflicts of interest and how such conflicts should be addressed?
13. Do the compliance procedures provide a system to monitor customer complaints and track their resolution?
14. When applicable, do compliance procedures call for verification that third-party sales are being conducted in a manner consistent with the agreement governing the third party's arrangement with the state member bank?
15. Is the compliance function conducted independently of the insurance or annuity sales and management activities?
16. Do compliance personnel determine the scope and frequency of the insurance-product review?
17. Are findings of insurance or annuity sales activity compliance reviews periodically reported directly to the state member bank's board of directors or a designated committee thereof?

CONSUMER PROTECTION IN SALES OF INSURANCE REGULATION

If applicable, review the state member bank's internal controls, policies, practices, and procedures for retail insurance or annuity sales activities conducted by the bank on bank premises or on behalf of the bank. The bank's program management for such activities should be well documented and should include appropriate personnel training, as well as compliance and audit-function coverage of all efforts to ensure compliance with the provisions of the Board's CPSI regulation.

Advertising and Promotional Materials

1. Do advertising materials associated with the insurance or annuity sales program create an erroneous belief that—
   a. an insurance product or annuity sold or offered for sale by the state member bank, or on behalf of the bank, is backed by the federal government or the bank, or that the product is insured by the FDIC?
   b. an insurance product or annuity that involves investment risk does not, in fact, have investment risk, including the potential that principal may be lost and the product may decline in value?
2. Does a review of advertising for insurance products or annuities sold or offered for sale create an erroneous impression that—
   a. the state member bank or an affiliate or subsidiary may condition the grant of an extension of credit to a consumer on the purchase of an insurance product or annuity by the consumer from the bank or an affiliate or subsidiary of the bank?
   b. the consumer is not free to purchase an insurance product or annuity from another source?

Disclosures

3. In connection with the initial purchase of an insurance product or annuity by a consumer, does the initial disclosure to the consumer, except to the extent the disclosure would not be accurate, state that—
   a. the insurance product or annuity is not a deposit or other obligation of, or is not guaranteed by, the state member bank or an affiliate of the bank?
   b. the insurance product or annuity is not insured by the FDIC or any other agency of the United States, the state member bank, or (if applicable) an affiliate of the bank?
   c. in the case of an insurance product or annuity that involves an investment risk, there is risk associated with the product, including the possible loss of value?
4. In the case of an application for credit, in connection with which an insurance product or annuity is solicited, offered, or sold, is a disclosure made that the state member bank may not condition an extension of credit on either—
   a. the consumer's purchase of an insurance product or annuity from the bank or any of its affiliates?
   b. the consumer's agreement not to obtain, or a prohibition on the consumer's obtaining, an insurance product or annuity from an unaffiliated entity?
5. Are the disclosures under question 3 above provided orally and in writing before the completion of the initial face-to-face sale of an insurance product or annuity to a consumer?
6. Are the disclosures under question 4 above made orally and in writing at the time the consumer applies in a face-to-face interaction for an extension of credit in connection with which insurance is solicited, offered, or sold?
7. If a sale of an insurance product or annuity is conducted by telephone, are the disclosures under question 3 above provided in writing, by mail, within three business days?
8. If an application for credit is by telephone, are the disclosures under question 4 above provided by mail to the consumer within three business days?
9. Are the disclosures under questions 3 and 4 above provided through electronic media, instead of on paper, only if the consumer affirmatively consents to receiving the disclosures electronically, and only if the disclosures are provided in a format that the consumer may retain or obtain later?
10. Are disclosures made through electronic media, for which paper or oral disclosures are not required, presented in a meaningful form and format?
11. Are disclosures conspicuous, simple, direct, readily understandable, and designed to call attention to the nature and significance of the information provided?

12. Are required disclosures presented in a meaningful form and format?

Consumer Acknowledgment

13. At the time a consumer receives the required disclosures, or at the time of the consumer's initial purchase of an insurance product or annuity, is a written acknowledgment from the consumer that affirms receipt of the disclosures obtained?
14. If the required disclosures are provided in connection with a transaction that is conducted by telephone—
    a. has an oral acknowledgment of receipt of the disclosures been obtained, and is sufficient documentation maintained to show that the acknowledgment was given?
    b. have reasonable efforts to obtain a written acknowledgment from the consumer been made?

Physical Separation from Deposit Activities

15. Does the state member bank, to the extent practicable—
    a. keep the area where the bank conducts transactions involving the retail sale of insurance products or annuities physically segregated from the areas where retail deposits are routinely accepted from the general public?
    b. identify the areas where insurance product or annuity sales activities occur?
    c. clearly delineate and distinguish insurance and annuity sales areas from the areas where the bank's retail deposit-taking activities occur?

Qualifications and Licensing

16. Does the state member bank permit any person to sell, or offer for sale, any insurance product or annuity in any part of its office, or on its behalf, only if the person is at all times appropriately qualified and licensed under applicable state insurance licensing standards for the specific products being sold or recommended?

Hiring, Training, and Supervision

17. Have background investigations of prospective employees that will sell insurance products or annuities been completed?
18. When a candidate for employment has previous insurance experience, has a review to determine whether the individual has been the subject of any disciplinary actions by state insurance regulators been completed?
19. Do all insurance or annuity sales personnel, or third-party sales personnel conducting sales activities at or on behalf of the state member bank, receive appropriate training and continue to meet licensing requirements?
20. Does training address policies and procedures for sales of insurance and annuity products, and does it cover personnel making referrals to a licensed insurance producer?
21. Does training ensure that personnel making referrals about insurance products or annuities are properly handling all inquiries so as not to be deemed to be acting as unlicensed insurance agents or registered (or equivalently trained) securities sales representatives (for insurance products that are also securities) if they are not qualified?
22. When insurance products or annuities are sold by the state member bank or third parties at an office of, or on behalf of, the organization, does the institution have policies and procedures to designate, by title or name, the individuals responsible for supervising insurance sales activities, as well as the referral activities of bank employees not authorized to sell these products?
23. Does the bank designate supervisory personnel responsible for monitoring compliance with any third-party agreement, as well as with the CPSI regulation?

Referrals

24. Are fees paid to nonlicensed personnel who are making referrals to qualified insurance or annuity salespersons limited to a one-time, nominal fee of a fixed dollar amount for each referral, and is the fee unrelated to whether the referral results in a sales transaction?

Third-Party Agreements

25. Does the state member bank's management conduct a comprehensive review of a third party before entering into any arrangement to conduct insurance or annuity sales activities through the third party?
26. Does the review include an assessment of the third party's financial condition, management experience, reputation, and ability to fulfill its contractual obligations to the bank, including compliance with applicable consumer protection laws and regulation?
27. Does the board of directors or a designated committee thereof approve any agreement with the third party?
28. Does the agreement outline the duties and responsibilities of each party; describe the third-party activities permitted on the institution's premises; address the sharing or use of confidential customer information; and define the terms for use of the bank's office space, equipment, and personnel?
29. Does the third-party agreement specify that the third party will comply with all applicable laws and regulations and will conduct its activities in a manner consistent with the CPSI regulation, if applicable?
30. Does the agreement authorize the bank to monitor a third party's compliance with the agreement, as well as to have access to third-party records considered necessary to evaluate compliance?
31. Does the agreement provide for indemnification of the institution by the third party for any losses caused by the conduct of the third party's employees in connection with its insurance or annuity sales activities?
32. If an arrangement includes dual employees, does the agreement provide for written employment contracts that specify the duties of these employees and their compensation arrangements?
33. If the state member bank contracts with a functionally regulated third party, does the bank obtain, as appropriate, any relevant regulatory reports of examination of the third party?
34. How does the state member bank ensure that a third party selling insurance or annuity products at or on behalf of the bank complies with all applicable regulations, including the CPSI regulation?
35. How does the state member bank ensure that any third party or dual employee selling insurance or annuity products at or on behalf of the bank is appropriately trained to comply with the minimum disclosures and other requirements of the Board's CPSI regulation and applicable state regulations?
36. Does the bank obtain and review copies of third-party training and compliance materials to monitor the third party's performance regarding its disclosure and training obligations?

Consumer Complaints

37. Does the state member bank have policies and procedures for handling customer complaints related to insurance and annuity sales?
38. Does the customer complaint process provide for the recording and tracking of all complaints?
39. Does the state member bank require periodic reviews of complaints by compliance personnel? Is a review by the state member bank's board and senior management required for significant compliance issues that may pose risk to the state member bank?

The examination of bank-related organizations must be of sufficient scope to determine a bank's compliance with laws and to evaluate its investments through an appraisal of related organizations' assets, earnings, and management. In addition, the examination must fully disclose the nature of the relationships between the bank and its related organizations, as well as the effects of these relationships on the operations and safety and soundness of the bank.

Various laws, rulings, and regulations have encouraged banks to expand their services by forming or acquiring related organizations. Examples include—

- permission for a member bank to purchase for its own account shares of a corporation that performs, at locations at which the bank is authorized to engage in business, functions that the bank is empowered to perform directly;
- authorization by specific laws to invest in various statutory subsidiaries; and
- permission by Federal Reserve regulations to invest in Edge Act and agreement corporations.

A bank also may be controlled by an individual or company that controls other bank or nonbank entities. No matter what the legal organization is between a bank and a related organization, a sound financial and satisfactory management relationship between both groups is essential to the bank's operation. Related organizations may assume several forms, as described later in this section.

SECTION 23A OF THE FEDERAL RESERVE ACT

Section 23A of the Federal Reserve Act (FRA) (12 USC 371c) is the primary statute governing transactions between a bank and its affiliates. Section 23A (1) designates the types of companies that are affiliates of a bank; (2) specifies the types of transactions covered by the statute; (3) sets the quantitative limitations on a bank's covered transactions with any single affiliate, and with all affiliates combined; and (4) sets forth collateral requirements for certain bank transactions with affiliates. (See also sections 2080.1 and 2080.3.)

In addition to the statutory provisions of section 23A, the Board approved the issuance of Regulation W, which became effective April 1, 2003, and implements comprehensively sections 23A and 23B of the Federal Reserve Act. To facilitate compliance with these statutes, the rule[1] provides several exemptions and combines the statutory restrictions on transactions between a member bank and its affiliates with numerous Board interpretations and exemptions that were previously issued.

Quantitative Limits

Section 23A(a)(1)(A) states that a member bank[1a] "may engage in a covered transaction with an affiliate only if . . . in the case of any affiliate," the aggregate amount of covered transactions of the bank would not exceed 10 percent of the capital stock and surplus of the bank. The rule's interpretation of the 10 percent limit is consistent with the statutory language. Section 223.11 of the rule clarified that a bank that has crossed the 10 percent threshold with one affiliate may still conduct additional covered transactions with other affiliates, if transactions with all affiliates would not exceed 20 percent of the bank's capital stock and surplus.[1b] Sections 223.11 and 223.12 of the rule set forth these quantitative limits. The rule's quantitative limits prohibit a member bank from engaging in a *new* covered transaction with that affiliate if the bank would be in excess of the 10 percent threshold with that affiliate or if the level of covered transactions with all its affiliates exceeded the 20 percent threshold. The rule generally does

1. In this section of the manual, Regulation W is referred to as "the rule" or by a specific section number of the rule.

1a. *Member bank* is defined in section 223.3(w) to mean "any national bank, state bank, banking association, or trust company that is a member of the Federal Reserve System." Other provisions of federal law apply section 23A to state nonmember banks and savings associations. The rule also states that most subsidiaries of a member bank are to be treated as part of the member bank itself for purposes of sections 23A and 23B. The only subsidiaries of a member bank that are excluded from this treatment are financial subsidiaries, insured depository institution subsidiaries, and certain joint venture subsidiaries—companies that are generally deemed affiliates of the member bank under the regulation. This treatment of subsidiaries reflects the fact that the statute typically does not distinguish between a member bank and its subsidiaries, and all the significant restrictions of the statute apply to actions taken by a member bank "and its subsidiaries."

1b. 12 USC 371c(a)(1).

not require a member bank to unwind existing covered transactions if the bank exceeds the 10 percent or 20 percent limit because its capital declined or a preexisting covered transaction increased in value.

The Board strongly encourages member banks with covered transactions in excess of the 10 percent threshold with any affiliate to reduce those transactions before expanding the scope or extent of the bank's relationships with other affiliates. Section 223.11 of the rule also clarifies that transactions between a bank and a financial subsidiary of the bank are not subject to the 10 percent limit of section 23A but instead are subject to the 20 percent limitation

Capital Stock and Surplus

Under section 23A, the quantitative limits on covered transactions are based on the "capital stock and surplus" of the member bank. Section 223.3(d) of the rule defines capital stock and surplus to be the sum of the member bank's tier 1 capital and tier 2 capital and the balance of the bank's allowance for loan and lease losses not included in its tier 2 capital plus the amount of any investment in a financial subsidiary that counts as a covered transaction that is required to be deducted from the bank's regulatory capital. Examiners can determine the amount of the quantitative limits based on the bank's most recent consolidated Report of Condition and Income (the Call Report).

Affiliates

The definition of an affiliate is found in section 23A of the FRA and is further defined in Regulation W. Affiliates are defined to include—

- any company that *controls* the member bank and any other company that is controlled by the company that controls the member bank;
- a bank subsidiary of the member bank;
- any company—
  - — that is controlled directly or indirectly, by a trust or otherwise, by or for the benefit of shareholders who beneficially or otherwise control, directly or indirectly, by trust or otherwise, the member bank or any company that controls the member bank; or
  - — in which a majority of its directors or trustees constitute a majority of the persons holding any such office with the member bank or any company that controls the member bank;
- any company, including a real estate investment trust, that is sponsored and advised on a contractual basis by the member bank or any subsidiary or affiliate of the member bank;
- any investment company with respect to which a member bank or any affiliate thereof is an investment adviser as defined in section 2(a)(20) of the Investment Company Act of 1940;
- any investment fund for which the member bank or any affiliate of the member bank serves as an investment adviser, if the member bank and its affiliates own or control in the aggregate more than 5 percent of any class of voting securities or of the equity capital of the fund;
- a depository institution that is a subsidiary of the member bank;
- a financial subsidiary of the member bank;
- any company in which a holding company of the member bank owns or controls, directly or indirectly, or acting through one or more other persons, 15 percent or more of the equity capital pursuant to the merchant banking authority in section 4(k)(4)(H) or (I) of the Bank Holding Company Act (12 USC 1843(k)(4)(H) or (I));
- any partnership for which the member bank or any affiliate of the member bank serves as a general partner or for which the member bank or any affiliate of the member bank causes any director, officer, or employee of the member bank or affiliate to serve as a general partner;
- any subsidiary of an affiliate described in paragraphs (a)(1) through (10) of section 223.2 of Regulation W; and
- any company that the Board, or the appropriate federal banking agency for the bank, determines by regulation or order to have a relationship with the member bank or any subsidiary or affiliate of the member bank, such that covered transactions by the member bank or its subsidiary with that company may be affected by the relationship, to the detriment of the member bank or its subsidiary.

The following are *not* considered to be affiliates of a bank:

- a nonbank subsidiary of that bank, unless a determination is made not to exclude such a subsidiary

- a company engaged solely in holding that bank's premises
- a company engaged solely in conducting a safe deposit business
- a company engaged solely in holding obligations of the United States or its agencies or obligations fully guaranteed by the United States or its agencies as to principal and interest
- a company in which control arises from the exercise of rights arising out of a bona fide debt previously contracted (for a limited period of time)

Definition of Affiliates by Type of Entity

Investment funds advised by the member bank or an affiliate of the member bank. As stated previously, section 23A includes as an affiliate any company that is sponsored and advised on a contractual basis by the member bank or any of its affiliates[1c] as well as any investment company for which the member bank or its affiliate serves as an investment adviser, as defined in the Investment Company Act of 1940 (the 1940 act).[1d] In Regulation W, the Board used its

1c. 12 USC 371c(b)(1)(D)(i).
1d. 12 USC 371c(b)(1)(D)(ii).

statutory authority to define as an affiliate any investment fund—even if not an investment company for purposes of the 1940 act—for which the member bank or an affiliate of the bank serves as an investment adviser, if the bank or an affiliate of the bank owns or controls more than 5 percent of any class of voting securities or similar interests of the fund.

Most investment funds that are advised by a member bank (or an affiliate of a member bank) are affiliates of the bank under section 23A because the funds either are investment companies under the 1940 act or are sponsored by the member bank (or an affiliate of the member bank). The member bank or its affiliate, in some instances, however, may advise but not sponsor an investment fund that is not an investment company under the 1940 act.[1e] The advisory relationship of a member bank or affiliate with an investment fund presents the same potential for conflicts of interest regardless of whether the fund is an investment company under the 1940 act.[1f] An investment fund typically escapes from the definition of investment company under the 1940 act because it (1) sells interests only to a limited number of investors or only to sophisticated investors or (2) invests primarily in financial instruments that are not securities.[1g] Section 223.2(a)(6) treats any investment fund as an affiliate if the bank or an affiliate of the bank serves as an investment adviser to the fund and owns more than 5 percent of the shares of the fund.

Financial subsidiaries. In 1999, the Gramm-Leach-Bliley Act (the GLB Act) authorized banks to own ''financial subsidiaries'' that engage in activities not permissible for the parent bank to conduct directly, such as underwriting and dealing in bank-ineligible securities. The GLB Act amended section 23A to define a financial subsidiary of a bank as an affiliate of the bank and thus subjected transactions between the bank and a financial subsidiary to the limitations of sections 23A and 23B.

Section 23A defines a financial subsidiary as a subsidiary of any bank (state or national) that is engaged in an activity that is not permissible for *national* banks to engage in directly (other than a subsidiary that federal law specifically authorizes national banks to own or control). Specifically, a ''financial subsidiary'' is defined as ''any company that is a subsidiary of a bank that would be a financial subsidiary of a national bank under section 5136A of the Revised Statutes of the United States.'' (See 12 USC 371c(e)(1).) Section 5136A, in turn, defines a financial subsidiary as any company that is controlled by one or more insured depository institutions, *other than* (1) a subsidiary that engages solely in activities that national banks are permitted to engage in directly or (2) a subsidiary that national banks are specifically authorized to control by the express terms of a federal statute (other than section 5136A), such as an Edge Act corporation or a small business investment company (SBIC). (See 12 USC 24a(g)(3).) Section 5136A also generally prohibits a financial subsidiary of a national bank from engaging in insurance underwriting, real estate investment and development, or merchant banking activities. (See 12 USC 24a(a)(2).) The rule defines a financial subsidiary of a bank, exempts certain companies from the definition, and sets forth special valuation and other rules for financial subsidiaries. (See sections 223.2(a)(8), 223.3(p), and 223.32 of the rule.)

Partnerships. Banks fund legitimate commercial and community development transactions through partnerships. Partnerships for which a member bank serves as a general partner are defined in Regulation W's section 223.2(a), which also lists the entities that generally are affiliates.

Regulation W also defines an affiliate of a member bank as any partnership if the member bank or an affiliate of the bank causes any officer or employee of the bank or affiliate to serve as a general partner of the partnership (unless the partnership is an operating subsidiary of the bank, as discussed above). The rule considers a partnership an affiliate of the member bank if the bank or an affiliate of the bank causes any *director* of the bank or affiliate to serve as a general partner of the partnership (unless the partnership is an operating subsidiary of the

1e. 12 USC 371c(b)(1)(E).

1f. A member bank may face greater risk from the conflicts of interest arising from its relationships with an investment fund that is not registered as an investment company under the 1940 act because the 1940 act restricts transactions between a registered investment company and entities affiliated with the company's investment adviser. (See 15 USC 80a-17.)

1g. The term ''investment company'' in the 1940 act does not include a company that is owned by qualified persons or by no more than 100 persons, provided that the company does not engage in a public offering of its securities. (See 15 USC 80a-3(c)(1) and (7).) The term also generally does not include investment funds that are engaged primarily in investing in financial instruments other than securities. (See 15 USC 80a-3(a)(1).)

bank). Also, if a company, such as a bank holding company, controls more than 25 percent of the equity through a partnership, that company is an affiliate under Regulation W.

Subsidiaries of affiliates. Regulation W's definition of an affiliate includes any company controlled by an investment fund that is an affiliate of the member bank. (See section 223.2(a)(11).) It accords affiliate status to any company controlled by an investment fund affiliate of a member bank. More broadly, the rule deems a subsidiary of an affiliate as an affiliate of the member bank. Subsidiaries of interlocking directorate affiliates (section 223.2(a)(4)) and sponsored and advised affiliates (section 223.2(a)(5)) also are treated as affiliates of the member bank. The control relationship between such statutory affiliates and their subsidiaries may affect covered transactions between the member bank and such subsidiaries to the detriment of the bank.

Companies designated by the appropriate federal banking agency. Under section 223.2(a)(12), the Board or the appropriate federal banking agency for the relevant depository institution (under authority delegated by the Board) can determine that any company that has certain relationships with a member bank or an affiliate of the bank is itself an affiliate of the bank. The Board and the federal banking agencies can thus protect depository institutions in their transactions with associated companies. A depository institution may petition the Board for review of any such affiliate determination made by the institution's appropriate federal banking agency under the general procedures established by the Board for review of actions taken under delegated authority.[1h]

Joint venture companies. Under the terms of section 23A, subsidiaries of a member bank generally are not treated as affiliates of the bank.[1i] The statute contains two specific exceptions to this general rule: ''financial subsidiaries'' of a member bank and ''bank'' subsidiaries of a member bank are treated as affiliates of the parent bank. The statute provides that the Board may determine that other subsidiaries of a member bank should be treated as affiliates in appropriate circumstances.[1j]

Under section 223.2(b)(1)(iii) of the rule, certain joint venture subsidiary companies of a member bank are treated as an affiliate. A subsidiary of a member bank is treated as an affiliate if one or more affiliates of the bank, or *one or more controlling shareholders of the bank*, directly *control* the joint venture. For example, if a bank controls 30 percent of a company and an affiliate controls 70 percent of Company A, then Company A is an affiliate. This expansion also covers situations in which a controlling natural-person shareholder or group of controlling natural-person shareholders of the member bank (who, as natural persons, are not themselves section 23A affiliates of the bank) exercise direct control over the joint venture company.

The rule's treatment of certain bank-affiliate joint ventures as affiliates does not apply to joint ventures between a member bank and any affiliated insured depository institutions. For example, if two affiliated member banks each own 50 percent of the voting common stock of a company, the company would continue to qualify as a subsidiary and not an affiliate of each bank (despite the fact that an affiliate of each bank owned more than 25 percent of a class of voting securities of the company). The Board has retained its authority to treat such joint ventures as affiliates under section 23A on a case-by-case basis.

Employee benefit plans. Many employee stock option plans, trusts, or similar entities that exist to benefit shareholders, members, officers, directors, or employees of a member bank or its affiliates (''ESOPs'') are treated as affiliates of the bank for purposes of sections 23A and 23B. The ESOP's share ownership or the interlocking management between the ESOP and its associated member bank (or BHC), in many cases, exceeds the statutory thresholds for determining that a company is an affiliate. For example, if an ESOP controls more than 25 percent of the voting shares of the bank or bank holding company, the ESOP is an affiliate. (Under sec-

1h. See 12 CFR 265.3.

1i. See 12 USC 371c(b)(1)(A) and (b)(2)(A). Section 23A defines a subsidiary of a specified company as a company that is controlled by the specified company. Under the statute, a company controls another company if the first company owns or controls 25 percent or more of a class of voting securities of the other company, controls the election of a majority of the directors of the other company, or exercises a controlling influence over the policies of the other company (12 USC 371c(b)(3) and (4).)

1j. 12 USC 371c(b)(2)(A).

tion 223.2(b)(1)(iv), an ESOP of a member bank or an affiliate of the bank cannot itself avoid classification as an affiliate of the bank by also qualifying as a subsidiary of the bank. The relationship between a member bank and its or its affiliate's ESOP generally warrants coverage by sections 23A and 23B.)

Determination of Control

The definition of ''control'' with respect to affiliates is the same as that used in the Bank Holding Company Act (the BHC Act), that is, a company or shareholder shall be deemed to have control over another company if—

- such company or shareholder, directly or indirectly, or acting through one or more other persons, owns, controls, or has power to vote 25 percent or more of any class of voting securities of the other company;
- such company or shareholder controls in any manner the election of a majority of the directors or trustees of the other company; or
- the Board determines, after notice and opportunity for hearing, that such company or shareholder, directly or indirectly, exercises a controlling influence over the management or policies of the other company.

However, no company shall be deemed to own or control another company by virtue of its ownership or control of shares in a fiduciary capacity except (1) a company that is controlled, directly or indirectly, by a trust for the benefit of shareholders who beneficially or otherwise control, directly or indirectly, a member bank, or (2) if the company owning or controlling such shares is a business trust.

Pursuant to the merchant banking provisions in section 4(k)(4)(H) or (I) of the BHC Act and in the Board's Regulation Y, a financial holding company (FHC) shall be presumed to control another company if the FHC directly or indirectly owns or controls 15 percent of the equity capital of the other company unless the FHC provides information acceptable to the Board demonstrating that the FHC does not control the other company.

Section 23A provides that a company or shareholder shall be deemed to have control over another company if, among other things, such company or shareholder controls in any manner the election of a majority of the ''directors or trustees'' of the other company.[1k] The rule, under section 223.3(g), expands the control definition of section 23A by providing, as in Regulation Y, that control also exists when a company or shareholder controls the election of a majority of the ''general partners (or individuals exercising similar functions)'' of another company. A company or shareholder would be deemed to control another company (including a partnership, limited-liability company, or other similar organization) under section 23A if the company or shareholder controls the election of a majority of the principal policymakers of such other company.

Under the rule, three additional presumptions of control are provided, similar to the presumptions contained in Regulation Y. First, a company will be deemed to control securities, assets, or other ownership interests controlled by any subsidiary of the company.[1*l*] Second, a company that controls instruments (including options and warrants) that are convertible or exercisable, at the option of the holder or owner, into securities, will be deemed to control the securities.[1m] Third, a rebuttable presumption provides that a company or shareholder that owns or controls 25 percent or more of the equity capital of another company controls the other company, unless the company or shareholder demonstrates otherwise to the Board based on the facts and circumstances of the particular case. (See section 223.3(g).)

Covered Transactions

The restrictions of section 23A do not apply to every transaction between a member bank and its affiliates. The section only applies to ''covered transactions'' between a member bank and its affiliates.[1n] The FRA defines five types of covered transactions:

- a loan or extension of credit to an affiliate
- a purchase of or an investment in securities issued by an affiliate

1k. 12 USC 371c(b)(3)(A)(ii).

1*l*. See 12 CFR 225.2(e)(2)(i).

1m. See 12 CFR 225.31(d)(1)(i). The rule refers more generically to convertible ''instruments.'' It clarifies that the convertibility presumption applies regardless of whether the right to convert resides in a financial instrument that technically qualifies as a ''security'' under section 23A or the federal securities laws.

1n. 12 USC 371c(b)(7).

- a purchase of assets from an affiliate, including assets subject to an agreement to repurchase from the affiliate, except for purchases of real and personal property as may be specifically exempted by the Board by order or regulation
- the acceptance of securities issued by an affiliate as collateral for a loan to any person or company (such an acceptance is prohibited if a loan is to an affiliate)
- the issuance of a guarantee, acceptance, or letter of credit, including an endorsement or standby letter of credit, on behalf of an affiliate

Covered transactions must be made on terms and conditions that are consistent with safe and sound banking practices.

Among the transactions that generally are not subject to section 23A are dividends paid by a member bank to its holding company, sales of assets by a member bank to an affiliate for cash, an affiliate's purchase of securities issued by a member bank, and many service contracts between a member bank and an affiliate. Certain classes of transactions between a member bank and an affiliate are discussed below as to whether they are covered transactions for purposes of section 23A. (See section 223.3(h).)

Confirmation of a Letter of Credit Issued by an Affiliate

Section 23A includes as a covered transaction the issuance by a member bank of a letter of credit on behalf of an affiliate, including the confirmation of a letter of credit issued by an affiliate as a covered transaction. (See section 223.3(h)(5).) When a bank confirms a letter of credit, it assumes the risk of the underlying transaction to the same extent as if it had issued the letter of credit.[1o] Accordingly, a confirmation of a letter of credit issued by an affiliate is treated in the same fashion as an issuance of a letter of credit on behalf of an affiliate.

Credit Enhancements Supporting a Securities Underwriting

The definition of guarantee in section 23A would not include a member bank's issuance of a guarantee in support of securities issued by a third party and underwritten by a securities affiliate of the bank.[2] Such a credit enhancement would not be issued "on behalf of" the affiliate. Although the guarantee does provide some benefit to the affiliate (by facilitating the underwriting), this benefit is indirect. The proceeds of the guarantee would not be transferred to the affiliate for purposes of the attribution rule of section 23A.[2a] Section 23B would apply to the transaction and, where an affiliate was issuer as well as underwriter, the transaction would be covered by section 23A because the credit enhancement would be on behalf of the affiliate.

Cross-Guarantee Agreements and Cross-Affiliate Netting Arrangements

A cross-guarantee agreement among a member bank, an affiliate, and a nonaffiliate in which the nonaffiliate may use the bank's assets to satisfy the obligations of a defaulting affiliate is a guarantee for purposes of section 23A. The cross-guarantee arrangements among member banks and their affiliates are subject to the quantitative limits and collateral requirements of section 23A. (See section 223.3(h)(5).)

As for cross-affiliate netting arrangements (CANAs), such arrangements involve a member bank, one or more affiliates of the bank, and one or more nonaffiliates of the bank, where a nonaffiliate is permitted to deduct obligations of an affiliate of the bank to the nonaffiliate when settling the nonaffiliate's obligations to the bank. These arrangements also would include agreements in which a member bank is required or permitted to add the obligations of an affiliate of the bank to a nonaffiliate when determining the bank's obligations to the nonaffiliate.

These types of CANAs expose a member bank to the credit risk of its affiliates because the bank may become liable for the obligations of its affiliates. Because the exposure of a member bank to an affiliate in such an arrangement resembles closely the exposure of a member bank when it issues a guarantee on behalf of an affiliate, the rule explicitly includes such arrangements in the definition of covered transaction. Accordingly, the quantitative limits of section 23A would prohibit a member bank from entering into such a CANA to the extent that the

1o. See UCC 5-107(2).

2. See 62 *Fed. Reg.* 45295 (August 27, 1997).

2a. See 12 USC 371c(a)(2).

netting arrangement does not cap the potential exposure of the bank to the participating affiliate (or affiliates).

Keepwell Agreements

In a keepwell agreement between a member bank and an affiliate, the bank typically commits to maintain the capital levels or solvency of the affiliate. The credit risk incurred by the member bank in entering into such a keepwell agreement is similar to the credit risk incurred by a member bank in connection with issuing a guarantee on behalf of an affiliate. As a consequence, keepwell agreements generally should be treated as guarantees for purposes of section 23A and, if unlimited in amount, would be prohibited by the quantitative limits of section 23A.

Extension of Credit

Section 23A includes a ''loan or extension of credit'' to an affiliate as a covered transaction, but does not define these terms. Section 223.3(o) of the rule defines ''extension of credit'' to an affiliate to mean the making or renewal of a loan to an affiliate, the granting of a line of credit to an affiliate, or the extending of credit to an affiliate in any manner whatsoever, including on an intraday basis. A nonexhaustive list of transactions is provided that the Board deems to be extensions of credit to an affiliate:

- an advance to an affiliate by means of an overdraft, cash item, or otherwise
- a sale of federal funds to an affiliate
- a lease that is the functional equivalent of an extension of credit to an affiliate[2b]
- an acquisition by purchase, discount, exchange, or otherwise of a note or other obligation, including commercial paper or other debt securities, of an affiliate
- any increase in the amount of, extension of the maturity of, or adjustment to the interest-rate term or other material term of, an extension of credit to an affiliate[2c]
- any other similar transaction as a result of which an affiliate becomes obligated to pay money (or its equivalent) to a member bank[2d]

A member bank's purchase of a debt security issued by an affiliate is an extension of credit by the bank to the affiliate for purposes of section 23A under the rule. A member bank that buys debt securities issued by an affiliate has made an extension of credit to an affiliate under section 23A and must collateralize the transaction in accordance with the collateral requirements of section 23A. An exemption from the collateral requirements is provided for situations in which a member bank purchases an affiliate's debt securities from a third party in a bona fide secondary-market transaction.

Prohibition on the Purchase of Low-Quality Assets

Section 23A includes a general prohibition on the purchase by a member bank of a low-quality asset from an affiliate.[2e] Section 23A defines a low-quality asset to include (1) an asset classified as ''substandard,'' ''doubtful,'' or ''loss,'' or treated as ''other loans specially mentioned,'' in the most recent report of examination or inspection by a federal or state supervisory agency (a ''classified asset''), (2) an asset in nonaccrual status, (3) an asset on which payments are more than 30 days past due, or (4) an asset whose terms have been renegotiated or compromised due to the deteriorating financial condition of the obligor.[2f] Any asset meeting one of the above four criteria, including securities and real property, is a low-quality asset.[2g] Regulation W

2b. The Board would consider a full-payout, net lease permissible for a national bank under 12 USC 24 (seventh) and 12 CFR 23 to be the functional equivalent of an extension of credit.

2c. A floating-rate loan does not become a new covered transaction whenever there is a change in the relevant index (for example, LIBOR or the member bank's prime rate) from which the loan's interest rate is calculated. If the member bank and the borrower, however, amend the loan agreement to change the interest-rate term from ''LIBOR plus 100 basis points'' to ''LIBOR plus 150 basis points,'' the parties have engaged in a new covered transaction.

2d. The definition of extension of credit would cover, among other things, situations in which an affiliate fails to pay on a timely basis for services rendered to the affiliate by the member bank.

2e. See 12 USC 371c(a)(3). Section 23A does not prohibit an affiliate from donating a low-quality asset to a member bank, so long as the bank provides no consideration for the asset.

2f. 12 USC 371c(b)(10).

2g. The federal banking agencies generally consider non-investment-grade securities to be classified assets. See, for example, the Uniform Agreement on the Classification of Assets and Appraisal of Securities Held by Banks (May 7, expands the definition of low-quality assets in several respects. (See 12 CFR 223.3(v).)

First, an asset identified by examiners as an ‘‘other transfer risk problem’’ (OTRP) is a low-quality asset. Such assets represent credits to countries that are not complying with their external debt-service obligations but are taking positive steps to restore debt service through economic adjustment measures, generally as part of an International Monetary Fund program. Although OTRP assets are not considered classified assets, examiners are to consider these assets in their assessment of a bank's asset quality and capital adequacy.[2h]

Second, the rule considers a financial institution's use of its own internal asset-classification systems. The rule includes within the definition of low-quality asset not only assets classified during the last examination but also assets classified or treated as special mention under the institution's internal classification system (or assets that received an internal rating that is substantially equivalent to classified or special mention in such an internal system).

The purchase by a depository institution from an affiliate of assets that have been internally classified raises potentially significant safety-and-soundness concerns. The Board expects companies with internal rating systems to use the systems consistently over time and over similar classes of assets and will view as an evasion of section 23A any company's deferral or alteration of an asset's rating to facilitate sale of the asset to an affiliated institution.

Finally, the rule defines low-quality asset to include foreclosed property designated ‘‘other real estate owned’’ (OREO), until it is reviewed by an examiner and receives a favorable classification. It further defines as a low-quality asset any asset (not just real estate) that is acquired in satisfaction of a debt previously contracted (not just through foreclosure) if the asset has not yet been reviewed in an examination or inspection. Under the rule, if a particular asset is good collateral taken from a bad borrower, the asset should cease to be a low-quality asset upon examination.

Section 23A provides a limited exception to the general rule prohibiting purchase of low-quality assets if the bank performs an independent credit evaluation and commits to the purchase of the asset before the affiliate acquires the asset.[2i] Section 223.15 of the rule also provides an exception from the prohibition on the purchase by a member bank of a low-quality asset from an affiliate for certain loan renewals. The rule allows a member bank that purchased a loan participation from an affiliate to renew its participation in the loan, or provide additional funding under the existing participation, even if the underlying loan had become a low-quality asset, so long as certain criteria were met. These renewals or additional credit extensions may enable both the affiliate and the participating member bank to avoid or minimize potential losses. The exception is available only if (1) the underlying loan was not a low-quality asset at the time the member bank purchased its participation and (2) the proposed transaction would not increase the member bank's proportional share of the credit facility. The member bank must also obtain the prior approval of its entire board of directors (or its delegees) and it must give a 20 days' post-consummation notice to its appropriate federal banking agency. A member bank is permitted to increase its proportionate share in a restructured loan by 5 percent (or by a higher percentage with the prior approval of the bank's appropriate federal banking agency). The scope of the exemption includes renewals of participations in loans originated by any affiliate of the member bank (not just affiliated depository institutions).

Attribution Rule

The ‘‘attribution rule,’’ found in section 223.16, prevents a member bank from evading its restrictions by using intermediaries, and it limits the exposure that a member bank has to customers of affiliates of the bank. Any covered transaction by a member bank or its subsidiary with any person is deemed to be a transaction with an affiliate of the bank if any of the proceeds of the transaction are used for the benefit of, or are transferred to, the affiliate. For example, a member bank's loan to a customer for the purpose of purchasing securities from the inventory of a broker-dealer affiliate of the bank would be a covered transaction under section 23A.

1979) and also table 3 in section 2020.1 of this manual. Assets identified by examiners through the Shared National Credit and International Country Exposure Review Committee processes also should be considered classified assets for purposes of section 23A.

2h. See sections 7040.1 and 7040.3.

2i. 12 USC 371c(a)(3).

Credit Transactions with an Affiliate

Valuation of Credit Transactions with an Affiliate

A credit transaction between a member bank and an affiliate initially must be valued at the amount of funds provided by the member bank to, or on behalf of, the affiliate plus any additional amount that the bank could be required to provide to, or on behalf of, the affiliate. The section 23A value of a credit transaction between a member bank and an affiliate is the *greater* of (1) the principal amount of the credit transaction; (2) the amount owed by the affiliate to the member bank under the credit transaction; or (3) the sum of (a) the amount provided to, or on behalf of, the affiliate in the transaction and (b) any additional amount that the member bank could be required to provide to, or on behalf of, the affiliate under the terms of the transaction.

The first prong of the rule's valuation formula for credit transactions (''the principal amount of the credit transaction'') would likely determine the valuation of a transaction in which a member bank purchased a zero-coupon note issued by an affiliate. A member bank should value such an extension of credit at the principal, or face, amount of the note (that is, at the amount that the affiliate ultimately must pay to the bank) rather than at the amount of funds initially advanced by the bank. For example, assume a member bank purchased from an affiliate for $50 a 10-year zero-coupon note issued by the affiliate with a face amount of $100. The rule's valuation formula requires the member bank to value this transaction at $100.

The second prong of the rule's valuation formula for credit transactions (''the amount owed by the affiliate'') likely would determine the valuation of a transaction in which an affiliate fails to pay a member bank when due a fee for services rendered by the bank to the affiliate. This prong of the valuation formula does not include within section 23A's quantitative limits items such as accrued interest not yet due on a member bank's loan to an affiliate or the credit exposure of a member bank to an affiliate on a derivative transaction that is not the functional equivalent of a credit transaction (unless and until the affiliate defaults in making a required payment to the bank on a settlement date).

Member banks will be able to determine the section 23A value for most credit transactions under the third prong of the rule's valuation formula. Under this prong, for example, a $100 term loan is a $100 covered transaction, a $300 revolving credit facility is a $300 covered transaction (regardless of how much of the facility the affiliate has drawn down), and a guarantee backstopping a $500 debt issuance of the affiliate is a $500 covered transaction.

Under section 23A and the rule, a member bank has made an extension of credit to an affiliate if the bank purchases from a third party a loan previously made to an affiliate of the bank. A different valuation formula is provided for these indirect credit transactions: The member bank must value the transaction at the price paid by the bank for the loan plus any additional amount that the bank could be required to provide to, or on behalf of, the affiliate under the terms of the credit agreement.

For example, if a member bank pays a third party $90 for a $100 term loan that the third party previously made to an affiliate of the bank (because, for example, the loan was at a fixed rate and has declined in value because of a rise in the general level of interest rates), the covered transaction amount is $90 rather than $100. The lower covered-transaction amount reflects the fact that the member bank's maximum loss on the transaction is $90 rather than the original principal amount of the loan. For another example, if a member bank pays a third party $70 for a $100 line of credit to an affiliate, of which $70 had been drawn down by the affiliate, the covered-transaction amount would be $100 (the $70 purchase price paid by the bank for the credit plus the remaining $30 that the bank could be required to lend under the credit line).

In another example, a member bank makes a term loan to an affiliate that has a principal amount of $100. The affiliate pays $2 in up-front fees to the member bank, and the affiliate receives net loan proceeds of $98. The member bank must initially value the covered transaction at $100.

Although the rule considers a member bank's purchase of, or investment in, a debt security issued by an affiliate as an extension of credit to an affiliate, these transactions are not valued like other extensions of credit. See section 223.23 for the valuation rules for purchases of, and investments in, the debt securities of an affiliate.

Timing of a Credit Transaction with an Affiliate

A member bank has entered into a credit transaction with an affiliate at *the time during the day* that the bank becomes legally obligated to make the extension of credit to, or issue the guarantee, acceptance, or letter of credit on behalf of, the affiliate. A covered transaction occurs at the moment that the member bank executes a legally valid, binding, and enforceable credit agreement or guarantee and does not occur only when a member bank funds a credit facility or makes payment on a guarantee. Consistent with section 23A, the rule only requires a member bank to compute compliance with its quantitative limits when the bank is about to engage in a new covered transaction. The rule does not require a member bank to compute compliance with the rule's quantitative limits on a continuous basis. See section 223.21(b)(1) of the rule.

The burden of the timing rule is significantly mitigated by the exemption for intraday extensions of credit found in section 223.42(*l*). The intraday credit exemption generally applies only to extensions of credit that a member bank expects to be repaid, sold, or terminated by the end of its U.S. business day. The rule generally requires a member bank to ensure its intraday compliance with section 23A when making a loan to an affiliate during the day, which the bank expects to remain a loan outstanding and on its books overnight.

Asset Purchases from an Affiliate

Regulation W provides that a purchase of assets by a member bank from an affiliate initially must be valued at the total amount of consideration given by the bank in exchange for the asset. (See section 223.22.) This consideration can take any form and includes an assumption of liabilities by the member bank. Asset purchases are a covered transaction for a member bank for as long as the bank holds the asset. The value of the covered transaction after the purchase may be reduced to reflect amortization or depreciation of the asset, to the extent that such reductions are consistent with GAAP and are reflected on the bank's financial statements.

Certain asset purchases by a member bank from an affiliate *are not* valued in accordance with the general asset-purchase valuation formula. First, if the member bank buys from one affiliate a loan to a second affiliate, the bank must value the transaction as a credit transaction with the second affiliate under section 223.21. Second, if the member bank buys from one affiliate a security issued by a second affiliate, the bank must value the transaction as an investment in securities issued by the second affiliate under section 223.23. Third, if the member bank acquires an affiliate that becomes an operating subsidiary of the bank after the acquisition, the bank must value the transaction under section 223.31.

A special valuation rule applies to a member bank's purchase of a line of credit or loan commitment from an affiliate. A member bank initially must value such asset purchases at the purchase price paid by the bank for the asset plus any additional amounts that the bank is obligated to provide under the credit facility.[2j] This special valuation rule ensures that there are limits on the amount of risk a company can shift to an affiliated bank.

In contrast with credit transactions, an asset purchase from a nonaffiliate that later becomes an affiliate generally does not become a covered transaction for the purchasing member bank. If a member bank purchases assets from a nonaffiliate in contemplation of the nonaffiliate's becoming an affiliate of the bank, however, the asset purchase becomes a covered transaction at the time the nonaffiliate becomes an affiliate. In addition, the member bank must ensure that the aggregate amount of the bank's covered transactions (including any such asset purchase from the nonaffiliate) would not exceed the quantitative limits of section 23A at the time the nonaffiliate becomes an affiliate.

The following examples are provided to assist member banks in valuing purchases of assets from an affiliate. A member bank's receipt of an encumbered asset from an affiliate ceases to be a covered transaction when, for example, the bank sells the asset.

- *Cash purchase of assets.* A member bank purchases a pool of loans from an affiliate for $10 million. The member bank initially must value the covered transaction at $10 million.

2j. A member bank would not be required to include unfunded, but committed, amounts in the value of the covered transaction if (1) the credit facility being transferred from the affiliate to the bank is unconditionally cancelable (without cause) at any time by the bank and (2) the bank makes a separate credit decision before each drawing under the facility.

Going forward, if the borrowers repay $6 million of the principal amount of the loans, the member bank may value the covered transaction at $4 million.

- *Purchase of assets through an assumption of liabilities.* An affiliate of a member bank contributes real property with a fair market value of $200,000 to the member bank. The member bank pays the affiliate no cash for the property, but assumes a $50,000 mortgage on the property. The member bank has engaged in a covered transaction with the affiliate and initially must value the transaction at $50,000. Going forward, if the member bank retains the real property but pays off the mortgage, the member bank must continue to value the covered transaction at $50,000. If the member bank, however, sells the real property, the transaction ceases to be a covered transaction at the time of the sale (regardless of the status of the mortgage).

Purchases of and Investments in Securities Issued by an Affiliate

Section 23A includes as a covered transaction a member bank's purchase of, or investment in, securities issued by an affiliate. Section 223.23 of the rule requires a member bank to value a purchase of, or investment in, securities issued by an affiliate (other than a financial subsidiary of the bank) at the *greater* of the bank's purchase price or carrying value of the securities. A member bank that paid no consideration in exchange for affiliate securities has to value the covered transaction at no less than the bank's carrying value of the securities.[2k] In addition, if the member bank's carrying value of the affiliate securities increased or decreased after the bank's initial investment (due to profits or losses at the affiliate), the amount of the bank's covered transaction would increase or decrease to reflect the bank's changing financial exposure to the affiliate. However, the amount of the bank covered transaction cannot decline below the amount paid by the bank for the securities.

Several important considerations support the general carrying-value approach of this valuation rule. First, the approach is consistent with GAAP, which would require a bank to reflect its investment in securities issued by an affiliate at carrying value throughout the life of the investment, even if the bank paid no consideration for the securities.

Second, the approach is supported by the terms of the statute, which defines both a "purchase of *and* an "investment in" securities issued by an affiliate as a covered transaction. The statute's "investment in" language indicates that Congress was concerned with a member bank's continuing exposure to an affiliate through an ongoing investment in the affiliate's securities.

Third, GLB Act amendments to section 23A support the approach. The GLB Act defines a financial subsidiary of a bank as an affiliate of the bank, but specifically provides that the section 23A value of a bank's investment in securities issued by a financial subsidiary does *not* include retained earnings of the subsidiary. The negative implication from this provision is that the section 23A value of a bank's investment in *other* affiliates *includes* the affiliates' retained earnings, which would be reflected in the bank's carrying value of the investment under the rule.

Finally, the carrying-value approach is consistent with the purposes of section 23A—limiting the financial exposure of banks to their affiliates and promoting safety and soundness. The valuation rule requires a member bank to revalue upwards the amount of an investment in affiliate securities only when the bank's exposure to the affiliate increases (as reflected on the bank's financial statements) and the bank's capital increases to reflect the higher value of the investment. In these circumstances, the valuation rule merely reflects the member bank's greater financial exposure to the affiliate and enhances safety and soundness by reducing the bank's ability to engage in additional transactions with an affiliate as the bank's exposure to that affiliate increases.

The valuation rule also provides that the covered-transaction amount of a member bank's investment in affiliate securities can be no less than the purchase price paid by the bank for the securities, even if the carrying value of the securities declines below the purchase price. Although this aspect of the valuation rule is not consistent with GAAP, using the member bank's purchase price for the securities as a floor for valuing the covered transaction is appropriate. First, it ensures that the amount of the covered transaction never falls below the amount of

2k. Carrying value refers to the amount at which the securities are carried on the GAAP financial statements of the member bank.

funds actually transferred by the member bank to the affiliate in connection with the investment. In addition, the purchase-price floor limits the ability of a member bank to provide additional funding to an affiliate as the affiliate approaches insolvency. If investments in securities issued by an affiliate were valued strictly at carrying value, then the member bank could lend more funds to the affiliate as the affiliate's financial condition worsened. As the affiliate declined, the member bank's carrying value of the affiliate's securities would decline, the section 23A value of the bank's investment likely would decline, and, consequently, the bank would be able to provide additional funding to the affiliate under section 23A. This type of increasing support for an affiliate in distress is what section 23A was intended to restrict.

The examples provided below are designed to assist member banks in valuing purchases of, and investments in, securities issued by an affiliate.

- *Purchase of the debt securities of an affiliate.* The parent holding company of a member bank owns 100 percent of the shares of a mortgage company. The member bank purchases debt securities issued by the mortgage company for $600. The initial carrying value of the securities is $600. The member bank initially must value the investment at $600.
- *Purchase of the shares of an affiliate.* The parent holding company of a member bank owns 51 percent of the shares of a mortgage company. The member bank purchases an additional 30 percent of the shares of the mortgage company from a third party for $100. The initial carrying value of the shares is $100. The member bank initially must value the investment at $100. Going forward, if the member bank's carrying value of the shares declines to $40, the member bank must continue to value the investment at $100.
- *Contribution of the shares of an affiliate.* The parent holding company of a member bank owns 100 percent of the shares of a mortgage company and contributes 30 percent of the shares to the member bank. The member bank gives no consideration in exchange for the shares. If the initial carrying value of the shares is $300, then the member bank initially must value the investment at $300. Going forward, if the member bank's carrying value of the shares increases to $500, the member bank must value the investment at $500.

Securities Issued by an Affiliate as Collateral

General Valuation Rule (Section 223.24(a) and (b))

Section 23A defines as a covered transaction a member bank's acceptance of securities issued by an affiliate as collateral for a loan or extension of credit to any person or company.[2l] This type of covered transaction has two classes: one in which the only collateral for the loan is affiliate securities and another in which the loan is secured by a combination of affiliate securities and other collateral.

Under the rule, if the credit extension is secured exclusively by affiliate securities, then the transaction is valued at the full amount of the extension of credit. This approach reflects the difficulty of measuring the actual value of typically untraded and illiquid affiliate securities and conservatively assumes that the value of the securities is equal to the full value of the loan that the securities collateralize. An exception is provided to the general rule when the affiliate securities held as collateral have a ready market (as defined by section 223.42 of the rule). In that case, the transaction may be valued at the fair market value of the affiliate securities. The exception grants relief in those circumstances when the value of the affiliate securities is independently verifiable by reference to transactions occurring in a liquid market.[2m]

Covered transactions of the second class, in which the credit extension is secured by affiliate securities and other collateral, are valued at the *lesser* of (1) the total value of the extension of credit minus the fair market value of the other collateral or (2) the fair market value of the

2*l*. See 12 USC 371c(b)(7)(D). This covered transaction only arises when the member bank's loan is to a nonaffiliate. Under section 23A, the securities issued by an affiliate are not acceptable collateral for a loan or extension of credit to any affiliate. (See 12 USC 371c(c)(4).) If the proceeds of a loan that is secured by an affiliate's securities are transferred to an affiliate by the unaffiliated borrower (for example, to purchase assets or securities from the inventory of an affiliate), the loan should be treated as a loan to the affiliate. The loan must then be secured with collateral in an amount and of a type that meets the requirements of section 23A for loans by a member bank to an affiliate.

2m. In either case, the transaction must comply with section 23B; that is, the member bank must obtain the same amount of affiliate securities as collateral on the credit extension that the bank would obtain if the collateral were not affiliate securities.

affiliate securities (if the securities have a ready market). The rule's ready-market requirement applies regardless of the amount of affiliate collateral.[2n]

Exemption for Shares Issued by an Affiliated Mutual Fund

Section 223.24(c) of the rule provides an exemption for extensions of credit by a member bank that are secured by shares of an affiliated mutual fund. The rule effects the exemption by providing that an affiliated mutual fund's shares that meet the above-mentioned criteria do not count as affiliate-issued securities for purposes of the valuation rule for extensions of credit secured by affiliate-issued securities. To qualify for the exemption, the transaction must meet several conditions. First, to ensure that the affiliate collateral is liquid and trades at a fair price, the affiliated mutual fund must be an open-end investment company that is registered with the SEC under the 1940 act. Second, to ensure that the member bank can easily establish and monitor the value of the affiliate collateral, the affiliated mutual fund's shares serving as collateral for the extension of credit must have a publicly available market price. Third, to reduce the member bank's incentives to use these extensions of credit as a mechanism to support the affiliated mutual fund, the member bank and its affiliates must not own more than 5 percent of the fund's shares (excluding certain shares held in a fiduciary capacity). Finally, the proceeds of the extension of credit must not be used to purchase the affiliated mutual fund's shares serving as collateral or otherwise used to benefit an affiliate. In such circumstances, the member bank's extension of credit would be covered by section 23A's attribution rule. For example, a member bank proposes to lend $100 to a nonaffiliate secured exclusively by eligible affiliated mutual fund securities. The member bank knows that the nonaffiliate intends to use all the loan proceeds to purchase the eligible affiliated mutual fund securities that would serve as collateral for the loan. Under the attribution rule in section 223.16, the member bank must treat the loan to the nonaffiliate as a loan to an affiliate, and because securities issued by an affiliate are ineligible collateral under section 223.14, the loan would not be in compliance with section 223.14.

Merger and Acquisition Transactions Between a Member Bank and an Affiliate

Under section 223.31 (a)–(c) of the rule, there are several methods by which a member bank acquires an affiliate. The first method is when a member bank directly purchases or otherwise acquires the affiliate's assets and assumes the affiliate's liabilities. In this case, the transaction is treated as a purchase of assets, and the covered-transaction amount is equal to the amount of any separate consideration paid by the member bank for the affiliate's assets (if any) plus the amount of any liabilities assumed by the bank in the transaction.

The second method is when a member bank acquires an affiliate by merger. Because a merger with an affiliate generally results in the member bank's acquiring all the assets of the affiliate and assuming all the liabilities of the affiliate, this transaction is effectively equivalent to the purchase and assumption transaction described in the previous paragraph. Accordingly, the merger transaction also is treated as a purchase of assets, and the covered-transaction amount is equal to the amount of any separate consideration paid by the member bank for the affiliate's assets (if any) plus the amount of any liabilities assumed by the bank in the transaction.[2o] Another illustrative structure, whereby the bank acquires an affiliate, involves the contribution or sale of a controlling block of an affiliate's shares to a member bank. For example, the parent holding company of a member bank contributes between 25 percent and 100 percent of the voting shares of a mortgage company to the member bank. The parent holding company retains no shares of the mortgage company. The member bank gives no consideration in exchange for the transferred shares. The mortgage company has total assets of $300,000 and total liabilities of $100,000. The mortgage company's assets do not include any loans to an

2n. Under the rule, a member bank may use the higher of the two valuation options for these transactions if, for example, the bank does not have the procedures and systems in place to verify the fair market value of affiliate securities.

2o. As noted, section 223.3(dd) of the rule makes explicit the Board's view that these merger transactions generally involve the purchase of assets by a member bank from an affiliate.

affiliate of the member bank or any other asset that would represent a separate covered transaction for the member bank upon consummation of the share transfer. As a result of the transaction, the mortgage company becomes an operating subsidiary of the member bank. The transaction is treated as a purchase of the assets of the mortgage company by the member bank from an affiliate under paragraph (a) of section 223.31. The member bank initially must value the transaction at $100,000, the total amount of the liabilities of the mortgage company. Going forward, if the member bank pays off the liabilities, the member bank must continue to value the covered transaction at $100,000. However, if the member bank sells $15,000 of the transferred assets of the mortgage company or if $15,000 of the transferred assets amortize, the member bank may value the covered transaction at $85,000.

As for the third type of transaction, the rule provides that the acquisition by a member bank of a company that was an affiliate of the bank before the acquisition is treated as a purchase of assets from an affiliate if (1) as a result of the transaction, the company becomes an operating subsidiary of the bank and (2) the company has liabilities, or the bank gives cash or any other consideration in exchange for the securities. The rule also provides that these transactions must be valued initially at the sum of (1) the total amount of consideration given by the member bank in exchange for the securities and (2) the total liabilities of the company whose securities have been acquired by the member bank. In effect, the rule requires member banks to treat such share donations and purchases in the same manner as if the member bank had purchased the assets of the transferred company at a purchase price equal to the liabilities of the transferred company (plus any separate consideration paid by the bank for the shares). (See 12 CFR 223.31.)

The assets and liabilities of an operating subsidiary of a member bank are treated in the rule as assets and liabilities of the bank itself for purposes of section 23A.[3] The rule only imposes asset-purchase treatment on affiliate share transfers when the company whose shares are being transferred to the member bank was an affiliate of the bank before the transfer. If the transferred company was not an affiliate before the transfer, it would not be appropriate to treat the share transfer as a purchase of assets *from an affiliate.* Similarly, the rule only requires asset-purchase treatment for affiliate share transfers when the transferred company becomes a subsidiary and not an affiliate of the member bank through the transfer.

If a bank purchases, or receives a donation, of a partial interest in an affiliate, that transaction is treated as a purchase of, or investment in securities issued by an affiliate. This type of transaction is valued according to the purchase price or GAAP carrying value. (See 12 CFR 223.23.)

Step-Transaction Exemption (Section 223.31(d) and (e))

Under section 223.31(d) of the rule, an exemption is provided for certain step transactions that are treated as asset purchases under section 223.31(a) when a BHC acquires the stock of an unaffiliated company and, immediately after consummation of the acquisition, transfers the shares of the acquired company to the holding company's subsidiary member bank. For example, a bank holding company acquires 100 percent of the shares of an unaffiliated leasing company. At that time, the subsidiary member bank of the holding company notifies its appropriate federal banking agency and the Board of its intent to acquire the leasing company from its holding company. On the day after consummation of the acquisition, the holding company transfers all of the shares of the leasing company to the member bank. No material change in the business or financial condition of the leasing company occurs between the time of the holding company's acquisition and the member bank's acquisition. The leasing company has liabilities. The leasing company becomes an operating subsidiary of the member bank at the time of the transfer. This transfer by the holding company to the member bank, although deemed an asset purchase by the member bank from an affiliate under paragraph (a) of section 223.31, would qualify for the exemption in paragraph (d) of section 223.31.

3. Because a member bank usually can merge a subsidiary into itself, transferring all the shares of an affiliate to a member bank often is functionally equivalent to a transaction in which the bank directly acquires the assets and assumes the liabilities of the affiliate. In a direct acquisition of assets and assumption of liabilities, the covered-transaction amount would be equal to the total amount of liabilities assumed by the member bank.

The rule exempts these ''step'' transactions under certain conditions. First, the member bank must acquire the target company immediately after the company became an affiliate (by being acquired by the bank's holding company, for example). The member bank must acquire the entire ownership position in the target company that its holding company acquired. Also, there must be no material change in the business or financial condition of the target company during the time between when the company becomes an affiliate of the member bank and when the bank is in receipt of the company. Finally, the entire transaction must comply with the market-terms requirement of section 23B, and the bank must notify its appropriate federal banking agency and the Board, at or before the time that the target company becomes an affiliate of the bank, of its intent ultimately to acquire the target company.

Regulation W requires that the bank consummate the step transaction immediately to ensure the quality and fairness of the transaction. To the extent that the member bank acquires the target company some time after the company becomes an affiliate, the transaction looks less like a single transaction in which the bank acquires the target company and more like two separate transactions, the latter of which involves the bank acquiring assets from an affiliate. The Board recognized, however, that banking organizations may need a reasonable amount of time to address legal, tax, and business issues relating to an acquisition. Regulation W thus permits member banks to avail themselves of the step-transaction exemption if the bank acquires the target company within three months after the target company becomes an affiliate so long as the appropriate federal banking agency for the bank has approved the longer time period.

The 100 percent ownership requirement (that the member bank must acquire the entire ownership position in the target company that its holding company acquired) prevents a holding company from keeping the good subsidiaries of the target company and transferring its bad subsidiaries to the holding company's subsidiary member bank. If a banking organization fails to meet the terms of the step-transaction exemption, the organization may be able to satisfy the conditions of the rule's internal-corporate-reorganization exemption or may be able to obtain a case-by-case exemption from the Board.

Financial Subsidiaries

Section 23A Statutory Provisions for Financial Subsidiaries

Section 23A has several special provisions that apply to covered transactions between a bank and its financial subsidiary. Section 23A defines a ''financial subsidiary'' as any company that is a subsidiary of a bank that would be a financial subsidiary of a national bank under section 5136A of the Revised Statutes of the United States.[3a] Section 5136A, in turn, defines a financial subsidiary of a national bank as any company that is controlled by one or more insured depository institutions, other than (1) a subsidiary that engages solely in activities that national banks are permitted to engage in directly (and subject to the same terms and conditions that apply to national banks) or (2) a national bank is specifically authorized by the express terms of a federal statute (other than section 5136A), such as an Edge Act corporation or an SBIC.[3b] Section 5136A also prohibits a financial subsidiary of a national bank from engaging in insurance underwriting, real estate investment and development, or merchant banking activities.[3c]

Under section 23A, the section's 10 percent quantitative limit does not apply to covered transactions between a bank and any individual financial subsidiary of the bank. Accordingly, a bank may engage in covered transactions with any individual financial subsidiary up to 20 percent of the bank's capital stock and surplus. A bank's covered transactions with its financial subsidiaries, however, are subject to a statutory 20 percent quantitative limit. Thus, a bank may not engage in a covered transaction with any affiliate (including a financial subsidiary) if the bank's aggregate amount of covered transactions with all affiliates (including financial subsidiaries) would exceed 20 percent of the bank's capital stock and surplus.

Because financial subsidiaries of a bank are considered affiliates of the bank for purposes of section 23A, purchases of and investments in the securities of a financial subsidiary are covered transactions under the statute and count against the bank's quantitative limit. A bank's investment in its financial subsidiary, for pur-

3a. 12 USC 24a(g)(3).
3b. 12 USC 24a(a)(2).
3c. 12 USC 371c(e)(1).

poses of section 23A, shall not include the retained earnings of the financial subsidiary.

Section 23A generally applies only to transactions between (1) a bank and an affiliate of the bank and (2) a bank and a third party in which some benefit from either type of transaction accrues to an affiliate of the bank. The statute generally does not apply to transactions between two affiliates. Section 23A establishes two special anti-evasion rules, however, that govern transactions between a financial subsidiary of a bank and another affiliate of the bank. First, the FRA provides that any purchase of or investment in the securities of a bank's financial subsidiary by an affiliate of the bank will be deemed to be a purchase of, or investment in, such securities by the bank itself. Second, the GLB Act authorizes the Board to deem a loan or other extensions of credit made by a bank's affiliate to any financial subsidiary of a bank to be an extension of credit by the bank to the financial subsidiary, if the Board determines that such action is necessary or appropriate to prevent evasion.

Regulation W Provisions for Financial Subsidiaries

Regulation W includes, in section 223.32, several special rules that apply to transactions with financial subsidiaries.

Applicability of the 10 percent quantitative limit to transactions with a financial subsidiary. First, section 223.32(a) of the rule provides that the 10 percent quantitative limit in section 23A does not apply with respect to covered transactions between a member bank and any individual financial subsidiary of the bank. A member bank's aggregate amount of covered transactions with any individual financial subsidiary of the bank may exceed 10 percent of the bank's capital stock and surplus.[3d] A member bank's covered transactions with its financial subsidiaries, however, are subject to the 20 percent quantitative limit in section 23A. Thus, a member bank may not engage in a covered transaction with any affiliate (including a financial subsidiary) if the bank's aggregate amount of covered transactions with all affiliates (including financial subsidiaries) would exceed 20 percent of the bank's capital stock and surplus.

The Board notes that the exemption from the 10 percent limit for investments by a member bank in its own financial subsidiary does not apply to investments by a member bank in the financial subsidiary of an affiliated depository institution. Although the financial subsidiary of an affiliated depository institution is an affiliate of the member bank for purposes of sections 23A and 23B, the GLB Act states that only "covered transactions between a bank and any individual financial subsidiary *of the bank*" are not subject to the 10 percent limit in section 23A.[3e] A member bank may not engage in a covered transaction with the financial subsidiary of an affiliated depository institution if the aggregate amount of the member bank's covered transactions with that financial subsidiary would exceed 10 percent of the bank's capital stock and surplus.

Valuation of investments in securities issued by a financial subsidiary. Because financial subsidiaries of a member bank are considered affiliates of the bank for purposes of section 23A, a member bank's purchases of and investments in the securities of its financial subsidiary are covered transactions under the statute. The GLB Act further provides that a member bank's investment in its own financial subsidiary, for purposes of section 23A, shall not include the retained earnings of the financial subsidiary.[3f] In light of this statutory provision, the rule's section 223.32(b) contains a special valuation rule for investments by a member bank in the securities of its own financial subsidiary.[3g] Such investments must be valued at the greater of (1) the price paid by the member bank for the securities or (2) the carrying value of the securities on the financial statements of the member bank (determined in accordance with GAAP but without reflecting the bank's pro rata share of any earnings retained or losses incurred by the financial subsidiary after the bank's acquisition of the securities).[3h]

3d. Section 223.11 also indicates that covered transactions between a member bank and its financial subsidiary are exempt from the 10 percent limit.

3e. See 12 USC 371c(e)(3)(A).

3f. GLB Act section 121(b)(1) (12 USC 371c(e)(3)(B)).

3g. The rule's special valuation formula for investments by a member bank in its own financial subsidiary does not apply to investments by a member bank in a financial subsidiary of an affiliated depository institution. Such investments must be valued using the general valuation formula set forth in section 223.23 for investments in securities issued by an affiliate and, further, may trigger the anti-evasion rule contained in section 223.32(c)(1) of the rule.

3h. The rule also makes clear that if a financial subsidiary

This valuation rule differs from the general valuation rule for investments in securities issued by an affiliate only in that the financial subsidiary rule requires, consistent with the GLB Act, that the carrying value of the investment be computed without consideration of the retained earnings or losses of the financial subsidiary since the time of the member bank's investment. As a result of this rule, the covered-transaction amount for a member bank's investment in securities issued by its financial subsidiary generally would not increase after the investment was made except if the member bank made an additional capital contribution to the subsidiary or purchased additional securities of the subsidiary.

The following examples were designed to assist member banks in valuing investments in securities issued by a financial subsidiary of the member bank. Each example involves a securities underwriter that becomes a financial subsidiary of the member bank after the transactions described below.

- *Initial valuation.*
  - *Direct acquisition by a member bank.* A member bank pays $500 to acquire 100 percent of the shares of a securities underwriter. The initial carrying value of the shares on the member bank's parent-only GAAP financial statements is $500. The member bank initially must value the investment at $500.
  - *Contribution of a financial subsidiary to a member bank.* The parent holding company of a member bank acquires 100 percent of the shares of a securities underwriter in a transaction valued at $500 and immediately contributes the shares to the member bank. The member bank gives no consideration in exchange for the shares. The member bank initially must value the investment at the carrying value of the shares on the member bank's parent-only GAAP financial statements. Under GAAP, the member bank's initial carrying value of the shares would be $500.
- *Carrying value not adjusted for earnings and losses of the financial subsidiary.* A member bank and its parent holding company engage in a transaction whereby the member bank acquires 100 percent of the shares of a securities underwriter in a transaction valued at $500. The member bank initially values the investment at $500. In the following year, the securities underwriter earns $25 in profit, which is added to its retained earnings. The member bank's carrying value of the shares of the underwriter is not adjusted for purposes of this part, and the member bank must continue to value the investment at $500. If, however, the member bank contributes $100 of additional capital to the securities underwriter, the member bank must value the aggregate investment at $600.

is consolidated with its parent member bank under GAAP, the carrying value of the bank's investment in the financial subsidiary shall be determined based on parent-only financial statements of the bank.

Anti-evasion rules as they pertain to financial subsidiaries. Section 23A generally applies only to transactions between a member bank and an affiliate of the bank and transactions between a member bank and a third party when some benefit of the transaction accrues to an affiliate of the bank. The statute generally does not apply to transactions between two affiliates. The GLB Act establishes two special anti-evasion rules, however, that govern transactions between a financial subsidiary of a member bank and another affiliate of the bank.[3i] First, the GLB Act provides that any purchase of, or investment in, securities issued by a member bank's financial subsidiary by an affiliate of the bank will be deemed to be a purchase of, or investment in, such securities by the bank itself. Second, the GLB Act authorizes the Board to deem an extension of credit made by a member bank's affiliate to any financial subsidiary of the bank to be an extension of credit by the bank to the financial subsidiary, if the Board determines that such action is necessary or appropriate to prevent evasions of the Federal Reserve Act or the GLB Act. Section 223.32(c) of the rule incorporates both of these provisions.

The Board exercised its authority under the second anti-evasion rule by stating that an extension of credit to a financial subsidiary of a member bank by an affiliate of the bank would be treated as an extension of credit by the bank itself to the financial subsidiary if the extension of credit is treated as regulatory capital of the financial subsidiary. An example of the kind of credit extension covered by this provision would be a subordinated loan to a financial subsidiary that is a securities broker-dealer where the loan is treated as capital of the subsidiary under the

3i. GLB Act section 121(b)(1) (12 USC 371c(e)(4)).

SEC's net capital rules. Treating such an extension of credit as a covered transaction is appropriate because the extension of credit by the affiliate has a similar effect on the subsidiary's regulatory capital as an equity investment by the affiliate, which is treated as a covered transaction by the terms of the GLB Act (as described above). The rule generally does not prevent a BHC or other affiliate of a member bank from providing financial support to a financial subsidiary of the bank in the form of a senior or secured loan.

Derivative Transactions

Derivative transactions between a bank and its affiliates generally arise either from the risk-management needs of the bank or the affiliate. Transactions arising from the bank's needs typically arise when a bank enters into a swap or other derivative contract with a customer but chooses not to hedge directly the market risk generated by the derivative contract or is unable to hedge the risk directly because the bank is not authorized to hold the hedging asset. In order to manage the market risk, the bank may have an affiliate acquire the hedging asset. The bank would then do a "bridging" derivative transaction between itself and the affiliate maintaining the hedge.

Other derivative transactions between a bank and its affiliate are affiliate-driven. A bank's affiliate may enter into an interest-rate or foreign-exchange derivative with the bank in order to accomplish the asset-liability management goals of the affiliate. For example, a BHC may hold a substantial amount of floating-rate assets but issue fixed-rate debt securities to obtain cheaper funding. The BHC may then enter into a fixed-to-floating interest-rate swap with its subsidiary bank to reduce the holding company's interest-rate risk.

Banks and their affiliates that seek to enter into derivative transactions for hedging (or risk-taking) purposes could enter into the desired derivatives with unaffiliated companies. Banks and their affiliates often choose to use each other as their derivative counterparties, however, in order to maximize the profits of and manage risks within the consolidated financial group.

Regulation W does not require most derivative transactions to meet the quantitative and collateral requirements of section 23A. Instead, the rule requires the member bank to establish and maintain policies and procedures designed to manage the credit exposure arising from the derivative. These policies and procedures require, at a minimum, that the bank monitor and control its exposure to its affiliates by imposing appropriate credit controls and collateral requirements.

Regulation W requires member banks to comply strictly with section 23B in their derivative transactions with affiliates. In this regard, section 23B requires a member bank to treat an affiliate no better than a *similarly situated* nonaffiliate. Section 23B generally does not allow a member bank to use with an affiliate the terms and conditions it uses with its most creditworthy unaffiliated customer unless the bank can demonstrate that the affiliate is of comparable creditworthiness as the bank's most creditworthy unaffiliated customer. Instead, section 23B requires that an affiliate be treated comparably (with respect to terms, conditions, and credit limits) to the majority of third-party customers engaged in the same business, and having comparable credit quality and size as the affiliate. Because a bank generally has the strongest credit rating within a holding company, the Board generally would not expect an affiliate to obtain better terms and conditions from a member bank than the member bank receives from its major unaffiliated counterparties. In addition, market terms for derivatives among major financial institutions generally include daily marks to market and two-way collateralization above a relatively small exposure threshold.

Covering Derivatives That Are the Functional Equivalent of a Guarantee

Although most derivatives are not treated as covered transactions, section 223.33 of the rule provides that credit derivatives between a member bank and a nonaffiliate in which the bank protects the nonaffiliate from a default on, or a decline in the value of, an obligation of an affiliate of the bank are covered transactions under section 23A. Such derivative transactions are viewed as guarantees by a member bank on behalf of an affiliate (and, hence, are covered transactions) under section 23A.

The rule provides that these credit derivatives are covered transactions under section 23A and gives several examples.[3j] A member bank is not

3j. In most instances, the covered-transaction amount for such a credit derivative would be the notional principal amount of the derivative.

allowed to reduce its covered-transaction amount for these derivatives to reflect hedging positions established by the bank with third parties. A credit derivative is treated as a covered transaction only to the extent that the derivative provides credit protection with respect to obligations of an affiliate of the member bank.

Collateral

There are collateral requirements for certain transactions with affiliates. Each loan or extension of credit to an affiliate or guarantee, acceptance, or letter of credit issued on behalf of an affiliate[3k] (herein referred to as credit transactions) by a member bank or its subsidiary must be secured at the time of the transaction by collateral. The required collateral, based on its fair market value, varies according to a percentage of the credit extended,[3*l*] depending on the type of collateral used to secure the transaction.[3m] The specific collateral requirements are—

- 100 percent of the amount of the credit extended if the collateral is composed of (1) obligations of the United States or its agencies; (2) obligations fully guaranteed by the United States or its agencies as to principal and interest; (3) notes, drafts, bills of exchange, or banker's acceptances that are eligible for rediscount or purchase by a Federal Reserve Bank; or (4) a segregated, earmarked deposit account with the member bank;
- 110 percent of the amount of the credit extended if the collateral is composed of obligations of any state or political subdivision of any state;
- 120 percent of the amount of the credit extended if the collateral is composed of other debt instruments, including receivables; or
- 130 percent of the amount of the credit extended if the collateral is composed of stock, leases, or other real or personal property.

For example, a member bank makes a $1,000 loan to an affiliate. The affiliate posts as collateral for the loan $500 in U.S. Treasury securities, $480 in corporate debt securities, and $130 in real estate. The loan satisfies the collateral requirements of this section because $500 of the loan is 100 percent secured by obligations of the United States, $400 of the loan is 120 percent secured by debt instruments, and $100 of the loan is 130 percent secured by real estate. The statute prohibits a member bank from counting a low-quality asset toward section 23A's collateral requirements for credit transactions with affiliates.[3n] A member bank must maintain a perfected security interest at all times in the collateral that secures the credit transaction.

Collateral Requirements in Regulation W

The collateral requirements for credit transactions are found in section 223.14 of the rule. Section 223.14(a) requires that a bank meet the collateral requirements only at the inception of a credit transaction with an affiliate.

Deposit account collateral. Under section 23A, a member bank may satisfy the collateral requirements of the statute by securing a credit transaction with an affiliate with a "segregated, earmarked deposit account" maintained with the bank in an amount equal to 100 percent of the credit extended.[3o] Member banks may secure covered transactions with omnibus deposit accounts so long as the member bank takes steps to ensure that the omnibus deposit accounts fully secure the relevant covered transactions. Such steps might include substantial overcollateralization or the use of subaccounts or other recordkeeping devices to match deposits with covered transactions. To obtain full credit for any deposit accounts taken as section 23A collateral, member banks must ensure that they have a perfected, first-priority security interest in the accounts. (See section 223.14(b)(1)(i)(D).)

Ineligible collateral. The purpose of section 23A's collateral requirements is to ensure that member banks that engage in credit transactions with affiliates have legal recourse, in the event of affiliate default, to tangible assets with a value at least equal to the amount of the credit extended. The statute recognizes that certain types of assets are not appropriate to serve as collateral for credit transactions with an affiliate.

3k. 12 USC 371c(b)(7).
3*l*. "Credit extended" means the loan or extension of credit, guarantee, acceptance, or letter of credit.
3m. 12 USC 371c(c)(1).
3n. 12 USC 371c(c)(3).
3o. 12 USC 371c(c)(1)(A)(iv).

In particular, the statute provides that low-quality assets and securities issued by an affiliate are not eligible collateral for such covered transactions.[3p]

Under section 223.14(c) of the rule, intangible assets are not deemed acceptable to meet the collateral requirements imposed by section 23A.[4] Intangible assets, including servicing assets, are particularly hard to value, and a member bank may have significant difficulty in collecting and selling such assets in a reasonable period of time.

Section 23A(c) requires that credit transactions with an affiliate be ''secured'' by collateral. A credit transaction between a member bank and an affiliate supported only by a guarantee or letter of credit from a third party does not meet the statutory requirement that the credit transaction be secured by collateral. Guarantees and letters of credit often are subject to material adverse change clauses and other covenants that allow the issuer of the guarantee or letter of credit to deny coverage. Letters of credit and guarantees are not balance-sheet assets under GAAP and, accordingly, would not constitute ''real or personal property'' under section 23A. There is a particularly significant risk that a member bank may have difficulty collecting on a guarantee or letter of credit provided by a nonaffiliate on behalf of an affiliate of the bank. Accordingly, guarantees and letters of credit are not acceptable section 23A collateral.[4a]

As noted above, section 23A prohibits a member bank from accepting securities issued by an affiliate as collateral for an extension of credit to any affiliate. The rule clarifies that securities issued by the member bank itself also are not eligible collateral to secure a credit transaction with an affiliate. Equity securities issued by a lending member bank, and debt securities issued by a lending member bank that count as regulatory capital of the bank, are not eligible collateral under section 23A. If a member bank were forced to foreclose on a credit transaction with an affiliate secured by such securities, the bank may be unwilling to liquidate the collateral promptly to recover on the credit transaction because the sale might depress the price of the bank's outstanding securities or result in a change in control of the bank. In addition, to the extent that a member bank is unable or unwilling to sell such securities acquired through foreclosure, the transaction would likely result in a reduction in the bank's capital, thereby offsetting any potential benefit provided by the collateral.

Perfection and priority. Under section 223.14(d) of the rule, a member bank's security interest in any collateral required by section 23A must be perfected in accordance with applicable law to ensure that a member bank has good access to the assets serving as collateral for its credit transactions with affiliates. This requirement ensures that the member bank has the legal right to realize on the collateral in the case of default, including a default resulting from the affiliate's insolvency or liquidation. A member bank also is required to either obtain a first-priority security interest in the required collateral or deduct from the amount of collateral obtained by the bank the lesser of (1) the amount of any security interests in the collateral that are senior to that obtained by the bank or (2) the amount of any credits secured by the collateral that are senior to that of the bank. For example, if a member bank lends $100 to an affiliate and takes as collateral a second lien on a parcel of real estate worth $200, the arrangement would only satisfy the collateral requirements of section 23A if the affiliate owed the holder of the first lien $70 or less (a credit transaction secured by real estate must be secured at 130 percent of the amount of the transaction).

The rule includes the following example of how to compute the section 23A collateral value of a junior lien: A member bank makes a $2,000 loan to an affiliate. The affiliate grants the member bank a second-priority security interest in a piece of real estate valued at $3,000. Another institution that previously lent $1,000 to the affiliate has a first-priority security interest in the entire parcel of real estate. This transaction is not in compliance with the collateral requirements of this section. Because of the existence of the prior third-party lien on the real estate, the effective value of the real estate collateral for the member bank for purposes of this section is only $2,000—$600 less than the amount of real estate collateral required by this section for the transaction ($2,000 × 130 percent = $2,600).

3p. 12 USC 371c(c)(3) and (4).

4. The rule does not confine the definition of intangible assets by reference to GAAP.

4a. The rule also provides that instruments ''similar'' to guarantees and letters of credit are ineligible collateral. For example, in the Board's view, a member bank cannot satisfy section 23A's collateral requirements by purchasing credit protection in the form of a credit-default swap referencing the affiliate's obligation.

Unused portion of an extension of credit. Section 23A requires that the ''amount'' of an extension of credit be secured by the statutorily prescribed levels of collateral. In general, if a member bank provides a line of credit to an affiliate, it must secure the full amount of the line of credit throughout the life of the credit. Section 223.14(f)(2) of the rule provides an exemption to the collateral requirements of section 23A for the unused portion of an extension of credit to an affiliate so long as the member bank does not have any legal obligation to advance additional funds under the credit facility until the affiliate has posted the amount of collateral required by the statute with respect to the entire used portion of the extension of credit.[4b] In such credit arrangements, securing the unused portion of the credit line is unnecessary from a safety-and-soundness perspective because the affiliate cannot require the member bank to advance additional funds without posting the additional collateral required by section 23A. If a member bank voluntarily advances additional funds under such a credit arrangement without obtaining the additional collateral required under section 23A to secure the entire used amount (despite its lack of a legal obligation to make such an advance), the Board views this action as a violation of the collateral requirements of the statute. Even if the line of credit does not need to be secured, the entire amount of the line counts against the bank's quantitative limit.

Purchasing affiliate debt securities in the secondary market. A member bank's investment in the debt securities issued by an affiliate is an extension of credit by the bank to the affiliate and thus is subject to section 23A's collateral requirements. Section 223.14(f)(3) of the rule provides an exemption that permits member banks in certain circumstances to purchase debt securities issued by an affiliate without satisfying the collateral requirements of section 23A. The exemption is available where a member bank purchases an affiliate's debt securities from a third party in a bona fide secondary-market transaction. When a member bank buys an affiliate's debt securities in a bona fide secondary-market transaction, the risk that the purchase is designed to shore up an ailing affiliate is reduced.

4b. This does not apply to guarantees, acceptances, and letters of credit issued on behalf of an affiliate. These instruments must be fully collateralized at inception.

Any purchase of affiliate debt securities that qualifies for this exemption would still remain subject to the quantitative limits of section 23A and the market-terms requirement of section 23B. In analyzing a member bank's good faith under this exemption transaction, examiners should look at the time elapsed between the original issuance of the affiliate's debt securities and the bank's purchase, the existence of any relevant agreements or relationships between the bank and the third-party seller of the affiliate's debt securities, any history of bank financing of the affiliate, and any other relevant information.

Credit transactions with nonaffiliates that become affiliates. Banks sometimes lend money to, or issue guarantees on behalf of, unaffiliated companies that later become affiliates of the bank. Section 223.21(b)(2) provides transition rules that exempt credit transactions from the collateral requirements in situations in which the member bank entered into the transactions with the nonaffiliate at least one year before the nonaffiliate became an affiliate of the bank.

For example, a member bank with capital stock and surplus of $1,000 and no outstanding covered transactions makes a $120 unsecured loan to a nonaffiliate. The member bank does not make the loan in contemplation of the nonaffiliate becoming an affiliate. Nine months later, the member bank's holding company purchases all the stock of the nonaffiliate, thereby making the nonaffiliate an affiliate of the member bank. The member bank is not in violation of the quantitative limits of the rule's section 223.11 or 223.12 at the time of the stock acquisition. The member bank is, however, prohibited from engaging in any additional covered transactions with the new affiliate at least until such time as the value of the loan transaction falls below 10 percent of the member bank's capital stock and surplus. In addition, the member bank must bring the loan into compliance with the collateral requirements of section 223.14 promptly after the stock acquisition.

Exemptions from Section 23A

Section 23A authorizes the Board to grant exemptions from the statute's restrictions if such exemptions are ''in the public interest and consistent with the purposes of this section'' (12

USC 371c(f)(2)). The Board has approved a number of exemptions over the past several years, most of which involve corporate reorganizations.

Section 23A exempts several types of transactions from the statute's quantitative and collateral requirements and exempts other types of transactions from the statute's quantitative, collateral, and low-quality-asset requirements.[4c] Regulation W, subpart E, sets forth the statutory exemptions, clarifies certain of these exemptions, and exempts a number of additional types of transactions

The Board reserves the right to revoke or modify any additional exemption granted by the Board in Regulation W, if the Board finds that the exemption is resulting in unsafe or unsound banking practices. The Board also reserves the right to terminate the eligibility of a particular member bank to use any such exemption if the bank's use of the exemption is resulting in unsafe or unsound banking practices.

Covered Transactions Exempt from the Quantitative Limits and Collateral Requirements

Under the rule's section 223.41, the quantitative limits (sections 223.11 and 223.12) and the collateral requirements (section 223.14) do not apply to the following transactions. The transactions are, however, subject to the safety-and-soundness requirement (section 223.13) and the prohibition on the purchase of a low-quality asset (section 223.15).

- *Parent institution/subsidiary institution transactions.* Transactions with a depository institution if the member bank controls 80 percent or more of the voting securities of the depository institution or the depository institution controls 80 percent or more of the voting securities of the member bank.
- *Purchase of loans on a nonrecourse basis from an affiliated depository institution.*

Sister-bank exemption (section 223.41(b)). Regulation W exempts transactions with a federally insured depository institution if the same company controls 80 percent or more of the voting securities of the member bank and the depository institution. In addition, the statute provides that covered transactions between sister banks must be consistent with safe and sound banking practices.[4d]

The sister-bank exemption generally applies only to transactions between insured depository institutions.[4e] The rule's definition of affiliate excludes uninsured depository institution subsidiaries of a member bank. Covered transactions between a member bank and a parent uninsured depository institution or a commonly controlled uninsured depository institution, under the rule, generally would be subject to section 23A whereas covered transactions between a member bank and a subsidiary uninsured depository institution would not be subject to section 23A.[4f]

The sister-bank exemption, by its terms, only exempts transactions by a member bank with a sister-bank affiliate; hence, the sister-bank exemption cannot exempt a member bank's extension of credit to an affiliate that is not a sister bank (even if the extension of credit was purchased from a sister bank). For example, a member bank purchases from Sister-Bank Affiliate A a loan to Affiliate B in a purchase that qualifies for the sister-bank exemption in section 23A. The member bank's asset purchase from Sister-Bank Affiliate A would be an exempt covered transaction under section 223.41(b), but the member bank also would have acquired an extension of credit to Affiliate B, which would be a covered transaction between the member bank and Affiliate B under section 223.3(h)(1) that does not qualify for the sister-bank exemption.

Internal corporate reorganizations. Section 223.41(d) of the rule provides an exemption for asset purchases by a bank from an affiliate that are part of a one-time internal corporate reorganization of a banking organization.[4g] The exemption includes purchases of assets in connection with a transfer of securities issued by an

4c. 12 USC 371c(d).

4d. 12 USC 371c(a)(4).

4e. A member bank and its operating subsidiaries are considered a single unit for purposes of section 23A. Under the statute and the regulation, transactions between a member bank (or its operating subsidiary) and the operating subsidiary of a sister insured depository institution generally qualify for the sister-bank exemption.

4f. The sister-bank exemption in section 23A does not allow a member bank to avoid any restrictions on sister-bank transactions that may apply to the bank under the prompt-corrective-action framework set forth in section 38 of the FDI Act (12 USC. 1831o) and regulations adopted thereunder by the bank's appropriate federal banking agency.

4g. See 1998 *Fed. Res. Bull.* 985 and 1013–14.

affiliate to a member bank, as described in section 223.31(a).

Under this exemption, a member bank would be permitted to purchase assets (other than low-quality assets) from an affiliate (including in connection with an affiliate share transfer that section 223.31 of the rule treats as a purchase of assets) exempt from the quantitative limits of section 23A if the following conditions are met.

First, the asset purchase must be part of an internal corporate reorganization of a holding company that involves the transfer of all or substantially all of the shares or assets of an affiliate or of a division or department of an affiliate.[4h] The asset purchase must not be part of a series of periodic, ordinary-course asset transfers from an affiliate to a member bank. Second, the member bank's holding company must provide the Board with contemporaneous notice of the transaction and must commit to the Board to make the bank whole, for a period of two years, for any transferred assets that become low-quality assets.[4i] Third, a majority of the member bank's directors must review and approve the transaction before consummation. Fourth, the section 23A value of the covered transaction must be less than 10 percent of the member bank's capital stock and surplus (or up to 25 percent of the bank's capital stock and surplus with the prior approval of the bank's appropriate federal banking agency). Fifth, the member bank's holding company and all its subsidiary depository institutions must be well capitalized and well managed and must remain well capitalized upon consummation of the transaction.

Covered Transactions Exempt from the Quantitative Limits, Collateral Requirements, and Low-Quality-Asset Prohibition

The quantitative limits (sections 223.11 and 223.12), the collateral requirements (section 223.14), and the prohibition on the purchase of a low-quality asset (section 223.15) do not apply to the following exempted transactions. (See section 223.42.) The transactions are, however, subject to the safety-and-soundness requirement (section 223.13). Detailed conditions or restrictions pertaining to these exemptions are discussed after this list.

- making correspondent banking deposits in an affiliated depository institution (as defined in section 3 of the FDI Act (12 USC 1813) or an affiliated foreign bank that represent an ongoing, working balance maintained in the ordinary course of correspondent business
- giving immediate credit to an affiliate for uncollected items received in the ordinary course of business
- transactions secured by cash or U. S. government securities
- purchasing securities of a servicing affiliate
- purchasing certain liquid assets
- purchasing certain marketable securities
- purchasing certain municipal securities
- purchasing from an affiliate an extension of credit subject to a repurchase agreement that was originated by a member bank and sold to the affiliate subject to a repurchase agreement or with recourse
- asset purchases from an affiliate by a newly formed member bank, if the appropriate federal banking agency for the member bank has approved the asset purchase in writing in connection with the review of the formation of the member bank
- transactions approved under the Bank Merger Act that involve federally insured depository institutions in U.S. branches and agencies of a foreign bank
- purchasing, on a nonrecourse basis, an extension of credit from an affiliate
- intraday extensions of credit
- riskless-principal transactions

Correspondent banking. Section 23A exempts from its quantitative limits and collateral requirements any deposit by a member bank in an affiliated bank or affiliated foreign bank that is made in the ordinary course of correspondent business, subject to any restrictions that the Board may impose.[4j] Section 223.42(a) of the rule further provides that such deposits must represent ongoing, working balances maintained by the member bank in the ordinary course of

4h. The notice also must describe the primary business activities of the affiliate whose shares or assets are being transferred to the member bank and must indicate the anticipated date of the reorganization.

4i. The holding company can meet this criteria by either repurchasing the assets at book value plus any write-down that has been taken or by making a quarterly cash contribution to the bank equal to the book value plus any write-downs that have been taken by the bank.

4j. 12 USC 371c(d)(2).

conducting the correspondent business.[4k] Although not required by section 23A or the Home Owners' Loan Act (HOLA), the rule also provides that correspondent deposits in an affiliated insured savings association are exempt if they otherwise meet the requirements of the exemption.

Secured credit transactions. Section 23A and section 223.42(c) of the rule exempt any credit transaction by a member bank with an affiliate that is ''fully secured'' by U.S. government obligations or by a ''segregated, earmarked'' deposit account.[4*l*] A deposit account meets the ''segregated, earmarked'' requirement only if the account exists for the sole purpose of securing credit transactions between the member bank and its affiliates and is so identified. Under section 23A, if U.S. government obligations or deposit accounts are sufficient to *fully* secure a credit transaction, then the transaction is completely exempt. If, however, the U.S. government obligations or deposit accounts represent less than full security for the credit transaction, then the amount of U.S. government obligations or deposits counts toward the collateral requirements of section 23A, but no part of the transaction is exempt from the statute's quantitative limits.

An additional exemption provided in the rule is consistent with the (d)(4) exemption in section 23A. A credit transaction with an affiliate will be exempt ''to the extent that the transaction is and remains secured'' by appropriate (d)(4) collateral. If a member bank makes a $100 nonamortizing term loan to an affiliate that is secured by $50 of U.S. Treasury securities and $75 of real estate, the value of the covered transaction will be $50. If the market value of the U.S. Treasury securities falls to $45 during the life of the loan, the value of the covered transaction would increase to $55. The Board expects member banks that use this expanded (d)(4) exemption to review the market value of their U.S. government obligations collateral regularly to ensure compliance with the exemption.

Purchases of assets with readily identifiable market quotes. Section 23A(d)(6) exempts the purchase of assets by a member bank from an affiliate if the assets have a ''readily identifiable and publicly available market quotation'' and are purchased at their current market quotation.[4m] The rule (section 223.42(e)) limits the availability of this exemption (the (d)(6) exemption) to purchases of assets with market prices that are recorded in widely disseminated publications that are readily available to the general public, such as newspapers with a national circulation. Because as a general matter only exchange-traded assets are recorded in such publications, this test has ensured that the qualifying assets are traded actively enough to have a true ''market quotation'' and that examiners can verify that the assets are purchased at their current market quotation. The rule applies if the asset is purchased at *or below* the asset's current market quotation.[5]

If a member bank purchases from one affiliate securities issued by another affiliate, the bank has engaged in two types of covered transactions. Under the rule, although the (d)(6) exemption may exempt the one-time asset purchase from the first affiliate, it would not exempt the ongoing investment in securities issued by the second affiliate.

The (d)(6) exemption may apply to a purchase of assets that are not traded on an exchange. In particular, purchases of foreign exchange, gold, and silver, and purchases of over-the-counter (OTC) securities and derivative contracts whose prices are recorded in widely disseminated publications, may qualify for the (d)(6) exemption.

Purchases of securities with a ready market from a securities affiliate. Section 223.42(f) of the rule expands the statutory (d)(6) exemption to allow a member bank to purchase securities from an affiliate based on price quotes obtained from certain electronic screens so long as, among other things, (1) the selling affiliate is a broker-dealer registered with the SEC, (2) the securities are traded in a ready market and eligible for purchase by state member banks, (3) the securities are not purchased within 30 days of an underwriting (if an affiliate of the bank is an

4k. Unlike the sister-bank exemption, the exemption for correspondent banking deposits applies to deposits placed by a member bank in an *uninsured* depository institution or foreign bank.

4*l*. 12 USC 371c(d)(4).

4m. 12 USC 371c(d)(6).

5. The rule provides that a U.S. government obligation is an eligible (d)(6) asset only if the obligation's price is quoted routinely in a widely disseminated publication that is readily available to the general public. Although all U.S. government obligations have low credit risk, not all U.S. government obligations trade in liquid markets at publicly available market quotations.

underwriter of the securities), and (4) the securities are not issued by an affiliate.

- *Broker-dealer requirement and securities purchases from foreign broker-dealers.* As stated above, the selling affiliate must be a registered broker-dealer. Broker-dealers that are registered with the SEC are subject to supervision and examination by the SEC and are required by SEC regulations to keep and maintain detailed records concerning each securities transaction conducted by the broker-dealer. In addition, SEC-registered broker-dealers have experience in determining whether a security has a ‘‘ready market’’ under SEC regulations. The rule does not expand the exemption to include securities purchases from foreign broker-dealers. The rule explicitly provides, however, that a member bank may request that the Board exempt securities purchases from a particular foreign broker-dealer, and the Board would consider these requests on a case-by-case basis in light of all the facts and circumstances.
- *Securities eligible for purchase by a state member bank.* The exemption requires that the bank's purchase of securities be eligible for purchase by a state member bank. The Board determined that a member bank may purchase equity securities from an affiliate under the (d)(6) exemption, if the purchase is made to hedge the bank's permissible customer-driven equity derivative transaction (and the purchase meets all the other requirements of the exemption).
- *No purchases within 30 days of an underwriting.* The (d)(6) rule generally prohibits a member bank from using the (d)(6) exemption to purchase securities during an underwriting, or within 30 days of an underwriting, if an affiliate of the bank is an underwriter of the securities. This provision applies unless the security is purchased as part of an issue of obligations of, or obligations fully guaranteed as to principal and interest by, the United States or its agencies. The rule includes the 30-day requirement because of the uncertain and volatile market values of securities during and shortly after an underwriting period and because of the conflicts of interest that may arise during and after an underwriting period, especially if an affiliate has difficulty selling its allotment.
- *No securities issued by an affiliate.* If a member bank purchases from one affiliate securities issued by another affiliate, it would not exempt the investment in securities issued by the second affiliate, even though the (d)(6) exemption may exempt the asset purchase from the first affiliate. The transaction would be treated as a purchase of, or an investment in, securities issued by an affiliate.
- *Price-verification methods.* The (d)(6) exemption applies only in situations in which the member bank is able to obtain price quotes on the purchased securities from an unaffiliated electronic, real-time pricing service. The Board reaffirms its position that it would not be appropriate to use independent dealer quotations to establish a market price for a security under the new (d)(6) exemption. A security that is not quoted routinely in a widely disseminated news source or a third-party electronic financial network may not trade in a sufficiently liquid market to justify allowing a member bank to purchase unlimited amounts of the security from an affiliate.
- *Record retention.* The rule expressly includes a two-year record-retention and supporting information requirement that is sufficient to enable the appropriate federal banking agencies to ensure that the member bank is in compliance with the terms of the (d)(6) exemption.

Purchasing municipal securities. Section 223.42(g) of the rule exempts a member bank's purchase of municipal securities from an affiliate if the purchase meets certain requirements.[5a] First, the member bank must purchase the municipal securities from a broker-dealer affiliate that is registered with the SEC. Second, the municipal securities must be eligible for purchase by a state member bank, and the member bank must report the transaction as a securities purchase in its call report. Third, the municipal securities must either be rated by a nationally recognized statistical rating organization or must be part of an issue of securities that does not exceed $25 million in size. Finally, the price for the securities purchased must be (1) quoted routinely on an unaffiliated electronic service that provides indicative data from real-time financial networks; (2) verified by reference to

5a. Municipal securities are defined by reference to section 3(a)(29) of the Securities Exchange Act. It defines municipal securities as direct obligations of, or obligations guaranteed as to principal or interest by, a state or agency, instrumentality, or political subdivision thereof, and certain tax-exempt industrial development bonds. (See 17 USC 78c(a)(29).)

two or more actual independent dealer quotes on the securities to be purchased or securities that are comparable to the securities to be purchased; or (3) in the case of securities purchased during the underwriting period, verified by reference to the price indicated in the syndicate manager's written summary of the underwriting.[5b] Under any of the three pricing options, the member bank must purchase the municipal securities at or below the quoted or verified price.

Purchases of assets by newly formed banks. Section 223.42(i) of the rule exempts a purchase of assets by a newly chartered member bank from an affiliate if the appropriate federal banking agency for the bank has approved the purchase. This exemption allows companies to charter a new bank and to transfer assets to the bank free of the quantitative limits and low-quality-asset prohibition of section 23A.

Transactions approved under the Bank Merger Act. The Bank Merger Act exemption applies to transactions between a member bank and an insured depository institution affiliate. Section 223.42(j) exempts transactions between insured depository institutions that are approved pursuant to the Bank Merger Act. The rule makes the Bank Merger Act exemption available for merger and other related transactions between a member bank and a U.S. branch or agency of an affiliated foreign bank, if the transaction has been approved by the responsible federal banking agency pursuant to the Bank Merger Act, and should help ensure that such transactions do not pose significant risks to the member bank. There is no regulatory exemption for merger transactions between a national bank and its nonbank affiliate. Any member bank merging or consolidating with a nonbank affiliate may be able to take advantage of the regulatory exemption for internal-reorganization transactions contained in section 223.41(d) of the rule.

Purchases of extensions of credit—the purchase exemption.

- The purchase of an extension of credit on a nonrecourse basis from an affiliate is exempt from section 23A's quantitative limits provided that—
  - — the extension of credit is originated by the affiliate;
  - — the member bank makes an independent evaluation of the creditworthiness of the borrower before the affiliate makes or commits to make the extension of credit; and
  - — the member bank does not make a blanket advance commitment to purchase extensions of credit from the affiliate. (See section 223.42(k) of the rule.)

  The rule also includes a 50 percent limit on the amount of loans a bank may purchase from an affiliate under the purchase exemption. When a member bank purchases more than half of the extensions of credit originated by an affiliate, the purchases represent the principal ongoing funding mechanism for the affiliate. The member bank's status as the predominant source of financing for the affiliate calls into question the availability of alternative funding sources for the affiliate, places significant pressure on the bank to continue to support the affiliate through asset purchases, and reduces the bank's ability to make independent credit decisions with respect to the asset purchases.
- *"Substantial, ongoing funding" test.* The rule allows the appropriate federal banking agency for a member bank to reduce the 50 percent threshold prospectively, on a case-by-case basis, in those situations in which the agency believes that the bank's asset purchases from an affiliate under the exemption may cause harm to the bank.
- *Independent credit review by the bank.* To qualify for the purchase exemption under section 223.42(k), a member bank must independently review the creditworthiness of each obligor before committing to purchase each loan. Under established Federal Reserve guidance, a state member bank is required to have clearly defined policies and procedures to ensure that it performs its own due diligence in analyzing the credit and other risks inherent in a proposed transaction.[5c] This function is not delegable to any third party, including affiliates of the member bank or government-sponsored enterprises. Accordingly, to qualify for this exemption, the member bank, independently and using its own credit policies

5b. Under the Municipal Securities Rulemaking Board's Rule G-11, the syndicate manager for a municipal bond underwriting is required to send a written summary to all members of the syndicate. The summary discloses the aggregate par values and prices of bonds sold from the syndicate account.

5c. See, for example, SR-97-21.

and procedures, must itself review and approve each extension of credit before giving a purchase commitment to its affiliate.

- *Purchase of loans from an affiliate must be without recourse.* In connection with a bank's purchase of loans from an affiliate, the affiliate cannot retain recourse on the loans. The rule (section 223.42(k)) specifies that the exemption does not apply in situations where the affiliate retains recourse on the loans purchased by the member bank. The rule also specifies that the purchase exemption only applies in situations where the member bank purchases loans from an affiliate that were originated by the affiliate. The exemption cannot be used by a member bank to purchase loans from an affiliate that the affiliate purchased from another lender. The exemption is designed to facilitate a member bank's using its affiliate as an origination agent, not to permit a member bank to take off an affiliate's books loans that the affiliate purchased from a third party.

Intraday extensions of credit. Section 223.42(*l*) of the rule provides that intraday credit extensions by a member bank to an affiliate are section 23A covered transactions but exempts all such intraday credit extensions from the quantitative and collateral requirements of section 23A if the member bank (1) maintains policies and procedures for the management of intraday credit exposure and (2) has no reason to believe that any affiliate receiving intraday credit would have difficulty repaying the credit in accordance with its terms. The establishment of policies and procedures are for—

- monitoring and controlling the credit exposure arising at any one time from the member bank's intraday extensions of credit to each affiliate and all affiliates in the aggregate and
- ensuring that any intraday extensions of credit by the member bank to an affiliate comply with the market-terms requirement of section 223.51 of the rule.

Standard under which the board may grant additional exemptions. Section 223.43 of the rule provides that exemption requests should (1) describe in detail the transaction or relationship for which the member bank seeks exemption, (2) explain why the Board should exempt the transaction or relationship, and (3) explain how the exemption would be in the public interest and consistent with the purposes of section 23A.

Exemptions from the Attribution Rule of Section 23A

The attribution rule of section 23A provides that "a transaction by a member bank with any person shall be deemed a transaction with an affiliate to the extent that the proceeds of the transaction are used for the benefit of, or transferred to, that affiliate" (12 USC 371c(a)(2)). One respective interpretation and three exemptions are discussed below.

Loans to a nonaffiliate that purchases securities or other assets through a depository institution affiliate agent or broker. The Board issued an interpretation on an insured depository institution's loan to a nonaffiliate that purchases assets through an institution's affiliate that is acting as agent. This interpretation confirms that section 23A of the FRA does not apply to extensions of credit an insured depository institution grants to customers that use the loan proceeds to purchase a security or other asset through an affiliate of the depository institution, so long as (1) the affiliate is acting exclusively as an agent or broker in the transaction and (2) the affiliate retains no portion of the loan proceeds as a fee or commission for its services.

Under this interpretation, the Board concluded that when the affiliated agent or broker retains a portion of the loan proceeds as a fee or commission, the portion of the loan not retained by the affiliate as a fee or commission would still be outside the coverage of section 23A. On the other hand, the portion of the loan retained by the affiliate as a fee or commission would be subject to section 23A because it represents proceeds of a loan by a depository institution to a third party that are transferred to, and used for the benefit of, an affiliate of the institution. The Board, however, granted an exemption from section 23A for that portion of a loan to a third party that an affiliate retains as a market-rate brokerage or agency fee.

The interpretation would not apply if the securities or other assets purchased by the third-party borrower through the affiliate of the depository institution were issued or underwritten by, or sold from the inventory of, another affiliate of the depository institution. In that case, the proceeds of the loan from the depository institution would be transferred to, and used for the benefit of, the affiliate that issued, underwrote, or sold the assets on a principal basis to the third party.

The above-mentioned transactions are subject to the market-terms requirement of section 23B, which applies to ‘‘any transaction in which an affiliate acts as an agent or broker or receives a fee for its services to the bank or any other person’’ (12 USC 371c-1(a)(2)(D)). A market-rate brokerage commission or agency fee refers to a fee or commission that is no greater than that prevailing at the same time for comparable agency transactions the affiliate enters into with persons who are neither affiliates nor borrowers from an affiliated depository institution. (See Regulation W at 12 CFR 223.16(b).)

Exemption—Loans to a nonaffiliate that purchases securities from a depository institution securities affiliate that acts as a riskless principal. The Board has granted an exemption from section 23A of the FRA for extensions of credit by an insured depository institution to customers who use the loan proceeds to purchase a security that is issued by a third party via a broker-dealer affiliate of the institution that acts as riskless principal. The exemption for riskless-principal transactions would not apply if the broker-dealer affiliate sold to the third-party borrower securities that were issued or underwritten by, or sold out of the inventory of, an affiliate of the depository institution. Riskless-principal trades, although the functional equivalent of securities brokerage transactions, involve the purchase of a security by the depository institution’s broker-dealer affiliate. Accordingly, the broker-dealer retains the loan proceeds at least for some moment in time.

There is negligible risk that loans a depository institution makes to borrowers to engage in riskless-principal trades through a broker-dealer affiliate of the depository institution would be used to fund the broker-dealer. For this reason, the Board adopted an exemption from section 23A to cover riskless-principal securities transactions engaged in by depository institution borrowers through broker-dealer affiliates of the depository institution. This exemption is applicable even if the broker-dealer retains a portion of the loan proceeds as a market-rate markup for executing the riskless-principal securities trade. (See Regulation W at 12 CFR 223.16(c)(1).)

Exemption—Loan to a nonaffiliate pursuant to a preexisting line of credit and the proceeds are used to purchase securities from the institution’s broker-dealer affiliate. The Board approved an exemption from section 23A for loans by an insured depository institution to a nonaffiliate pursuant to a preexisting line of credit, in which the loan proceeds are used to purchase securities from a broker-dealer affiliate. In more detail, the Board exempted extensions of credit by an insured depository institution to its customers that use the credit to purchase securities from a registered broker-dealer affiliate of the institution, so long as the extension of credit is made pursuant to, and consistent with any conditions imposed in, a preexisting line of credit. This line of credit should not have been established in expectation of a securities purchase from or through an affiliate of the institution. The preexisting requirement is an important safeguard to ensure that the depository institution did not extend credit for the purpose of inducing a borrower to purchase securities from or issued by an affiliate. The preexisting line of credit exemption may not be used in circumstances in which the line has merely been preapproved. (See Regulation W at 12 CFR 223.16(c)(3).)

Exemption—Credit card transactions. An exemption is provided from section 23A’s attribution rule for general-purpose credit card transactions that meet certain criteria. (See section 223.16(c)(4).) The rule defines a general-purpose credit card as a credit card issued by a member bank that is widely accepted by merchants that are not affiliates of the bank (such as a Visa card or Mastercard) if less than 25 percent of the aggregate amount of purchases with the card are purchases from an affiliate of the bank. Extensions of credit to unaffiliated borrowers pursuant to special-purpose credit cards (that is, credit cards that may only be used or are substantially used to buy goods from an affiliate of the member bank) are subject to the rule.

The credit card exemption includes several alternatives. First, several different methods are provided for a member bank to demonstrate that its credit card meets the 25 percent test. If a member bank has no commercial affiliates (other than those permitted for an FHC under section 4 of the BHC Act), the bank would be deemed to satisfy the 25 percent test if the bank has no reason to believe that it would fail the test. (A member bank could use this method of complying with the 25 percent test even if, for example, the bank’s FHC controls, under section 4(a)(2), 4(c)(2), or 4(k)(4)(H) of the BHC Act, several companies engaged in nonfinancial activities.) Such a member bank would not be obligated to establish systems to verify strict, ongoing compliance with the 25 percent test. Most BHCs and FHCs should meet this test. If a member bank has commercial affiliates (beyond those permitted for an FHC under section 4 of the BHC Act), the bank would be deemed to satisfy the 25 percent test if—

- the bank establishes systems to verify compliance with the 25 percent test on an ongoing basis and periodically validates its compliance with the test, or
- the bank presents information to the Board demonstrating that its card would comply with the 25 percent test. (One way that a member bank could demonstrate that its card would comply with the 25 percent test would be to show that the total sales of the bank's affiliates are less than 25 percent of the total purchases by cardholders.)

Second, for those member banks that fall out of compliance with the 25 percent test, there is a three-month grace period to return to compliance before extensions of credit under the card become covered transactions. Third, member banks that are required to validate their ongoing compliance with the 25 percent test have a fixed method, time frames, and examples for computing compliance.

Example of calculating compliance with the 25 percent test. A member bank seeks to qualify a credit card as a general-purpose credit card under section 223.16, paragraph (c)(4)(ii)(A), of the rule. The member bank assesses its compliance under paragraph (c)(4)(iii) of this section on the 15th day of every month (for the preceding 12 calendar months). The credit card qualifies as a general-purpose credit card for at least three consecutive months. On June 15, 2005, however, the member bank determines that, for the 12-calendar-month period from June 1, 2004, through May 31, 2005, 27 percent of the total value of products and services purchased with the card by all cardholders were purchases of products and services from an affiliate of the member bank. Unless the credit card returns to compliance with the 25 percent limit by the 12-calendar-month period ending August 31, 2005, the card will cease to qualify as a general-purpose credit card as of September 1, 2005. Any outstanding extensions of credit under the credit card that were used to purchase products or services from an affiliate of the member bank would become covered transactions at such time.

SECTION 23B OF THE FEDERAL RESERVE ACT

Regulation W, subpart F, sets forth the principal restrictions of section 23B. These include (1) a requirement that most transactions between a member bank and its affiliates be on terms and circumstances that are substantially the same as those prevailing at the time for comparable transactions with nonaffiliates; (2) a restriction on a member bank's purchase as fiduciary of assets from an affiliate unless certain criteria are met; (3) a restriction on a member bank's purchase, during the existence of an underwriting syndicate, of any security if a principal underwriter of the security is an affiliate; and (4) a prohibition on publishing an advertisement or entering into an agreement stating that a member bank will be responsible for the obligations of its affiliates. For the most part, subpart F restates the operative provisions of section 23B. The following transactions with affiliates are subject to restrictions:

- any covered transaction with an affiliate
- the sale of securities or other assets to an affiliate, including assets subject to repurchase
- the payment of money or the furnishing of services to an affiliate under contract, lease, or otherwise
- any transaction in which an affiliate acts as an agent or broker or receives a fee for its services to the bank or to any other person
- any transaction or series of transactions with a third party—
  - — if an affiliate has a financial interest in the third party or
  - — if an affiliate is a participant in this transaction or series of transactions

Any transaction by a member bank or its subsidiary with any person is deemed to be a transaction with an affiliate of the bank if any of the proceeds of the transaction are used for the benefit of, or are transferred to, the affiliate. A member bank and its subsidiaries may engage in the transactions covered by section 23B of the FRA only on terms and under circumstances, including credit standards, that are substantially the same, or at least as favorable to the bank or its subsidiary, as those prevailing at the time for comparable transactions with, or that in good faith would be offered to, nonaffiliate companies.

Section 23B also restricts the following transactions with affiliates:

- A member bank or its subsidiary cannot purchase as fiduciary any securities or other assets from any affiliate unless the purchase is permitted—
  - under the terms of the instrument creating the fiduciary relationship,
  - by court order, or
  - by the law of the jurisdiction governing the fiduciary relationship.
- A member bank or its subsidiary, whether acting as principal or fiduciary, cannot knowingly purchase or acquire, during the existence of any underwriting or selling syndicate, any security if a principal underwriter of that security is an affiliate of the bank. This limitation applies unless the purchase or acquisition of the security has been approved before it is initially offered for sale to the public by a majority of the directors of the bank. The purchase should be based on a determination that it is a sound investment for the bank irrespective of the fact that an affiliate of the bank is a principal underwriter of the securities.

Transactions Exempt from Section 23B

The market-terms requirement of section 23B applies to, among other transactions, any ‘‘covered transaction’’ between a member bank and an affiliate.[5d] Section 23B(d)(3) makes clear that the term ‘‘covered transaction’’ in section 23B has the same meaning as the term ‘‘covered transaction’’ in section 23A, but does not include any transaction that is exempt under section 23A(d)—for example, transactions between sister banks, transactions fully secured by a deposit account or U.S. government obligations, and purchases of assets from an affiliate at a readily identifiable and publicly available market quotation.[5e] Consistent with the statute, Regulation W's section 223.52(a)(1) exempts from section 23B any transaction that is exempt under section 23A(d).[5f]

The rule also excludes from section 23B any covered transaction that is exempt from section 23A under section 223.42(i) or (j) (that is, asset purchases by a newly formed member bank and transactions approved under the Bank Merger Act). The Board excluded from section 23B this additional set of transactions because, in each case, the appropriate federal banking agency for the member bank involved in the transaction should ensure that the terms of the transaction are not unfavorable to the bank.

Purchases of Securities for Which an Affiliate Is the Principal Underwriter

The GLB Act amended section 23B to permit a member bank to purchase securities during an underwriting conducted by an affiliate if the following two conditions are met. First, a majority of the directors of the member bank (with no distinction drawn between inside and outside directors) must approve the securities purchase before the securities are initially offered to the public. Second, such approval must be based on a determination that the purchase would be a sound investment for the member bank regardless of the fact that an affiliate of the bank is a principal underwriter of the securities.[5g] Section 223.53(b) includes this standard and clarifies that if a member bank proposes to make such a securities purchase in a fiduciary capacity, then the directors of the bank must base their approval on a determination that the purchase is a sound investment for the person on whose behalf the bank is acting as fiduciary.

A member bank may satisfy this director-approval requirement by obtaining specific prior director approval of each securities acquisition otherwise prohibited by section 23B(b)(1)(B). The rule clarifies, however, that a member bank also satisfies this director-approval requirement if a majority of the directors of the bank approves appropriate standards for the bank's acquisition of securities otherwise prohibited by section 23B(b)(1)(B) and each such acquisition meets the standards adopted by the directors. In addition, a majority of the member bank's directors

5d. 12 USC 371c-1(a)(2)(A).
5e. 12 USC 371c-1(d)(3).

5f. Regulation W will again be subsequently referred to as the ‘‘rule’’ or by its specified section-numbered discussion of section 23B provisions.
5g. GLB Act, section 738 (12 USC 371c-1(b)(2)).

must periodically review such acquisitions to ensure that they meet the standards and must periodically review the standards to ensure they meet the ''sound investment'' criterion of section 23B(b)(2). The appropriate period of time between reviews would vary depending on the scope and nature of the member bank's program, but such reviews should be conducted by the directors at least annually. Before the passage of the GLB Act, Board staff informally allowed member banks, based on the legislative history of section 23B, to meet the director-approval requirement in this fashion, and there is no indication that Congress in the GLB Act intended to alter the procedures that a member bank could use to obtain the requisite director approval.[5h] The rule codifies staff's preexisting approach to the director-approval requirement.[5i]

Definition of Affiliate Under Section 23B

Section 23B states that the term ''affiliate'' under section 23B has the meaning given to such term in section 23A except that the term ''affiliate'' under section 23B does not include a ''bank,'' as defined in section 23A.[5j] In the case of the sister-bank exemption, the rule's section 223.2(c) clarifies that the only companies that qualify for the ''bank'' exception to section 23B's definition of affiliate are insured depository institutions.

Advertising Restriction

In section 23B(c), the ''advertising restriction'' prohibits a member bank from publishing any advertisement or entering into any agreement stating or suggesting that the bank shall in any way be responsible for the obligations of its affiliates unless the transaction satisfies the quantitative and collateral restrictions of section 23A.[5k] The rule clarifies that section 23B(c) does not prohibit a member bank from making reference to such a guarantee, acceptance, or letter of credit in a prospectus or other disclosure document, for example, if otherwise required by law.

OPERATIONS SUBSIDIARIES

The Board has authorized member banks to establish and own operations subsidiaries. ''Operations subsidiaries'' are organizations that are, in effect, designed to serve as separately incorporated departments of a bank.

Member Bank Purchases of Stock of Operations Subsidiaries

The Board concluded in 1968 that ''. . . a member bank may purchase for its own account shares of a corporation to perform, at locations at which the bank is authorized to engage in business, functions that the bank is empowered to perform directly'' (12 CFR 250.141(i)). The Board reasoned that this authority could reasonably be interpreted as within a bank's incidental powers to ''organize its operations in the manner that it believes best facilitates the performance thereof,'' and that the subsidiary essentially constitutes a separately incorporated division or department of the bank.

No specific rule requires a state member bank to give the Board prior notice of, or to acquire the Board's approval for, the acquisition of an operations subsidiary to engage in activities that the bank itself may lawfully perform. However, section 208.3(d)(2) of Regulation H (12 CFR 208.3(d)(2)) prohibits a state member bank from causing or permitting a change in the general character of its business or in the scope of its corporate powers approved at the time of admission to membership, except with the permission of the Board.

Transactions Between a Member State Bank and Its Operations Subsidiary

The Board noted in 1970 that ''[S]ince an

5h. The conference report accompanying the Competitive Equality Banking Act of 1987 stated that the prior-approval requirement of section 23B(b) could be met ''by the establishment in advance of specific standards by the outside directors for such acquisitions. If the outside directors establish such standards, they must regularly review acquisitions to assure that the standards have been followed, and they must periodically review the standards to assure that they continue to be appropriate in light of market and other conditions.'' See *H.R. Conf. Rep. No. 100-261* at 133 (1987).

5i. The rule also provides, consistent with existing Board interpretations, that a U.S. branch, agency, or commercial lending company of a foreign bank may comply with this requirement by obtaining the required approvals and reviews from either a majority of the directors or a majority of the senior executive officers of the foreign bank.

5j. 12 USC 371c-1(d)(1).

5k. 12 USC 371c-1(c).

operations subsidiary is in effect a part of, and subject to the same restrictions as, its parent bank, there is no reason to limit transactions between the bank and such subsidiary any more than transactions between departments of a bank.'' The Board concluded that ''a credit transaction by a member State bank with its operations subsidiary . . . is not a 'loan or . . . extension of credit' of the kind intended to be restricted and regulated by section 23A and is, therefore, outside the purview of that section'' (12 CFR 223.2(b)(1)–(2)).

Operations Subsidiary Not Wholly Owned

The previously mentioned 1968 interpretation only expressly authorized state member banks to establish wholly owned operations subsidiaries, in that a wholly owned subsidiary of a bank is functionally indistinguishable from a division or department of the bank. In enacting the GLB Act, Congress recognized the authority of national and state member banks to own and control an operations subsidiary. The GLB Act recognized traditional operations subsidiaries by distinguishing them from financial subsidiaries. A financial subsidiary is defined so as not to include a company engaged solely in activities that a parent bank may perform, subject to the limitations that govern the conduct of these activities.

The GLB Act also does not appear to require that a state member bank own 100 percent of an operations subsidiary or a financial subsidiary. The GLB Act defines the term ''subsidiary'' by reference to the BHC Act. Under the BHC Act, a company is a ''subsidiary'' of a bank holding company if the BHC (1) owns or controls 25 percent or more of the company's voting shares, or (2) controls the election of a majority of the company's directors.[6]

The Board thus believes that, as a result of the GLB Act and consistent with section 5136 of the Revised Statutes (12 USC 24 (seventh)) and the Board's 1968 interpretation, a state member bank may acquire shares of a company that is not wholly owned and that (1) on consummation of the acquisition would be a subsidiary of the bank within the meaning of the BHC Act, and (2) engages only in activities in which the parent bank may engage, at locations at which the bank may engage in the activities, subject to the same limitations as if the bank were engaging in the activities directly.

FINANCIAL SUBSIDIARIES

Qualifying state member banks may control or hold an interest in a ''financial subsidiary.'' A financial subsidiary is any company that is controlled by one or more insured depository institutions and engages in activities that are financial in nature or incidental to a financial activity. A financial subsidiary does not include (1) a subsidiary that the state member bank is specifically authorized to hold by the express terms of federal law (other than by section 9 of the FRA), such as an Edge Act subsidiary held under section 25 of the FRA, or (2) a subsidiary that engages only in activities that the parent bank could conduct directly and that are conducted on the same terms and conditions that govern the conduct of the activity by the state member bank. A financial subsidiary is authorized for national banks by section 5136A of the Revised Statutes (12 USC 24a) and for state banks by section 46 of the Federal Deposit Insurance Act (FDI Act) (12 USC 1831w). To implement the authorization for state member banks, a new subpart G was added to Regulation H (12 CFR 208.71 et seq.).

Investing in or Controlling a Financial Subsidiary

Under the GLB Act, a state member bank may control, or hold an interest in, a financial subsidiary only if—

- the state member bank and each of its depository institution affiliates is well capitalized and well managed;[7]
- the aggregate consolidated total assets of all the bank's financial subsidiaries do not exceed the lesser of 45 percent of the consolidated total assets of the bank or $50 billion;[8]
- the state member bank is one of the 100 largest insured banks and meets the following debt-rating or alternative debt-rating requirements:
  - — for the 50 largest insured banks, the bank must have at least one issue of outstanding eligible debt that is currently rated in one of the three highest investment-grade rating categories by a nationally recognized statistical rating organization;[9]

6. See 12 USC 1841(d). A company also is considered a subsidiary of a bank holding company if the Board determines, after notice and opportunity for a hearing, that the bank holding company directly or indirectly exercises a controlling influence over the managment or policies of the company.

7. An institution is ''well capitalized'' if it meets or exceeds the capital levels designated by the institution's appropriate federal banking agency (section 38 of the FDI Act (12 USC 1831o)). A depository institution will be deemed ''well managed'' by references to specific examination ratings, or if its federal banking agency determines that the managerial resources are satisfactory, or if it has not been examined.

8. This dollar amount will be adjusted based on an indexing mechanism that is established jointly by the Federal Reserve Board and the Secretary of the Treasury.

9. ''Eligible debt'' refers to unsecured debt that has an initial maturity of more than 360 days. The debt must be issued and outstanding, may not be supported by any form of credit enhancement, and may not be held in whole or any

— for the second 50 largest insured banks, the bank must meet the issuer-credit-rating requirement for the 50 largest insured banks or the bank must meet the alternative criteria established jointly by regulation by the Secretary of the Treasury and the Federal Reserve[10]

(the debt-rating and alternative criteria are not applicable if the bank's financial subsidiaries engage in any newly authorized financial activities solely as agent and not as principal); and

- the state member bank obtains the Federal Reserve's approval to engage in the activities of the financial subsidiary (using the notice procedures in section 208.76 of Regulation H). The state member bank also must obtain any necessary approvals from its state supervisory authority.

Issuer-Credit-Rating Requirement

The issuer-credit-rating requirement of the rule (12 CFR 208.71) requires a long-term issuer credit rating from a nationally recognized statistical rating organization that is within the three highest investment-grade rating categories used by the organization. An ''issuer credit rating'' is one that assesses the bank's overall capacity and willingness to pay, on a timely basis, its unsecured financial obligations. An issuer credit rating differs from a debt rating in that it does not assess the bank's ability or willingness to make payments on any individual class or issue of debt, nor does it reflect payment priority or payment preferences among financial obligations.

For this rule, the issuer credit rating must be assigned to the national or state member bank that controls or holds an interest in a financial subsidiary. Issuer credit ratings that are assigned to a subsidiary or affiliate of the parent bank, such as a subsidiary engaged in derivatives activities, do not meet the rule's requirements. Rating organizations may issue long-term or short-term issuer credit ratings for the same bank and separate ratings for dollar-denominated and foreign-currency-denominated obligations. Only long-term issuer ratings for dollar-denominated obligations satisfy the requirements of the rule. A ''long-term credit rating'' means a written opinion that is issued by a nationally recognized statistical rating organization regarding the bank's overall capacity and willingness to pay on a timely basis its unsecured, dollar-denominated financial obligations maturing in no less than one year.

The Secretary of the Treasury and the Federal Reserve have determined that certain types of ratings assigned by the rating agencies indicated in table 1 currently meet the requirements of the rule, provided that the ratings assess the parent bank's ability and willingness to meet its financial obligations denominated in U.S. dollars.

Standard and Poor's may modify its AA or A ratings to include a plus (+) or minus (-) sign to show relative standing within these rating categories. Any rating from A minus to AAA would satisfy the long-term issuer-credit-rating requirement; an A minus would constitute the lowest acceptable rating in the case of Standard & Poor's and Fitch. Moody's top three investment-grade categories for long-term issuer credit ratings are Aaa, Aa, or A, with Aaa denoting the highest rating. Moody's applies numerical modifiers of 1, 2, and 3 in the Aa and A rating

significant part by affiliates or insiders of the bank or by any other person acting on behalf of or with funds from the bank or an affiliate.

10. The size of an insured bank is determined based on the consolidated total assets of the bank as of the end of each calendar year.

Table 1—Acceptable Rating Organizations and Ratings

Rating Organization	*Type of Rating*	*Rating*
Standard & Poor's	Issuer credit rating (including a counterparty credit rating)	AAA, AA, or A
Moody's	Issuer credit rating	Aaa, Aa, or A
Fitch	International credit rating	AAA, AA, or A

categories, with 3 denoting the lowest end of the letter-rating modifiers. Any rating from A-3 to Aaa would satisfy the long-term issuer-credit-rating requirement; a rating of A-3 would be the lowest acceptable rating in the case of Moody's.

Prudential Standards

A state member bank that owns a financial subsidiary must comply with certain prudential safeguards. These standards pertain to the bank's capital requirements and its establishment of policies and procedures arising from financial subsidiary ownership.

As for the capital requirements, the state member bank must ''deconsolidate'' the assets and liabilities of all of its financial subsidiaries from those of the bank. Although the GLB Act requires a bank to deconsolidate the assets and liabilities of any financial subsidiary for regulatory capital purposes, a financial subsidiary remains a subsidiary of a state member bank. The Board will continue to review the operations and financial and managerial resources of the bank on a consolidated basis as part of the supervisory process. The Board may take appropriate supervisory action if it believes that the bank does not have the appropriate financial and managerial resources (including capital resources and risk-management controls) to conduct its direct or indirect activities in a safe and sound manner.

In addition to the deconsolidation described above, the bank must also deduct a specified percentage of the aggregate amount of the equity investment (including retained earnings) (''the aggregate amount'') in all financial subsidiaries from the bank's capital and assets. Therefore, the bank must deduct—

- 50 percent of the aggregate amount from both the bank's tier 1 capital and its tier 2 capital for purposes of determining its risk-based capital ratios;
- 50 percent of the aggregate amount from the bank's tier 1 capital for purposes of determining its leverage ratios; and
- 100 percent of the aggregate amount from its tangible equity for purposes of determining its tangible equity capital ratio. It must also deduct 100 percent of the aggregate amount from the bank's risk-weighted assets, average total assets, and total assets when determining its risk-based, leverage, and tangible capital ratios.

The bank must meet all capital requirements—including the ''well-capitalized'' requirement (Regulation H, section 208.71) and the capital levels established by the Board under section 38 of the FDI Act—after the adjustments described above.

The member bank must also establish and maintain policies and procedures to manage the financial and operational risks associated with its ownership of a financial subsidiary. These procedures must identify and manage financial and operational risks with the bank and its financial subsidiaries. They must adequately protect the bank from such risks and preserve the bank's separate corporate identity and the limited liability of the bank and its financial subsidiaries. In addition, a financial subsidiary of a state member bank is considered a non-subsidiary affiliate of the bank for purposes of sections 23A and 23B of the FRA and a subsidiary of the BHC (and not a subsidiary of a bank) for the purposes of the anti-tying prohibitions of the Bank Holding Company Act Amendments of 1970.

Permissible Activities for a Financial Subsidiary

A financial subsidiary can engage in three types of permissible activities:

1. Those activities that are determined to be financial in nature or incidental to financial activities under section 4(k)(4) of the BHC Act. These permissible activities include—
   - general insurance agency activities in any location and travel agency activities;
   - underwriting, dealing in, and making a market in all types of securities; and
   - any activity that the Federal Reserve determined by regulation or order to be closely related to banking or managing or controlling banks so as to be a proper incident thereto and that was in effect on the effective date of the GLB Act. (See section 225.86 of the Board's Regulation Y (12 CFR 225.86).)
2. Activities that the Secretary of the Treasury, in consultation with the Board, determines to

be financial in nature or incidental to financial activities and permissible for financial subsidiaries of national banks pursuant to section 5136A(b) of the Revised Statutes of the United States (12 USC 24a(b)).
3. Activities that the state member bank is permitted to engage in directly, subject to the same terms and conditions that govern the conduct of the activity by the state member bank (12 USC 24a(a)(2)(A)(ii)).

Impermissible Activities for a Financial Subsidiary

A financial subsidiary *may not* engage as principal in insurance underwriting (except to the extent permitted for national banks by the Comptroller of the Currency as of January 1, 1999, and not subsequently overturned in certain grandfathered titile insurance activities), providing or issuing annuities, real estate investment or development (except as expressly authorized by law), and merchant banking and insurance company investment activities.

Federal Reserve Approval Requirements

Federal Reserve approval of a financial subsidiary involves a streamlined notice procedure. A state member bank must file a notice with the appropriate Reserve Bank before acquiring control of, or an interest in, a financial subsidiary, or before engaging in an additional financial activity through an existing financial subsidiary. No notice is required for a financial subsidiary to engage in an additional activity that the parent state member bank could conduct directly. The notice must include basic information on the financial subsidiary and its existing and proposed activities. In the case of an acquisition, the notice should include a description of the transaction through which the bank proposes to acquire control of or an interest in the financial subsidiary. The notice also must contain a certification that the state member bank and its depository institution affiliates meet the capital, management, and credit-rating requirements to own a financial subsidiary, as stated in the GLB Act and subpart G of Regulation H. If the notice is for the state member bank's initial affiliation with a company engaged in insurance activities, the notice must describe the company's insurance activities and identify the states where the company holds an insurance license. A notice will be considered approved on the fifteenth day after receipt of a complete notice by the appropriate Reserve Bank, unless before that date, the notice is approved or disapproved or the bank is notified that additional time is needed to review the submitted notice.

The GLB Act permits a state member bank to acquire an interest in or control a financial subsidiary if the bank meets the criteria and requirements set forth in the rule. The Board, however, retains its general supervisory authority for state member banks and may restrict or limit the activities of, or the acquisition or ownership of a subsidiary by, a state member bank if the Board finds that the bank does not have the appropriate financial and managerial resources to conduct the activities or to acquire or retain ownership of the company.

AGRICULTURAL CREDIT CORPORATIONS

The increasing number of agricultural credit corporations and their effect on parent banks have intensified the need for their supervision. Most agricultural credit corporations come under the direct supervision of the district Federal Intermediate Credit Bank (FICB) where the corporations discount most of their loans. However, a corporation may obtain funds exclusively in the open market and avoid FICB regulation.

EDGE ACT AND AGREEMENT CORPORATIONS

U.S.-based corporations and permissible activities for their Edge Act and agreement corporation subsidiaries are described in detail in the Board's Regulation K (12 CFR 211). Edge Act and agreement corporations provide banks with a vehicle for engaging in international banking or foreign financial operations. They also have the power, with supervisory consent, to purchase and hold the stock of foreign banks and other international financial concerns. Edge Act and agreement corporations are examined by the Federal Reserve, and their respective reports of examination should be reviewed during each examination of a parent member bank. The

Federal Reserve examination report and the amount and quality of paper held by these corporations must provide the basis for evaluating the bank's investment in them.

Transactions between the parent bank and the bank's Edge Act and agreement corporation subsidiaries are not subject to the limitations in section 23A. However, they are subject to limitation under section 25 of the FRA (12 USC 601) and under the Board's Regulation K. In addition, transactions with such bank subsidiaries and the parent bank's affiliates are aggregated with transactions by the bank and its affiliates for purposes of section 23A limitations and restrictions. Transactions between a bank and Edge Act and agreement corporation subsidiaries of the bank's holding company are also subject to section 23A.

FOREIGN BANKING ORGANIZATIONS

Under section 211.21(o) of Regulation K (12 CFR 211.21(o)), the term *a foreign banking organization* means—

- a foreign bank, as defined in section 1(b)(7) of the International Banking Act (12 USC 3101(7)) that—
  - — operates a branch, agency, or commercial lending company subsidiary in the United States;
  - — controls a bank in the United States; or
  - — controls an Edge corporation acquired after March 5, 1987; and
- any company of which the foreign bank is a subsidiary.

On March 15, 2006, the Board approved a revision to its Regulation K (effective April 19, 2006), incorporating the provisions of section 208.63 of Regulation H by reference into sections 211.5 and 211.24 of Regulation K. Edge and agreement corporations and other foreign banking organizations (that is, U.S. branches, agencies, and representative offices of foreign banks that are supervised by the Federal Reserve) must establish and maintain procedures reasonably designed to ensure and monitor compliance with the Bank Secrecy Act and related regulations. Each of these banking organizations' compliance programs must include, at a minimum, (1) a system of internal controls to ensure ongoing compliance, (2) independent testing of compliance by the institution's personnel or by an outside party, (3) the designation of an individual or individuals responsible for coordinating and monitoring day-to-day compleance, and (4) training for appropriate personnel. (See SR-06-7.)

FOREIGN BANKS

A foreign bank is an organization that is—

- organized under the laws of a foreign country and
- engages directly in the business of banking outside the United States.

FOREIGN BANK OFFICES

A *foreign bank office* consists of any branch, agency, representative office, or commercial lending company subsidiary of a foreign bank in the United States.

Branches of a Foreign Bank

A *branch of a foreign bank* means any place of business of a foreign bank, located in any state, at which deposits are received, and that is not an agency.

Agencies

An *agency* of a foreign bank means any place of business of a foreign bank, located in any state, at which credit balances are maintained, checks are paid, money is lent, or, to the extent not prohibited by state or federal law, deposits are accepted from a person or entity that is not a citizen or resident of the United States. Obligations are not to be considered credit balances unless they are—

- incidental to, or arise out of the exercise of, other lawful banking powers;
- to serve a specific purpose;
- not solicited from the general public;
- not used to pay routine operating expenses in

the United States such as salaries, rent, or taxes;
- withdrawn within a reasonable period of time after the specific purpose for which they were placed has been accomplished; and
- drawn upon in a manner reasonable in relation to the size and nature of the account.

Commercial Lending Company

A *commercial lending company* means any organization, other than a bank or an organization operating under section 25 of the Federal Reserve Act (FRA) (12 USC 601–604a), organized under the laws of any state, that maintains credit balances permissible for an agency and engages in the business of making commercial loans. A commercial lending company includes any company chartered under article XII of the banking law of the state of New York. (See Regulation K, section 211.21(g) (12 CFR 211.21(g)).)

Representative Office

A *representative office* means any office of a foreign bank that is located in any state and is not a federal branch, federal agency, state branch, state agency, or commercial lending company subsidiary. (See section 211.21(x) of Regulation K (12 CFR 211.21(x)).) A representative office is usually established when a bank's board of directors and management desire to establish a physical presence in a foreign market and very limited functions are to be (or can be made) available. A representative office cannot provide traditional banking services, such as accepting deposits or making loans directly. The office basically serves as a liaison and marketing function for the parent bank.

A U.S. subsidiary of a foreign bank may be considered to be a representative office of the foreign bank when it holds itself out to the public as a representative of the foreign bank that is acting on behalf of the foreign bank, even if the subsidiary engages in other nonbank business. In addition, an individual or a unit of a subsidiary that acts as a representative of a foreign bank from the location of the nonbank subsidiary may be treated as a representative office. A representative office may make credit decisions only if—

- the foreign bank also operates one or more branches or agencies in the United States,
- the loans approved at the representative office are made by a U.S. office of the bank, and
- the loan proceeds are not disbursed in the representative office.

(See section 211.24(d)(1)(ii) of Regulation K (12 CFR 211.24(d)(1)(ii)).)

CORRESPONDENT BANKS

A correspondent bank provides certain services to banks located in other countries that do not have local offices or whose local office is prohibited from engaging in certain activities. Such a relationship allows a foreign bank to provide trade-related and foreign-exchange services for its multinational customers in a foreign market without having to establish a physical presence in that market.

PARALLEL-OWNED BANKING ORGANIZATIONS

A parallel-owned banking organization is created when at least one U.S. depository institution and a foreign bank[10a] are controlled, either directly or indirectly, by the same person or group of persons[10b] who are closely associated in their business dealings or otherwise acting in concert. Parallel-owned banking organizations do not include structures in which one depository institution is a subsidiary of the other or in which the organization is controlled by a company subject to the BHC Act or the Savings and Loan Holding Company Act.[10c] The banking agencies consider whether "control" of a depository institution exists when a person or group of persons controls 10 percent or more of any class

10a. References to "foreign bank" or "foreign parallel bank" also include a holding company of the foreign bank and any U.S. or foreign affiliates of the foreign bank. References to "U.S. depository institution" do not include a U.S. depository institution that is controlled by a foreign bank.

10b. The term "persons" includes both business entities and natural persons, which may or may not be U.S. citizens.

10c. A bank holding company or savings and loan holding company, however, may be a component of a parallel-owned banking organization. This situation may arise when a bank holding company or savings and loan holding company controls the U.S. depository institution, and the holding company, in turn, is controlled by a person or group of persons who also controls a foreign bank.

of the depository institution's voting shares. Parallel-owned banking organizations are established and maintained for a variety of reasons, including tax and estate planning and the potential risks associated with nationalization. While these reasons may be legitimate and not prohibited by U.S. or foreign law, the structure of such organizations creates or increases certain risks and may make it more difficult for supervisors to monitor and address those risks. On April 23, 2002, the U.S. banking agencies (the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision) issued a joint agency statement that addresses the potential risks associated with parallel-owned banking organizations. The existence of one or more of the following factors may, depending on the circumstances, warrant additional inquiry:

- An individual or group of individuals acting in concert that controls a foreign bank also controls any class of voting shares of a U.S. depository institution, or financing for persons owning or controlling the shares is received from, or arranged by, the foreign bank, especially if the shares of the U.S. depository institution are collateral for the stock-purchase loan.
- The U.S. depository institution has adopted particular or unique policies or strategies similar to those of the foreign bank, such as common or joint marketing strategies, sharing of customer information, cross-selling of products, or linked web sites.
- An officer or director of the U.S. depository institution either (1) serves as an officer or director[10d] of a foreign bank or (2) controls a foreign bank or is a member of a group of individuals acting in concert or with common ties that controls a foreign bank.
- The name of the U.S. depository institution is similar to that of the foreign bank.

Parallel-owned banking organizations present supervisory risks similar to those arising from chain banking organizations in the United States. The fundamental risk presented by these organizations is that they may be acting in a de facto organizational structure that, because it is not formalized, is not subject to comprehensive consolidated supervision. Therefore, relationships between the U.S. depository institution and other affiliates may be harder to understand and monitor. To reduce these risks, the U.S. banking agencies (1) work with appropriate non-U.S. supervisors to better understand and monitor the activities of the foreign affiliates and owners; (2) share information, as appropriate, with foreign and domestic bank supervisory agencies; and (3) impose special conditions or obtain special commitments or representations related to an application or an enforcement or other supervisory action, when warranted.

Parallel-owned banking organizations may foster additional management and supervisory risks:

- Officers and directors of the U.S. depository institution may be unable or unwilling to exercise independent control to ensure that transactions with the foreign parallel bank or affiliates are legitimate and comply with applicable laws and regulations. As a result, the U.S. depository institution may be the conduit or participant in a transaction that violates U.S. law or the laws of a foreign country, or that is designed to prefer a foreign bank or nonbank entity in the group, to the detriment of the U.S. depository institution.
- Money-laundering concerns may be heightened due to the potential lack of arm's-length transactions between the U.S. depository institution and the foreign parallel bank. Specifically, the flow of funds through wires, pouch activity, and correspondent accounts may be subject to less internal scrutiny by the U.S. depository institution than usually is warranted.[10e] This risk is greatly increased

10d. The sharing of a director, by itself, is unlikely to indicate common control of the U.S. and foreign depository institutions.

10e. On October 28, 2002, the U.S. Department of the Treasury's regulation to implement sections 313 and 319(b) of the USA Patriot Act became effective. (See 31 CFR 103.177 and 103.185.) The regulation implemented new provisions of the Bank Secrecy Act that relate to foreign correspondent accounts. A covered financial institution (CFI) (a financial institution that is covered by the regulation) is prohibited from establishing, maintaining, administering, or managing a correspondent account in the United States for, or on behalf of, a foreign shell bank (a foreign bank that has no physical presence in any country) that is not affiliated with a U.S.-domiciled financial institution or with a foreign bank that maintains a physical presence in the United States or a foreign country and that is supervised by its home-country banking authority. A CFI must take reasonable steps to ensure that a correspondent account of a foreign bank (an account established by a CFI for a foreign bank to receive deposits from, to make payments or other disbursements on behalf of a foreign bank, or to handle other financial transactions related to the foreign bank) is not being used to indirectly provide banking

when the foreign parallel bank is located in an offshore jurisdiction or other jurisdiction that limits exchange of information through bank secrecy laws, especially if the jurisdiction has been designated as a ''non-cooperating country or territory'' or the jurisdiction or the foreign bank has been found to be of primary money-laundering concern under the International Money Laundering Abatement and Financial Anti-Terrorism Act of 2001.
- Securities, custodial, and trust transactions may be preferential to the extent that assets, earnings, and losses are artificially allocated among parallel banks. Similarly, low-quality assets and problem loans can be shifted among parallel banks to manipulate earnings or losses and avoid regulatory scrutiny. Also, if the foreign parallel bank were to begin experiencing financial difficulties, the foreign bank or the common owners might pressure the U.S. depository institution to provide credit support or liquidity to an affiliate in excess of the legal limits of 12 USC 371c and 371c-1.
- The home country of the foreign parallel bank may have insufficient mechanisms or authority to monitor changes in ownership or to ensure arm's-length intercompany transactions between the foreign parallel bank and other members of the group, including the U.S. depository institution, or to monitor concentrations of loans or transactions with third parties that may present safety-and-soundness concerns to the group.
- Capital may be generated artificially through the use of international stock-purchase loans. Such loans can be funded by the U.S. depository institution to the foreign affiliate or to a nonaffiliate with the purpose of supporting a loan back to the foreign affiliate and used to leverage the U.S. depository institution or vice versa. This concern is heightened for parallel-owned banking organizations if the foreign bank is not adequately supervised.
- Political, legal, or economic events in the foreign country may affect the U.S. depository institution. Events in the foreign country, such as the intervention and assumption of control of the foreign parallel bank by its supervisor, may trigger a rapid inflow or outflow of deposits at the U.S. depository institution, thereby affecting liquidity. Foreign events may increase reputational risk to the U.S. depository institution. In addition, these events may adversely affect the foreign bank owner's financial resources and decrease the ability of the foreign bank owner to provide financial support to the U.S. depository institution. Foreign law may change without the U.S. depository institution or the banking agencies becoming aware of the effect of legal changes on the parallel-owned banking organization, including the U.S. depository institution.
- Parallel-owned banking organizations may seek to avoid legal lending limits or limitations imposed by securities or commodities exchanges or clearinghouses on transactions by one counterparty, thereby unduly increasing credit risk and other risks to the banking organizations and others.

To minimize risks, the U.S. banking agencies coordinate the supervision of a parallel-owned banking organization's U.S. operations. The supervisory approach may include unannounced coordinated examinations if more than one regulator has examination authority. Such examinations may be conducted if regulators suspect irregular transactions between parallel-owned banks, such as the shifting of problem assets between the depository institutions. Factors to consider in determining whether to conduct coordinated reviews of an organization's U.S. operations include intercompany and related transactions; strategy and management of the parallel-owned banking organization; political, legal, or economic events in the foreign country; and compliance with commitments or representations made or conditions imposed in the application process or pursuant to prior supervisory action.

The U.S. depository institution's board of directors and senior management are expected to be cognizant of the risks associated with being part of a parallel-owned banking structure, especially with respect to diversion of a depository institution's resources, conflicts of interest, and affiliate transactions. The depository institution's internal policies and procedures should provide guidance on how person-

services to foreign shell banks. The regulation includes recordkeeping requirements and required account-termination procedures that are to be used by CFIs having correspondent accounts of foreign banks. See SR-03-17, which discusses the additional requirements of the regulation and provides additional Bank Secrecy Act examination procedures that are designed to focus on particular areas of risk. See also SR-04-13, SR-05-9, and SR-01-29 (section 326 of the Patriot Act) for a discussion of the Patriot Act requirements for a financial institution's customer identification program. A customer identification program should part of an institution's overall anti-money-laundering and BSA compliance program.

nel should treat affiliates. The Federal Reserve and other U.S. banking agencies will expect to have access to such policies, as well as to the results of any audits of compliance with the policies. The agencies will seek an overview of the entire organization, as well as a better understanding of how foreign bank affiliates are supervised. Authorized bank regulatory supervisory staff will work with foreign supervisors to better understand the activities of the foreign affiliates and owners. As appropriate and feasible, and in accordance with applicable law, such authorized staff will share information regarding material developments with foreign and domestic supervisory agencies that have supervisory responsibility over relevant parts of the parallel-owned banking organization.

DOMESTIC AND FOREIGN SUBSIDIARIES

Domestic subsidiaries are any majority-owned companies, other than Edge Act or agreement corporations, domiciled in the United States and its territories and possessions. Foreign subsidiaries are any majority-owned or -controlled companies domiciled in a foreign country or any Edge Act or agreement corporation. Section 211.13 of Regulation K (12 CFR 211.13) requires foreign subsidiaries to maintain effective systems of records, controls, and reports to keep bank management informed of their activities and conditions. In particular, these systems are to provide information on risk assets, exposure to market risk, liquidity management, operations, internal controls, and conformance with management policies. Reports on risk assets must be sufficient enough to allow for an appraisal of credit quality and an assessment of exposure to loss; for that purpose, they must provide full information on the condition of material borrowers. Reports on the operations and controls are to include internal and external audits of the branch or subsidiary.

On-site examinations of foreign subsidiaries are sometimes precluded because of objections voiced by foreign directors, minority shareholders, or local bank supervisors. In addition, secrecy laws in countries such as Switzerland, Singapore, Luxembourg, and the Bahamas sometimes preclude on-site examinations. When on-site examinations cannot be performed, foreign subsidiary reports submitted according to section 211.13 and reports submitted to foreign banking authorities must serve as the basis for evaluating the bank's investment.

Additionally, Regulation K allows for investments in foreign companies to be made under the general-consent provisions without prior approval of the Board. These investments can be sizable and can pose significant risk to the banking organization. Investments in foreign subsidiaries should be reviewed for compliance with the FRA and investment limitations in Regulation K. (See Regulation K, sections 211.8 and 211.9.)

SIGNIFICANT SUBSIDIARIES

As used in the consolidation instructions for certain regulatory reports, ''significant subsidiaries'' refers to subsidiaries that meet any one of the following tests:

- a majority-owned subsidiary in which the bank's direct and indirect investment and advances represent 5 percent or more of the parent bank's equity capital accounts
- a majority-owned subsidiary whose gross operating revenues amount to 5 percent or more of the parent bank's gross operating revenues
- a majority-owned subsidiary whose ''income (loss) before income taxes and securities gains or losses'' amounts to 5 percent or more of the parent bank's ''income (loss) before income taxes and securities gains or losses''
- a majority-owned subsidiary that is the parent of one or more subsidiaries that, when consolidated, constitute a ''significant subsidiary'' as defined above

ASSOCIATED COMPANIES

Associated companies are those in which the bank directly or indirectly owns 20 percent to 50 percent of the outstanding common stock, unless the bank can rebut to the Federal Reserve the presumption of exercising significant influence. However, as noted above, for purposes of section 23A, affiliation is defined by 25 percent share ownership. Because of the absence of direct or indirect control, regulators have no legal authority to conduct full examinations of this type of company. Investments in these companies are generally appraised in the same way as commercial loans, that is, by a credit analysis of the underlying financial information.

CHAIN BANKING SYSTEMS

Chain banking systems exist when an individual (or group of individuals) is a principal in two or more banking institutions, in either banks or bank holding companies or a combination of both types of institutions. In these systems, the possibility exists that problems in one or more of the entities may adversely affect the safety and soundness of the bank entities because of pressure exerted by their common principal (or principals). Examiners should determine whether the bank is a member of a chain. If so, the extent of its relationship with other links of the chain should be determined, as well as the effects these relationships have on the bank.

REAL ESTATE INVESTMENT TRUSTS AND OTHER RELATED ORGANIZATIONS

Although a bank, its parent holding company, or its nonbank affiliate may not have a direct investment in an "other related organization," the bank may sponsor, advise, or influence the activities of these companies. The most notable examples are real estate investment trusts (REITs) or special-purpose vehicles (SPVs). Transactions between the bank and REITs and between other investment companies sponsored or advised by the bank are subject to the limitations in section 23A. In other cases, because of nonownership or a less-than-majority ownership, legal authority to conduct an examination does not exist.

A REIT may be considered an affiliate if it is sponsored and advised on a contractual basis by the member bank or by any subsidiary or affiliate of the member bank. In these cases, transactions between the bank and an affiliated REIT are subject to the requirements of section 23A. Because a REIT frequently carries a name that closely identifies it with its sponsoring bank or bank holding company, failure of the REIT could have an adverse impact on public confidence in the holding company and its subsidiaries.

The examiner should be aware of all significant transactions between the bank under examination and its related REIT in order to determine conflicts of interest and contingent risks. In several instances, REITs have encountered serious financial problems and have attempted to avoid failure by selling questionable assets to or swapping these assets with their bank affiliates. In other instances, because of the adversary relationship, REITs have been encouraged to purchase assets of inferior quality from their related organizations.

FINANCIAL HOLDING COMPANIES

Section 4(k) of the BHC Act authorizes affiliations among banks, securities firms, insurance firms, and other financial companies. It provides for the formation of financial holding companies (FHCs) and allows a BHC or foreign bank that qualifies as an FHC to engage in a broad range of activities that are (1) defined by the GLB Act to be financial in nature or incidental to a financial activity or (2) determined by the Board, in consultation with the secretary of the Treasury, to be financial in nature or incidental to a financial activity or that are determined by the Board to be complementary to a financial activity and not to pose a substantial risk to the safety and soundness of depository institutions or the financial system generally.

Certain conditions must be met for a BHC or a foreign bank to be deemed an FHC and to engage in the expanded activities. BHCs that do not qualify as FHCs are limited to engaging in those nonbanking activities that are permissible under section 4(c)(8) of the BHC Act. Section 4(k) of the BHC Act authorizes an FHC to engage in designated financial activities, including insurance and securities underwriting and agency activities, securities underwriting, merchant banking, and insurance company portfolio investment activities.

Supervisory Oversight

The Federal Reserve has supervisory oversight authority and responsibility for BHCs that operate as FHCs and for BHCs that are not FHCs. The GLB Act sets parameters for operating relationships between the Federal Reserve and other regulators. The statute differentiates between the Federal Reserve's relations with

(1) depository institution regulators and (2) functional regulators, which include insurance, securities, and commodities regulators. The Federal Reserve's relationships with functional regulators will, in practice, depend on the extent to which an FHC is engaged in functionally regulated activities; those relationships will also be influenced by existing working arrangements between the Board and the functional regulator.

The Federal Reserve's supervisory oversight role is that of an umbrella supervisor concentrating on a consolidated or group-wide analysis of an organization. Umbrella supervision is not an extension of more traditional bank-like supervision throughout an FHC. The FHC framework is consistent with and incorporates principles that are well established for BHCs. The FHC supervisory policy focuses on addressing supervisory practice for and relationships with FHCs, particularly those that are engaged in securities or insurance activities. (See SR-00-13.)

The Federal Reserve is responsible for the consolidated supervision of FHCs. The Federal Reserve thus assesses the holding company on a consolidated or group-wide basis. The objective is to ensure that the holding company does not threaten the viability of its depository institution subsidiaries. Depository institution subsidiaries of FHCs are supervised by their appropriate primary bank or thrift supervisor (federal and state). However, the GLB Act did not change the Federal Reserve's role as the federal bank holding company supervisor.

Nonbank (or nonthrift) subsidiaries engaged in securities, commodities, or insurance activities are to be supervised by their appropriate functional regulators. Examples of these functionally regulated subsidiaries include a broker, dealer, investment adviser, and investment company registered with and regulated by the Securities and Exchange Commission (SEC) (or, in the case of an investment adviser, registered with any state); an insurance company or insurance agent subject to supervision by a state insurance regulator; and a nonbank subsidiary engaged in activities regulated by the Commodity Futures Trading Commission (CFTC).

As the umbrella supervisor, the Federal Reserve will seek to determine that FHCs are operated in a safe and sound manner so that their financial condition does not threaten the viability of affiliated depository institutions. Oversight of FHCs (particularly those engaged in a broad range of financial activities) at the consolidated level is important because the risks associated with an FHC's activities can cut across legal entities and business lines. The purpose of FHC supervision is to identify and evaluate, on a consolidated or group-wide basis, the significant risks that exist in a diversified holding company to assess how these risks might affect the safety and soundness of depository institution subsidiaries.

The Federal Reserve's focus will be on the financial strength and stability of FHCs, their consolidated risk-management processes, and overall capital adequacy. The Federal Reserve will review and assess internal policies, reports, and procedures, as well as the effectiveness of the FHC consolidated risk-management process. The appropriate bank, thrift, or functional regulator will continue to have primary responsibility for evaluating risks, hedging, and risk management at the legal-entity level for the entity or entities that it supervises.

Permissible Activities

Permissible activities for FHCs include any activity that the Board determined to be closely related to banking under section 4(c)(8) of the BHC Act by regulation or order that was in effect on November 12, 1999. This includes the long-standing ''laundry list'' of nonbanking activities for BHCs. (See section 225.28(b) of Regulation Y.) Section 225.86(a)(2) of Regulation Y lists the nonbanking activities approved for BHCs by Board order as of November 12, 1999.[11]

Section 4(k)(4)(G) of the BHC Act also defines ''financial in nature'' as any activity (1) in which a BHC may engage outside the United States, and (2) that the Board has determined, by regulation or interpretations issued under section (4)(c)(13) of the BHC Act that were in effect on November 11, 1999, to be usual in conducting banking or other financial services abroad. Section 225.86(b) of Regulation Y lists three activities that the Board has found to be usual in connection with the transaction of banking or other financial operations abroad.[12] The activities are providing management consulting services; operating a travel agency; and organizing, sponsoring, and managing a mutual fund. The conduct of each activity has certain prescribed limitations. Management consulting services must be advisory and not allow the FHC to control the person to whom the services are provided. These services, however, may be offered to any person on nonfinancial matters. An FHC may also operate a travel agency in connection with financial services offered by the FHC or others. Finally, a mutual fund organized, sponsored, or managed by an FHC may not

11. Section 20 company activities are not included in this list. Section 4(k)(4)(E) of the BHC Act authorizes FHCs to engage in securities underwriting, dealing, and market-making activities in a broader form than was previously authorized by Board order.

12. See section 211.10 of Regulation K (12 CFR 211.10).

exercise managerial control over the companies in which the fund invests, and the FHC must reduce its ownership of the fund, if any, to less than 25 percent of the equity of the fund within one year of sponsoring the fund (or within such additional period as the Board permits).

The activities that a BHC is authorized to engage in outside the United States under section 211.10 of Regulation K have been either (1) authorized for FHCs in a broader form by the GLB Act (for example, underwriting, distributing, and dealing in securities and underwriting various types of insurance) or (2) authorized in the same or a broader form in Regulation Y (for example, data processing activities; real and personal property leasing; and acting as agent, broker, or adviser in leasing property). Section 4(k)(4)(G) of the BHC Act and section 225.86 of Regulation Y only authorize FHCs to engage in the activities that are listed in section 211.10 of Regulation K, as interpreted by the Board. The Board has also approved activities found in individual orders issued under section 4(c)(13) of the BHC Act. Section 4(k)(4)(G) and Regulation Y do not authorize an FHC to engage in activities that the Board authorized a BHC to provide in individual orders issued under section 4(c)(13) of the BHC Act.

The remaining activities authorized by section 4(k)(4) of the BHC Act are those that are defined to be ‘‘financial in nature’’ under section 4(k)(4)(A) through (E), (H), and (I). (See section 225.86(c) of Regulation Y.) These activities include issuing annuity products and acting as principal, agent, or broker for purposes of insuring, guaranteeing, or indemnifying against loss, harm, damage, illness, disability, or death. Permissible insurance activities as principal include reinsuring insurance products. An FHC acting under section 4(k)(4) of the BHC Act may conduct insurance activities without regard to the restrictions on the insurance activities imposed on BHCs under section 4(c)(8). (See section 3905.0 of the *Bank Holding Company Supervision Manual* for more information pertaining to the activities of FHCs.)

BANK HOLDING COMPANIES

As defined in section 2 of the BHC Act of 1956 (12 USC 1841 et seq.), a bank holding company is any company that directly or indirectly, or acting through one or more other persons, owns, controls, or has power to vote 25 percent or more of any class of voting securities of the bank or company; that controls in any manner the election of a majority of the directors or trustees of the bank or company; or that the Board determines, after notice and opportunity for hearing, directly or indirectly exercises controlling influence over the management or policies of the bank or company. A bank and its parent holding company are considered affiliates when the holding company controls the bank in a manner consistent with the definition of control in section 23A of the FRA. Section 23A exempts from the quantitative and collateral requirements of the law all transactions (except for the purchase of low-quality assets) between ‘‘sister’’ banks (banks with 80 percent or more common ownership) in a bank holding company system. A low-quality asset is any asset (1) classified ‘‘substandard,’’ ‘‘doubtful,’’ or ‘‘loss’’ or treated as ‘‘other loans especially mentioned’’ in the most recent federal or state examination report; (2) on nonaccrual status; (3) with principal or interest payments more than 30 days past due; or (4) whose terms have been renegotiated or compromised due to the deteriorated financial condition of the borrower.

Under the BHC Act, the Federal Reserve has authority to examine bank holding companies and their nonbank subsidiaries. The Federal Reserve requires periodic inspections of all bank holding companies, the frequency of which is based on the size, complexity, and condition of the organization. Often a bank holding company is inspected at the same time as the examination of its state member bank subsidiaries. In these cases, the examiner at the bank should collaborate closely with inspection personnel on those holding company issues that directly affect the condition of the bank. When the BHC inspection is not conducted simultaneously with the examination, the bank examiner should closely review the most recent report of inspection and may also need to consult the Y-series of reports regularly submitted to the Federal Reserve System by bank holding companies.

Many banks are owned by bank holding companies. To understand the effects of the holding company structure on the subsidiary bank, the examiner should evaluate the overall financial support provided by the parent company, quality of supervision and centralized functions provided, and appropriateness of intercompany transactions. Since financial and managerial issues at the bank holding company and subsidiary bank levels are so closely connected, it is strongly recommended that a holding company inspection and its respective bank examination (or examinations) be conducted at the same time. A combined examination/inspection report, as discussed in SR-94-46, is available to facilitate this coordination when the lead subsidiary is a state member bank.

Financial Support

The holding company structure can provide its subsidiary bank with strong financial support because of its greater ability to attract and shift funds to less capital-intensive areas and to enter markets in a wider geographic area than would otherwise be possible. Financial support may take the form of capital (equity or debt) or funding of loans and investments. In general, the lower the parent bank holding company's leverage, the more it is able to serve as a source of financial strength to its bank subsidiaries. This is because less cash flow will be required from the banks for debt servicing, and the parent has more borrowing capacity, which could be used to provide funds to the bank. When the financial condition of the holding company or its nonbanking subsidiaries is unsound, the operations of its subsidiary bank can be adversely affected. To service its debt or provide support to another subsidiary that is experiencing financial difficulty, the holding company may involve its bank subsidiary in the following imprudent actions:

- engaging in high-risk investments to obtain increased yields
- purchasing or swapping its high-quality assets for the parent's or other affiliate's lower-quality assets
- entering into intercompany transactions that are detrimental because of inordinately high fees or inadequate or unnecessary services
- paying excessive dividends
- making improper tax payments or unfavorably altering its tax situation

Even when the holding company's structure is financially sound, the holding company's ability to sell short- or long-term debt and to pass the proceeds down to its bank subsidiary in the form of equity capital may still present problems. That procedure is frequently referred to as "double leveraging," the amount of the equity investment in the bank subsidiary is financed by debt. Problems may arise when the holding company must service its debt out of dividends from the subsidiary, and the subsidiary, if it encounters an earnings problem or is prevented by regulatory agreement or action, may not be able to pass dividends up to its parent.

Another potential problem may develop when the holding company sells its commercial paper and funds its subsidiary's loans with those proceeds. This may cause a liquidity problem if the maturities of the commercial paper sold and loans funded are not matched appropriately and if the volume of such funding is large in relation to the subsidiary's overall operations.

On April 24, 1987, the Federal Reserve adopted a policy statement on the responsibility of bank holding companies to act as sources of financial and managerial strength to their subsidiary banks. The Board's statement reiterates a general policy that has been expressed on numerous occasions, in accordance with authority that is provided under the BHC Act and the enforcement provisions of the FDI Act.

BHC Supervision of Subsidiaries

Bank holding companies use a variety of methods to supervise their bank subsidiaries, including—

- having holding company senior officers serve as directors on the bank's board;
- establishing reporting lines from senior bank management to corporate staff;
- formulating or providing input into key policies; and
- establishing management information systems, including internal audit and loan review.

As part of the evaluation of bank management, the examiner should be aware of these various control mechanisms and determine whether they are beneficial to the bank. Examiners should keep in mind that, even in a bank holding company organization, the directors and senior management of the bank are ultimately responsible for operating it in a safe and sound manner.

In addition, many bank functions (investment management, asset/liability management, human resources, operations, internal audit, and loan review) may be performed on behalf of the bank by its parent bank holding company or by a nonbank affiliate. These functions are reviewed at inspections of the bank holding company. Examiners at the bank should be aware of the evaluation of these functions by inspection personnel, either at a concurrent inspection or in the report of a prior inspection. In addition, a review of these same issues at the level of the subsidiary bank is useful to determine compliance with corporate policies, corroborate inspection findings, and identify any inappropriate transactions that may have been overlooked in the more general, top-down review at the parent level.

EVALUATION OF INVESTMENTS IN AND LOANS TO BANK-RELATED ORGANIZATIONS

To properly evaluate affiliates and other bank-related organizations[13] relative to the overall condition of the bank, the examiner must—

- know the applicable laws and regulations that define and establish limitations with respect to investments in and extensions of credit to affiliates and
- analyze thoroughly the propriety of the related organizations' carrying value, the nature of the relationships between the bank and its related organizations, and the effect of such relationships on the affairs and soundness of the bank.

The propriety of the carrying value of a bank's investment in any related organization is determined by evaluating the balance sheet and income statement of the company in which the bank has the investment. At times, this may not seem important in relation to the overall condition of the bank because the amount invested may be small relative to the bank's capital. It may appear that a cursory appraisal of the company's assets would therefore be sufficient. However, the opposite is often true. Even though a bank's investment in a subsidiary or associated company is relatively small, the underlying legal or moral obligation may be substantial and may greatly exceed the total amount of the reported investment. If the subsidiary experiences large losses, the bank may have to recapitalize the subsidiary by injecting much more than its original investment to protect unaffiliated creditors of the subsidiary or protect its own reputation.

When examining and evaluating the bank's investment in and loans to related organizations, classified assets held by such companies should first be related to the capital structure of the company, and then be used as a basis for classifying the bank's investment in and loans to that company.

One problem that examiners may encounter when they attempt to evaluate the assets of some subsidiaries and associated companies is inadequate on-premises information. This may be especially true of foreign investments and associated companies in which the bank has less than a majority interest. In those instances, the examiner should request that adequate information be obtained during the examination and should establish agreed-on standards for that information in the future. The examiner should insist that the organization have adequate supporting information readily obtainable or available in the bank and that the information be of sufficient quality to allow for an informed evaluation of the investment. Bank management, as well as regulatory authorities, must be adequately informed of the condition of the companies in which the bank has an investment. For subsidiary companies, it is necessary that bank representatives be a party to policy decisions, have some on-premises control of the company (such as board representation), and have audit authority. In the case of an associated company, the bank should participate in company affairs to the extent practicable. Information documenting the nature, direction, and current financial status of all such companies should be maintained at the bank's head office or maintained regionally for global companies. Full audits by reputable certified public accountants are often used to provide much of this information.

For foreign subsidiaries, in addition to the audited financial information prepared for management, the bank should have on file the following:

13. Information about related organizations and interlocking directorates and officers can be obtained from the bank holding company form FR Y-6 and SEC form 10-K, if applicable, or from other required domestic and foreign regulatory reports. Further information on business interests of directors and principal officers of the bank can be obtained by reviewing information maintained by the bank in accordance with the Board's Regulation O.

- reports prepared according to the Board's Regulation K
- reports prepared for foreign regulatory authorities
- information on the country's cultural and legal influence on banking activities, current economic conditions, anticipated relaxation or strengthening of capital or exchange controls, fiscal policy, political goals, and the risk of expropriation
- adequate information to review compliance with the investment provisions of Regulation K (For each investment, information should be provided on the type of investment (equity, binding commitments, capital contributions, subordinated debt), dollar amount of the investment, percentage ownership, activities conducted by the company, legal authority for such activities, and whether the investment was made under Regulation K's general-consent, prior-notice, or specific-consent procedures. With respect to investments made under the general-consent authority, information also must be maintained that demonstrates compliance with the various limits set out in section 211.9 of Regulation K. (See Regulation K, sections 211.8 and 211.9.)

For agricultural credit corporations, the examiner-in-charge normally decides when to examine such an entity. A complete analysis of the entity's activities should always be performed if—

- the corporation is not supervised by the Federal Intermediate Credit Bank (FICB),
- the most recent FICB examination occurred over a year ago, or
- the most recent FICB examination indicates that the corporation is in less than satisfactory condition.

The extent of any analysis should be based on the examiner's assessment of the corporation's effect on the parent bank. That analysis should include, but not be limited to, a review of—

- asset quality;
- the volatility, maturity, and interest-rate sensitivity of the asset and liability structures; and
- the bank's liability for guarantees issued on behalf of the corporation.

When the same borrower is receiving funds from both the corporation and the parent bank, and the combined exposure exceeds 25 percent of total consolidated capital, the debt should be detailed on the concentration page of the examination report. The consolidation procedures listed in the instructions for the preparation of Consolidated Reports of Condition and Income should be used when consolidating the figures of the corporation with those of its parent.

INTERCOMPANY TRANSACTIONS

As with the supervision of subsidiaries, intercompany transactions should be reviewed at both the parent level during inspections and at the subsidiary-bank level during examinations. The transactions should comply with sections 23A and 23B of the FRA and should not otherwise adversely affect the financial condition of the bank.

Intercompany Tax Payments

As set forth in the policy statement regarding intercorporate income tax accounting transactions of bank holding companies and state-chartered banks that are members of the Federal Reserve System (September 20, 1978), Federal Reserve policy relative to intercompany tax payments is to treat the bank as a separate taxpayer whose tax payments to its parent should not exceed payments it would make on a separate-entity basis. Payments should not be made to the parent before the time payments are or would have been made to the Internal Revenue Service. Refunds to the bank should be timely. Individual situations may result in complicated issues, and the examiner should consult with Reserve Bank personnel before reaching conclusions concerning a particular transaction. Bank holding company inspection report comments and bank examination report comments should be consistent concerning the nature and propriety of intercompany transactions.

Management and Other Fees

Banks often obtain goods and services from the parent bank holding company or an affiliated nonbank subsidiary. These arrangements may benefit the bank, since the supplier may offer lower costs because of economies of scale, such as volume dealing. Furthermore, banks may be able to purchase a package of services that otherwise might not be available. However, because of the interrelationship between the bank and the supplier, examiners should ensure that the fees being paid represent reasonable reimbursement for goods and services received. Fees paid by the bank to the parent or nonbank affiliates should have a direct relationship to, and be based solely on, the fair value of goods and services provided and a reasonable profit. Fees should compensate the affiliated supplier only for providing goods and services that meet the legitimate needs of the bank.

Banks should retain satisfactory records that substantiate the value of goods and services received, their benefit to the bank, and their cost efficiencies. There are no other minimum requirements for records, but an examiner should be able to review the records maintained and determine that fees represent reasonable payment. In general, the supplier will decide on the amount to be charged by using one of three methods:

- reimbursement for cost of goods or services
- cost plus a reasonable profit margin
- comparative fair-market value

Any of these methods may be acceptable as long as the bank can substantiate that the fees paid are reasonable for the value received. Basing fees on costs may be the most common approach since market comparisons often are difficult to obtain. A holding company may be able to offer a number of services on a cost basis to a subsidiary bank, any one of which might be contracted elsewhere for less. However, in the aggregate, the services may be cost effective or produce economies of scale for the entire organization. Nevertheless, having one or more subsidiary banks pay excessive fees for services to subsidize other unprofitable operations is not an acceptable practice.

When the servicer incurs overhead expenses, recovery of those costs is acceptable to the extent they represent a legitimate and integral part of the service rendered. Overhead includes salaries and wages, occupancy expenses, utilities, payroll taxes, supplies, and advertising. Debt-service requirements of holding companies, shareholders, or other related organizations are not legitimate overhead expenses for a subsidiary bank.

Generally, the payment of excessive fees is considered an unsafe and unsound practice. When fees are not justified, appear excessive, do not serve legitimate needs, or are otherwise abusive, the examiner should inform the board of directors through appropriate criticism in the report of examination.

Dividends

Dividends represent a highly visible cash outflow by banks. If the dividend-payout ratio exceeds the level at which the growth of retained earnings can keep pace with the growth of assets, the bank's capital ratios will deteriorate. Examiners should evaluate the appropriateness of dividends relative to the bank's financial condition, prospects, and asset-growth forecast.

Purchases or Swaps of Assets

Asset purchases or swaps between affiliates create the potential for abuse. Regulatory concern focuses on the fairness of such asset transactions, their financial impact, and timing. Fairness and financial considerations include the quality and collectibility of such assets and liquidity effects. Asset exchanges may be a mechanism to avoid regulations designed to protect subsidiary banks from becoming overburdened with nonearning assets.

Compensating Balances

A subsidiary bank may be required to maintain excess balances at a correspondent bank that lends to other parts of the holding company organization, possibly to the detriment of the bank. The subsidiary bank may be foregoing earnings on such excess funds, which may adversely affect its financial condition.

Split-Dollar Life Insurance

Split-dollar life insurance is a type of life insurance in which the purchaser of the policy pays at least part of the insurance premiums and is entitled to only a portion of the cash surrender value, or death benefit, or both. In some circumstances, when the subsidiary bank pays all or substantially all of the insurance premiums, an unsecured extension of credit from the bank to its parent holding company generally results because the bank has paid the holding company's portion of the premium, and the bank will not be fully reimbursed until later. In other arrangements, when the parent uses the insurance policy as collateral for loans from the subsidiary bank, the loan may not meet the collateral requirements of section 23A. In addition, split-dollar arrangements may not comply with section 23B if the return to the bank is not commensurate with the size and nature of its financial commitment. Finally, split-dollar arrangements may be considered unsafe and unsound, which could be the case if the bank is paying the entire premium but is not the beneficiary, or if it receives less than the entire proceeds of the policy. (See SR-93-37.)

Other Transactions with Affiliates

Checking accounts of the parent or nonbank subsidiaries at subsidiary banks present the potential for overdrafts, which are regarded as unsecured extensions of credit to an affiliate by the subsidiary bank. In general, a subsidiary bank should be adequately compensated for its services or for the use of its facilities and personnel by other parts of the holding company organization. In addition, a subsidiary bank should not pay for expenses for which it does not receive a benefit (for example, the formation expenses of a one-bank holding company).

Situations sometimes arise in which more than one legal entity in a banking organization shares offices or staff. In certain cases, it can be hard to determine whether a legal entity is operating within the scope of its permissible activities. In addition, a counterparty may be unclear as to which legal entity an employee is representing. Finally, there may be expense-allocation problems and, thus, issues pertaining to sections 23A and 23B. Examiners should be aware of these concerns and make sure that institutions have the proper records and internal controls to ensure an adequate separation of legal entities. (See SR-95-34.)

1. To determine if policies, procedures, and internal controls for bank-related organizations are adequate.
2. To determine if bank and affiliate management are complying with the established policies.
3. To determine compliance with sections 23A and 23B of the Federal Reserve Act and other applicable laws and regulations involving intercompany and other transactions.
4. To evaluate the bank's investment in and loans to its related organizations, as well as the propriety of those carrying values.
5. To determine the relationships between the bank and its related organizations and the effects of those relationships on the operations and safety and soundness of the bank.
6. To initiate corrective action when policies, practices, procedures, or internal controls are deficient or when violations of law or regulations have been noted.

PRE-EXAMINATION ANALYSIS

During the pre-examination analysis of the bank, it should be determined which related organizations should be examined in depth. The criteria for that determination are as follows:

1. All operating subsidiaries should be examined concurrently with the regular examination of the parent bank, unless such examination is specifically waived by the Federal Reserve Bank.
2. Other subsidiaries should be examined except when relationships between the subsidiary, its parent, and other related organizations are fully disclosed by material on hand and when the subsidiary's condition or operations are determined not to be detrimental to the safety and soundness of the bank. Factors to be considered in making the determination to examine a subsidiary are as follows:
   a. the bank's percent of ownership and dollar amount of investment in the subsidiary
   b. nature of the subsidiary's business
   c. types and amounts of intercompany transactions
   d. types and amounts of participations and purchased, sold, or swapped assets between the subsidiary and the bank or other related organizations
   e. types of services performed by the subsidiary for the bank or other related organizations
   f. outstanding contingent liabilities by the bank in favor of the subsidiary
   g. the bank's potential contingent liabilities, moral or legal, as a result of litigation, claims, or assessments pending against the subsidiary
3. If practical under the circumstances, the parent holding company and nonbank affiliates should be inspected in conjunction with the examination of the lead state member bank. The decision to coordinate the timing of the bank holding company inspection and the state member bank examination should be based on the nature and extent of interaction between the bank and its parent holding company and nonbank affiliates. Factors to be considered in making the decision to coordinate the examination and inspection are as follows:
   a. dollar amount of loans or advances by the bank
   b. nature of business of the nonbank affiliates
   c. types and amount of intercompany transactions
   d. types and amounts of participations and other assets purchased, sold, or swapped
   e. types of services performed for or by the bank and fees paid or received
   f. outstanding contingent liabilities by the bank in favor of its parent or nonbank affiliates

   Factors to be considered in determining whether to examine nonbanking subsidiaries within the parent holding company under inspection are detailed in the *Bank Holding Company Supervision Manual*.

EXAMINATION PROCEDURES FOR RELATED ORGANIZATIONS

The following procedural steps should be performed in all banks that have related organizations.

1. If selected for implementation, complete or update the bank-related organizations section of the internal control questionnaire.
2. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examination procedures.
3. When appropriate, obtain the following reports or forms prepared or filed since the preceding examination:
   a. annual report on SEC Form 10-K
   b. current report on SEC Form 8-K
   c. quarterly report on SEC Form 10-Q
   d. quarterly report on Federal Reserve Form Y-8
   e. annual fiscal year-end report on Federal Reserve Form Y-6
   f. annual report to shareholders
   g. required reports under Federal Reserve Regulation K and to foreign banking authorities for foreign subsidiaries

   h. subsidiary and affiliate reports prepared by examiners
   i. federal reports of examination for non-banking subsidiaries
4. Request that the bank provide a list of the names of all related organizations; the list should set forth the loans to and investments in these organizations and any management official interlocks among these organizations and the banks.
5. Circulate a list of the names of the related organizations and the loans to and investments in these organizations. This list should be circulated among the examiners assigned to each bank department. The accuracy and completeness of this information should be verified by the recipients.
6. Obtain, from the examiners assigned to other assets and other liabilities, information concerning receivables from or payables to related organizations.
7. Review the bank's files and reports obtained in step 3, and transcribe for the workpapers pertinent financial data and comments regarding related organizations.
8. Review fees paid by the bank to related organizations, bank insider–related organizations, and stockholders. Determine that the fees represent reasonable reimbursement for goods and services received by—
   a. determining the method used to compute the charge to the bank for goods or services (cost, cost plus profit, fair market value),
   b. reviewing documentation maintained by the bank to substantiate the fair value of the goods or services received, their benefit to the bank, and the cost efficiencies of the alternative selected,
   c. comparing the schedule of fees currently in effect with those in effect 12 months ago, and
   d. comparing the fees paid during the last three months with those paid for the same period one year ago.
9. On the basis of the information obtained above, review the following for each related organization:
   a. the quality of loans, investments, and future commitments to any related organization
   b. the nature and volume of transactions between the related organization and the bank and—
      - the extent of any participations and the purchase, sale, or swap of assets between the bank and the related organizations, as well as the propriety of the transactions and related considerations;
      - the fees these organizations charge the bank for services rendered and the reasonableness of those fees;
      - cash transfers to or from a related organization in connection with a consolidated income tax obligation (Amounts paid should be based on that amount due if a separate return was filed. They should be paid only at such time to reasonably permit required estimated payments or final settlements to be made to the IRS.);
      - fees received by the bank from the organization for the use of bank personnel, premises, marketing services, and equipment, and the adequacy of those fees; and
      - any agreements, guarantees, pledges, or hypothecations between the bank and any related organization, if they are properly reflected on the books of the bank, and whether there are any apparent conflicts of interest.
   c. litigation, when the related organization is a defendant in a suit and if the litigation could have an adverse effect on the bank (from SEC Form 10-K or another source)
   d. each interlocking officer and/or director relationship as reflected by the information obtained in step 4. Determine—
      - whether fees or salaries are excessive for duties performed and
      - if adequate time is devoted to management responsibilities.
10. *Section 23A of the Federal Reserve Act (12 USC 371c), Relations with Affiliates, and the Board's Regulation W.* By coordinating work with the examiners assigned to the various loan areas, determine compliance with laws and regulations pertaining to related organizations by performing the following procedures.
    a. Obtain a listing of loans to affiliates.
    b. Compare the listing with the bank's customer liability records to determine the list's accuracy and completeness.
    c. Obtain a listing of other covered transactions with affiliates (that is, purchase of securities issued by an affiliate, pur-

chase of assets, acceptance of securities issued by an affiliate as collateral for a loan to any person or company, or the issuance of a guarantee, acceptance, or letter of credit on behalf of an affiliate).

d. Conduct transaction testing of intercompany affiliate transactions[1] for compliance with the limitations of section 23A of the Federal Reserve Act and the Board's Regulation W (see SR-03-02) by—
   - reviewing—
     - the time elapsed between the original issuance of the affiliate's debt securities and the bank's purchase,
     - the existence of any relevant agreements or relationships between the bank and the third-party seller of the affiliate's debt securities,
     - any history of bank financing of the affiliate, and
     - any other relevant information;
   - documenting any violations or potential violations, and reaching an agreement with the directors and senior management to resolve violations quickly; and
   - considering the inclusion of "other transfer-risk problem" (OTRP) assets in the evaluation of asset quality and capital adequacy. (See section 7040.1 for a discussion of OTRP credits.)

e. Ensure that transactions with affiliates meet the collateral requirements of section 23A.

f. Ensure that low-quality loans have not been purchased from an affiliate.

g. Determine that all transactions with affiliates are on terms and conditions that are consistent with safe and sound banking practices.

h. *Policies and procedures.*
   - Obtain the bank's policies and procedures to determine compliance with sections 23A and 23B of the Federal Reserve Act.
   - Ensure the policies and procedures cover all relevant affiliates (e.g., financial subsidiaries and joint ventures) and transactions covered by section 23A, and verify that the bank treats "sponsored and advised" companies as affiliates ("Sponsored and advised" companies would include, at a minimum, any company that receives investment advice and administrative services on a contractual basis from a member bank, whose trustees or managers are selected by the bank, and that has a name similar to that of the bank.).
   - Ensure that the policies and procedures are comprehensive and include adequate controls—
     - to identify covered transactions and
     - to ensure that necessary steps are performed for identified transactions (e.g., the required collateralization of loans to affiliates).

i. *Covered transactions.*
   - If the controls for section 23A are considered adequate, use the list of covered transactions provided by the bank.
   - If controls are considered inadequate (for example, for transactions testing), review the bank's general ledger to identify transactions that are covered transactions.
   - Verify that covered transactions count against required limits and are collateralized when required.
   - If the bank uses an internal rating system for its assets, determine that the bank has not deferred or altered an asset's rating to facilitate sale of the asset to an affiliate.
   - Review controls for monitoring compliance with the established limits and for collateralizing required credit-extension transactions.
   - If controls are considered inadequate (for example, for transactions testing), ensure that covered transactions are properly valued.
   - Verify that identified covered transactions comply with the limits of sections 23A and 23B (If the covered transactions do not comply with the

1. Examples of affiliates include a bank holding company and its nonbank subsidiaries, companies under the member bank's control (see Regulation W, section 223.3(g)), any mutual fund advised by a member bank, merchant banking investments, a member bank or affiliate serving as a general partner in a partnership, and affiliates' subsidiaries. In addition, certain joint venture companies, ESOPs of banks and their affiliates, and special-purpose entities are affiliates if the regulatory definitions of control are met.

limits, criticize the bank for inadequate controls, and discuss what steps the bank will use to correct the violations.).

- Obtain collateral listings, and verify that necessary covered transactions are adequately collateralized:
  - — Verify that the values of omnibus deposit accounts used to secure covered transactions are sufficient to fully secure the relevant covered transactions.
  - — Review collateral documentation to ensure that the bank's interest is adequately perfected and prioritized (Regulation W, section 223.14(d)).

j. *Corporate lending (funding).* Ensure that there is compliance with the collateral requirements and quantitative limits:
- Obtain the bank's "trial balances" of loans.
- Check that loans to affiliates are included on the list of "covered transactions" and included in measurements for compliance with the quantitative limits. If some loans are not included, ascertain why.
- If an exemption is being used, verify that its application is correct.
- Verify that the loans are collateralized (using collateral listings), and review the documentation to ensure proper collateralization.

k. *Verification of exemptions.*
- For renewal of participations involving problem loans (see Regulation W, section 223.15(b)) involving nondepository affiliates, review supporting documentation to ensure that—
  - — the loan was not low quality at the time the bank purchased the participation,
  - — the renewal is approved at the board committee or senior management level as appropriate, and
  - — the bank's share of the renewal does not exceed its original share by more than 5 percent (unless approved by an appropriate federal bank regulator) and that the bank notified the federal bank regulator within 20 days.
- For retail lending (e.g., credit cards and mortgage banking) involving the funding of loans and the purchase of loans, ensure compliance with quantitative limits (for funding and compliance with collateral requirements) as follows:
  - — For credit card examinations, obtain the "trial balances" of the outstanding balances, and for mortgage banking exams, obtain lists of the loans sold.
  - — Check that credit card amounts generated by bank affiliates and mortgage loans sold to the bank by affiliates are included on the list of covered transactions and in measurements for compliance with the quantitative limits. If they are not included, ascertain why.
  - — If an exemption is being used, verify that its use is correct.
  - — Verify that loans are collateralized (using collateral), and review the documentation to ensure proper collateralization.
- For the general-purpose credit card exemption (Regulation W, section 223.16(c)(4)), verify, through review of relevant documentation, that the bank can demonstrate that its credit card meets the less than 25 percent test through one of three available methods. (An exemption from the attribution rule for extensions of credit under a general-purpose credit card is defined as one on which "less than 25 percent of the aggregate amount of purchases are purchases from a bank affiliate.")
  - — The bank has no commercial affiliates.
  - — The bank establishes systems to verify compliance with the less than 25 percent test on an ongoing basis.
  - — The bank presents information to the Board of Governors to demonstrate its card would comply.
- For purchases of extensions of credit—the "250.250 exemption" (Regulation W, section 223.42(k))—review supporting documentation to ensure that—
  - — the member bank makes an independent creditworthiness evaluation before the affiliate makes or commites to make the loan,

- the bank commits to make the loan purchase before the affiliate makes the loan,
- the bank does not make a blanket advance commitment to purchase loans, and
- the purchases from the affiliate by the depository institution and all depository institution affiliates in the prior 12 months represent 50 percent or less of all loans originated by the affiliate during such period.

l. If the bank is critically undercapitalized (under prompt-corrective-action rules), determine if the bank has engaged in any covered transaction, as defined in section 23A, without the prior approval of the FDIC or FRS.

m. *Internal controls.*
   - Determine the bank's methods for identifying transactions subject to sections 23A and 23B of the Federal Reserve Act. Determine if these methods adequately identify such transactions. Consider the following information:
     - internal reports (Management should document any covered transactions with affiliates.)
     - loan records
     - deposit accounts
     - accounts payable and receivable
     - board minutes
   - Determine if management understands what services its affiliates provide.
   - Determine the volume and frequency of inter-institution transactions, such as loan participations or sales, purchases or sales of other assets, bank stock loans, insider transactions, and contractual obligations for services. Review these transactions for possible noncompliance or abusive practices.
   - Review any formal or informal agreements regarding covered transactions. Determine if management adequately documents the cost, fee structure, and quality of services.
   - Determine the bank's compliance with any outstanding conditions of an approved order or commitment issued by the regulator.

n. Determine if the affiliates are in compliance with the capital requirements of their functional regulator.

o. If the bank has used the expanded (d)(4) exemption, determine that the bank regularly reviews the market value of its U.S. government obligations collateral.

p. Determine that the bank's program for monitoring and controlling the credit exposure from derivative transactions with affiliates includes, at a minimum, imposing appropriate credit limits, mark-to market requirements, and collateral requirements.

q. Determine that the limits and requirements reflect the nature, volume, and complexity of the bank's derivatives transactions.

r. Determine that the limits and requirements on credit exposures from derivative transactions have been approved by the board of directors of the bank or an appropriate board committee.

s. Determine that the bank's program for monitoring and controlling the credit exposure from intraday extensions of credit to affiliates includes, at a minimum, imposing appropriate credit limits (on a per-affiliate and aggregate basis) and collateral requirements.

t. Determine that that the limits and requirements imposed by the bank reflect the volume of intraday credit transactions and the reasons for those transactions.

u. Determine that the limits and requirements on intraday credit transactions have been approved by the board of directors of the bank or an appropriate board committee.

11. *Section 23B of the Federal Reserve Act (12 USC 371c-1), Restrictions on Transactions with Affiliates, and the Board's Regulation W.*

   a. Determine that covered transactions with affiliates comply with the restrictions in section 23B.

   b. If the bank has derivative transactions with affiliates, determine that the bank has treated the affiliate no better than a similarly situated nonaffliate.

   c. Determine that management and other fees paid by the bank have a direct relationship to the value of the actual goods and services rendered, based on reasonable costs consistent with current market values for such goods and services.

   d. Review any mortgage banking activity and servicing contracts with affiliates, if

applicable. Give particular attention to—
- the capacity in which the affiliate is acting,
- the nature of the services provided,
- the billing arrangement, frequency of billing, method of computation, and the basis for fees,
- the method of compensating the bank for balances maintained and net interest earned on warehouse loans and lines (This method should not be preferential.),
- the pricing of loan and servicing-right sales,
- advertising restrictions (for noncompliance).

12. *Regulation O (12 CFR 215), Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks.*
    a. Obtain lists of loans to executive officers and business interests of directors, executive officers, and principal shareholders from the examiner assigned to duties and responsibilities of directors.
    b. Determine the accuracy and completeness of the list as it concerns related organizations by comparing it with information obtained from management and other examiners.
    c. Investigate to determine undisclosed affiliate relationships if there are several directors or officers who have a common interest in the same entity by—
    - obtaining a listing of all directors for the entity that are suspected of maintaining an affiliate relationship,
    - reviewing authorizing signatures on corporate resolutions to borrow, and
    - reviewing signatory authorities on deposit signature cards.
13. If the bank engaged in an impermissible nonbank activity, determine that it has divested itself of that activity.
14. If the bank is a subsidiary of a holding company and the parent has sold commercial paper and funded bank loans with the proceeds, obtain or prepare the following schedules and forward them to the examiner assigned to funds management:
    a. amount and maturities of commercial paper outstanding
    b. amount and maturity of the assets the paper supports
15. If the bank is a subsidiary of a holding company and if the parent has sold long-term debt and passed the proceeds down to the bank in the form of equity, obtain or prepare the following schedules and forward them to the examiner assigned to assessment of capital adequacy:
    a. amount, maturity, and repayment terms of long-term debt sold
    b. amount of equity capital passed to bank
    c. expected minimum dividend payment required by bank to service the debt of the parent
16. From the results of previous steps and discussion with management, determine if there are any anticipated changes in the related organization–bank relationship that may possibly have adverse effects on the affairs and soundness of the bank.
17. On the basis of the above steps, determine the propriety of the carrying value and nature of the relationship between the bank and its related organizations and the effect of that relationship on the affairs and soundness of the bank.
18. If, in the performance of the above procedures, the full nature and extent of interaction between the bank and its related organizations cannot be determined, consider the necessity of an in-depth examination of related organizations. Perform appropriate procedures in step 19, and develop additional specific procedures based on the type and scope of activities being conducted.
19. The following procedures should be considered when an in-depth examination of a bank's nonbank subsidiaries is deemed appropriate:
    a. Review and analyze the liability structure of the nonbank subsidiaries.
    - Review and appraise any funding agreements with the parent bank.
    - Review all arrangements whereby the bank purchases assets, pursuant to 12 CFR 223.42(k).
    - Review and appraise any funding agreements with (including guarantees) and debt instruments issued to outside creditors.
    - Review agreements with third parties involving the outright purchase of assets to determine liability for the repurchase of assets or any other contingent liabilities.

    b. Analyze cash flow, earnings, and tax policies of the nonbank subsidiaries. Prepare cash-flow statements for the previous three fiscal years and compare current year-to-date with previous year-to-date.

c. Review and evaluate capital adequacy by—
   - relating the consolidated classified assets of the subsidiaries against the consolidated net worth, or by relating classifieds proportionately to the parent's investment in and advances to each subsidiary;
   - commenting on the overall capital structure of both the parent bank and specific nonbank subsidiaries, as warranted; and
   - discussing the adequacy of capital with management, and noting management's future plans to raise capital.

d. Review and evaluate management and control policies by—
   - reviewing board meeting minutes of the parent corporation, and assessing director interest in and awareness of subsidiaries;
   - reviewing and evaluating corporate management's internal audit procedures for those policies;
   - reviewing "management letters" from certified public accountants about those internal controls; and
   - reviewing shareholder records, noting significant concentrations, and, when officers or directors are involved, noting any undue influence with regard to policies, practices, and procedures.

e. Review management's future operating plan for the subsidiary company.
   - Analyze the subsidiary's earnings and capital projections for one and five years.
   - Obtain underlying assumptions for—
     — return on assets,
     — dividend retention rate,
     — asset growth rate, and
     — capital growth rate.
   - Compare projections against past operating performance, and comment on the plan.

20. Discuss findings and conclusions reached in the examination of any nonbank subsidiary with the management of that entity. Prepare comments for the examination report.

21. Prepare, in appropriate report form, and discuss with appropriate bank management the following:
    a. the adequacy of written policies on related organizations
    b. the manner in which bank officers are operating in conformance with established policy
    c. violations of law or regulations
    d. the impropriety of any transaction between the related organization and the bank
    e. loans to or investments in related organizations that the examiner questions for any reason, such as their quality, carrying value, or ultimate collection
    f. litigation, commitments, contingent liabilities, or current or anticipated changes between the bank and its related organizations that may have adverse effects on the affairs and soundness of the bank
    g. interlocking officer or director relationships that are detrimental to the bank under examination or to any of its related organizations
    h. any other information that will communicate the condition of the related organization and the nature and effect of the relationship between the related organization and the bank under examination
    i. recommended corrective action when policies, practices, or procedures are deficient

22. Consolidate information in the operating subsidiary report (or reports) for inclusion in the report of examination.

23. Consolidate financial information and any other comments concerning related organizations for inclusion, when appropriate, in the report of examination.

24. If material changes have occurred in related organizations since the most recent examination of the bank, and if the changes may have a substantial impact on the bank, this information should be communicated by separate memorandum to the Federal Reserve Bank.

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

Review the bank's internal controls, policies, practices, and procedures concerning related organizations. The bank's system should be documented completely and concisely and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used, and other pertinent information.

POLICIES AND OBJECTIVES

1. Does the bank have written guidelines for the expansion of services through the formation or acquisition of related organizations?
2. Are established objectives and policies adhered to?
   a. Is there an overall lending policy that would bring banking- and nonbanking-related organizations under a common set of controls?
   b. Are bank officials an integral part of subsidiary or related-company management?
   c. Can operating procedures be monitored from available internal or external audit reports?
3. Are periodic independent reviews performed to assess bank management's objectives and policies on the current status of their association with the related organizations?
4. Does bank management have an active role in the related organizations' audit committees, or does management retain the right to examine the companies' records, including the right to receive third-party letters from the external auditors?
5. Are policies and procedures such that the effect on the bank's liquidity is monitored when commercial paper or other proceeds are used to fund bank loans?

RECORDS

1. Are records maintained for the companies in which the bank has a capital investment, including foreign companies, so that a determination can be made of the extent of bank control, quality of assets, profitability of the company, legality of operations, and compliance with the investment limitations of Regulation K? (See Regulation K, sections 211.8 and 211.9.)
2. Does the bank maintain current records on the form and status of each related organization (such a list should include name, location, nature of business, manner of affiliation, relationship with bank, amount of loans, investments in and other extensions of credit, security pledged, obligations of any affiliate that is used as collateral security for advances made to others, commitments, and litigation)?
3. Does the bank maintain a copy of all internal or external audit reports, including management letters and responses, of the subsidiary or related company?
4. In the case of registered bank holding companies and nonbank affiliates arising through the holding company relationship, are copies of the Federal Reserve's inspection reports and forms 10-Q, 10-K, 8-K, Y-6, and Y-8 available for review?
5. In the case of Edge Act and agreement corporations and foreign subsidiaries, are copies of Federal Reserve examination reports and foreign regulatory reports available for review?
6. Do credit files of foreign subsidiaries include information regarding a particular country's cultural and legal influences on banking activities, current economic conditions, anticipated relaxation or strengthening of capital or exchange controls, fiscal policy, political goals, and risk of expropriation?
7. Are adequate records maintained to determine compliance with the investment provisions of Regulation K, including information on the type of investment (equity, binding commitments, capital contributions, subordinated debt), the dollar amount of the investment, the percentage ownership, the activities conducted by the company, the legal authority for such activities, and whether the investment was made under Regulation K's general-consent, prior-notice, or specific-consent procedures? (See Regulation K, sections 211.8 and 211.9.)
8. Is the carrying value of all subsidiaries and related companies accounted for on the equity basis and adjusted, at least quarterly,

to reflect the reporting bank's cumulative share of the company's earnings or losses?

9. Is an objective review performed of the benefits or quality of assets received relative to the cost incurred?
10. Are money transfers between the bank and any related organization adequately documented to justify the equity of the transaction?

CONCLUSION

1. Is the foregoing information considered an adequate basis for evaluating internal controls, that is, there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.

2. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

Banking organizations increasingly rely on information technology (IT) to conduct their operations and manage risks. The use of IT can have important implications for a banking organization's financial condition, risk profile, and operating performance and should be incorporated into the safety-and-soundness assessment of each organization. As a result, all safety-and-soundness examinations (or examination cycles) of banking organizations conducted by the Federal Reserve should include an assessment and evaluation of IT risks and risk management. Further information about banks' IT activities and examination methodology can be found in the *FFIEC Information Technology Examination Handbook* (the *IT Handbook*) and in supervisory guidance issued by the Federal Reserve and the other federal banking agencies.

ASSESSING INFORMATION TECHNOLOGY IN THE RISK-FOCUSED SUPERVISORY FRAMEWORK

The risk-focused supervisory process is evolving to adapt to the changing role of IT in banking organizations, with greater emphasis on an assessment of IT's effect on an organization's safety and soundness. Accordingly, examiners should explicitly consider IT when developing risk assessments and supervisory plans. Examiners should use appropriate judgment in determining the level of review, given the characteristics, size, and business activities of the organization. Moreover, to determine the scope of supervisory activities, close coordination is needed between general safety-and-soundness examiners and IT specialists during the risk-assessment and planning phase, as well as during on-site examinations. Given the variability of IT environments, the level of technical expertise needed for a particular examination will vary across institutions and should be identified during the planning phase of the examination. In general, examiners should accomplish the following goals during a risk-focused examination:

- Develop a broad understanding of the organization's approach to and strategy and structure for IT activities within and across business lines. Determine also the role and importance of IT to the organization and any unique characteristics or issues.
- Incorporate an analysis of IT activities into risk assessments, supervisory plans, and scope memoranda. An organization's IT systems should be considered in relation to the size, activities, and complexity of the organization, as well as the degree of reliance on these systems across particular business lines. Although IT concerns would clearly affect an institution's operational risk profile, IT also can affect other business risks (such as credit, market, liquidity, legal, and reputational risk), depending upon the specific circumstances, and should be incorporated into these assessments as appropriate.
- Assess the organization's critical systems, that is, those that support its major business activities, and the degree of reliance those activities have on IT systems. The level of review should be sufficient to determine that the systems are delivering the services necessary for the organization to conduct its business in a safe and sound manner.
- Determine whether the board of directors and senior management are adequately identifying, measuring, monitoring, and controlling the significant risks associated with IT for the overall organization and its major business activities.

INTERAGENCY GUIDELINES ESTABLISHING INFORMATION SECURITY STANDARDS

The federal banking agencies jointly issued interagency guidelines establishing information security standards (the information security standards), which became effective July 1, 2001.[1] (See appendix B of this section.) The Board of Governors of the Federal Reserve System approved amendments to the standards on December 16, 2004 (effective July 1, 2005). The amended information security standards implement sections 501 and 505 of the Gramm-Leach-Bliley Act (15 USC 6801 and 6805) and section 216 of the Fair and Accurate Credit Transac-

1. See 66 *Fed. Reg.* 8616–8641 (February 1, 2001) and 69 *Fed. Reg.* 77610–77612 (December 28, 2004); Regulation H, 12 CFR 208, appendix D-2; Regulation K, 12 CFR 211.9 and 211.24; and Regulation Y, 12 CFR 225, appendix F.

tions Act of 2003 (15 USC 1681w). The Gramm-Leach-Bliley Act requires the agencies to establish financial-institution information security standards for administrative, technical, and physical safeguards for customer records and information. (See SR-01-15.)

Under the information security standards, institutions must establish an effective *written* information security program to assess and control risks to customer information. An institution's information security program should be appropriate to its size and complexity and to the nature and scope of its operations. The board of directors should oversee the institution's development, implementation, and maintenance of the information security program and also approve written information security policies and programs.

The information security program should include administrative, technical, and physical safeguards appropriate to the size and complexity of the bank and the nature and scope of its activities. The program should be designed to ensure the security and confidentiality of customer information,[2] protect against anticipated threats or hazards to the security or integrity of such information, protect against unauthorized access to or use of such information that could result in substantial harm or inconvenience to any customer,[3] and ensure the proper disposal of customer information and consumer information. Each institution must assess risks to customer information and implement appropriate policies, procedures, training, and testing to manage and control these risks. Institutions must also report annually to the board of directors or a committee of the board of directors.

The information security standards outline specific security measures that banking organizations should consider in implementing a security program based on the size and complexity of their operations. Training and testing are also critical components of an effective information security program. Financial institutions are required to oversee their service-provider arrangements in order to (1) protect the security of customer information maintained or processed by service providers; (2) ensure that its service providers properly dispose of customer and consumer information; and (3) where warranted, monitor its service providers to confirm that they have satisfied their contractual obligations.

The Federal Reserve recognizes that banking organizations are highly sensitive to the importance of safeguarding customer information and the need to maintain effective information security programs. Existing examination procedures and supervisory processes already address information security. As a result, most banking organizations may not need to implement any new controls and procedures.

Examiners should assess compliance with the standards during each safety-and-soundness examination, which may include targeted reviews of information technology. Ongoing compliance with the standards should be monitored as needed during the risk-focused examination process. Material instances of noncompliance should be noted in the examination report.

The information security standards apply to customer information maintained by or on behalf of state member banks and bank holding companies and the nonbank subsidiaries of each.[4] The information security standards also address standards for the proper disposal of consumer information, pursuant to sections 621 and 628 of the Fair Credit Reporting Act (15 USC 1681s and 1681w). To address the risks associated with identity theft, a financial institution is generally required to develop, implement, and maintain, as part of its existing information security program, appropriate measures to properly dispose of consumer information derived from consumer reports.

Consumer information is defined as any record about an individual, whether in paper, electronic, or other form, that is a consumer report or is derived from a consumer report and that is maintained or otherwise possessed by or on

2. *Customer information* is defined to include any record, whether in paper, electronic, or other form, containing *nonpublic personal information*, as defined in Regulation P, about a financial institution's customer that is maintained by or on behalf of the institution.

3. A *customer* is defined in the same manner as in Regulation P: a consumer who has established a continuing relationship with an institution under which the institution provides one or more financial products or services to the consumer to be used primarily for personal, family, or household purposes. The definition of customer does not include a business, nor does it include a consumer who has not established an ongoing relationship with the financial institution.

4. The information security standards do not apply to brokers, dealers, investment companies, and investment advisers, or to persons providing insurance under the applicable state insurance authority of the state in which the person is domiciled. The appropriate federal agency or state insurance authority regulates insurance entities under sections 501 and 505 of the GLB Act.

behalf of the bank for a business purpose. Consumer information also means a compilation of such records.

The following are examples of consumer information:

- a consumer report that a bank obtains
- information from a consumer report that the bank obtains from its affiliate after the consumer has been given a notice and has elected not to opt out of that sharing
- information from a consumer report that the bank obtains about an individual who applies for but does not receive a loan, including any loan sought by an individual for a business purpose
- information from a consumer report that the bank obtains about an individual who guarantees a loan (including a loan to a business entity)
- information from a consumer report that the bank obtains about an employee or prospective employee

Consumer information does not include any record that does not personally identify an individual, nor does it include the following:

- aggregate information, such as the mean score, derived from a group of consumer reports
- blind data, such as payment history on accounts that are not personally identifiable, that may be used for developing credit scoring-models or for other purposes
- information from a consumer report that the bank obtains about an individual who applies for but does not receive a loan, including any loan sought by an individual for a business purpose
- information from a consumer report that the bank obtains about an individual who guarantees a loan (including a loan to a business entity)
- information from a consumer report that the bank obtains about an employee or prospective employee

An institution or banking organization is not required to implement a *uniform* information security program. For example, a bank holding company may include subsidiaries within the scope of its information security program, or the subsidiaries may implement separate information security programs. The institution or bank holding company is expected, however, to coordinate all the elements of its information security program.

Institutions must exercise due diligence when selecting service providers, including reviewing the service provider's information security program or the measures the service provider uses to protect the institution's customer information.[5] All contracts must require that the service provider implement appropriate measures designed to meet the objectives of the standards. Institutions must also conduct ongoing oversight to confirm that the service provider maintains appropriate security measures. An institution's methods for overseeing its service-provider arrangements may differ depending on the type of services or service provider or the level of risk. For example, if a service provider is subject to regulations or a code of conduct that imposes a duty to protect customer information consistent with the objectives of the standards, the institution may consider that duty in exercising its due diligence and oversight of the service provider. In situations where a service provider hires a subservicer (or subcontractor), the subservicer would not be considered a ''service provider'' under the guidelines.

Response Programs for Unauthorized Access to Customer Information and Customer Notice

Response programs specify actions that are to be taken when a financial institution suspects or detects that unauthorized individuals have gained access to customer information systems, including appropriate reports to regulatory and law enforcement agencies.[6] A response program is the principal means for a financial institution to protect against unauthorized ''use'' of customer information that could lead to ''substantial harm or inconvenience'' to the institution's customer. For example, customer notification is an important tool that enables a customer to take steps to prevent identity theft, such as by arranging to have a fraud alert placed in his or her credit file.

The measures enumerated in the information security standards include ''response programs

5. A *service provider* is deemed to be a person or entity that maintains, processes, or is otherwise permitted access to customer information through its provision of services directly to the bank.

6. See the information security standards, 12 CFR 208, appendix D-2, section III.C.

that specify actions to be taken when the bank suspects or detects that unauthorized individuals have gained access to customer information systems, including appropriate reports to regulatory and law enforcement agencies.''[7] Prompt action by both the institution and the customer following the unauthorized access to customer information is crucial to limiting identity theft. As a result, every financial institution should develop and implement a response program appropriate to its size and complexity and to the nature and scope of its activities. The program should be designed to address incidents of unauthorized access to customer information.

The Interagency Guidance on Response Programs for Unauthorized Access to Customer Information and Customer Notice[8] (the guidance) interprets section 501(b) of the Gramm-Leach-Bliley Act (the GLB Act) and the information security standards.[9] The guidance describes the response programs, including customer notification procedures, that a financial institution should develop and implement to address unauthorized access to or use of customer information that could result in substantial harm or inconvenience to a customer.

When evaluating the adequacy of an institution's information security program that is required by the information security standards, examiners are to consider whether the institution has developed and implemented a response program equivalent to the guidance. At a minimum, an institution's response program should contain procedures for (1) assessing the nature and scope of an incident, and identifying what customer information systems and types of customer information have been accessed or misused; (2) notifying its primary federal regulator as soon as possible when the institution becomes aware of an incident involving unauthorized access to or use of *sensitive* customer information, as defined later in the guidance; (3) immediately notifying law enforcement in situations involving federal criminal violations requiring immediate attention; (4) taking appropriate steps to contain and control the incident to prevent further unauthorized access to or use of customer information, such as by monitoring, freezing, or closing affected accounts, while preserving records and other evidence; and (5) notifying customers when warranted.

The guidance does not apply to a financial institution's foreign offices, branches, or affiliates. However, a financial institution subject to the information security standards is responsible for the security of its customer information, whether the information is maintained within or outside of the United States, such as by a service provider located outside of the United States.

The guidance also applies to *customer information,* meaning any record containing ''nonpublic personal information'' about a financial institution's customer, whether the information is maintained in paper, electronic, or other form, *that is maintained by or on behalf of the institution.*[10] (See the Board's privacy rule, Regulation P, at section 216.3(n)(2) (12 CFR 216.3 (n)(2).) Consequently, the guidance applies only to information that is within the control of the institution and its service providers. The guidance would not apply to information directly disclosed by a customer to a third party, for example, through a fraudulent web site.

The guidance also does not apply to information involving business or commercial accounts. Instead, the guidance applies to nonpublic personal information about a *customer,* as that term is used in the information security standards, namely, a consumer who obtains a financial product or service from a financial institution to be used primarily for personal, family, or household purposes and who has a continuing relationship with the institution.[11]

Response Programs

Financial institutions should take preventative measures to safeguard customer information against attempts to gain unauthorized access to the information. For example, financial institutions should place access controls on customer information systems and conduct background checks for employees who are authorized to

7. See the information security standards, section III.C.1.g.

8. The guidance was jointly issued on March 23, 2005 (effective March 29, 2005), by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision.

9. See 12 CFR 208, appendix D-2, and 12 CFR 225, appendix F. The Interagency Guidelines Establishing Information Security Standards were formerly known as the Interagency Guidelines Establishing Standards for Safeguarding Customer Information.

10. See the information security standards, 12 CFR 208, appendix D-2, section I.C.2.e.

11. See the information security standards, 12 CFR 208, appendix D-2, section I.C.2.d., and the Board's privacy rule (Regulation P), section 216.3(h) (12 CFR 216.3(h)).

access customer information.[12] However, every financial institution should also develop and implement a risk-based response program to address incidents of unauthorized access to customer information in customer information systems[13] that occur nonetheless. A response program should be a key part of an institution's information security program.[14] The program should be appropriate to the size and complexity of the institution and the nature and scope of its activities.

In addition, each institution should be able to address incidents of unauthorized access to customer information in customer information systems maintained by its domestic and foreign service providers. Therefore, consistent with the obligations in the information security standards that relate to these arrangements, and with existing guidance on this topic issued by the agencies,[15] an institution's contract with its service provider should require the service provider to take appropriate actions to address incidents of unauthorized access to the financial institution's customer information, including notification to the institution as soon as possible of any such incident, to enable the institution to expeditiously implement its response program.

Components of a response program. At a minimum, an institution's response program should contain procedures for the following:

- assessing the nature and scope of an incident, and identifying what customer information systems and types of customer information have been accessed or misused
- notifying its primary federal regulator as soon as possible when the institution becomes aware of an incident involving unauthorized access to or use of *sensitive* customer information, as defined below
- consistent with the Suspicious Activity Report by Depository Institutions (SAR-DI) regulations,[16] notifying appropriate law enforcement authorities, in addition to filing a timely SAR-DI form in situations involving federal criminal violations requiring immediate attention, such as when a reportable violation is ongoing
- taking appropriate steps to contain and control the incident to prevent further unauthorized access to or use of customer information, for example, by monitoring, freezing, or closing affected accounts, while preserving records and other evidence
- notifying customers when warranted

Where an incident of unauthorized access to customer information involves customer information systems maintained by an institution's service providers, it is the responsibility of the financial institution to notify the institution's customers and regulator. However, an institution may authorize or contract with its service provider to notify the institution's customers or regulator on its behalf.

Customer Notice

Financial institutions have an affirmative duty to protect their customers' information against unauthorized access or use. Notifying customers of a security incident involving the unauthorized access or use of the customer's information in accordance with the standard set forth below is a key part of that duty. Timely notification of customers is important to managing an institution's reputation risk. Effective notice also may reduce an institution's legal risk, assist in maintaining good customer relations, and enable the institution's customers to take steps to protect themselves against the consequences of identity theft. When customer notification is warranted, an institution may not forgo notifying its customers of an incident because the institution

12. Institutions should also conduct background checks of employees to ensure that the institution does not violate 12 USC 1829, which prohibits an institution from hiring an individual convicted of certain criminal offenses or who is subject to a prohibition order under 12 USC 1818(e)(6).

13. Under the information security standards, an institution's *customer information systems* consist of all the methods used to access, collect, store, use, transmit, protect, or dispose of customer information, including the systems maintained by its service providers. See the information security standards, 12 CFR 208, appendix D-2, section I.C.2.f.

14. See SR-97-32, "Sound Practices Guidance for Information Security for Networks," for additional guidance on preventing, detecting, and responding to intrusions into financial institution computer systems.

15. See SR-00-04, "Outsourcing of Information and Transaction Processing," and the subsection "Outsourcing Information Technology."

16. An institution's obligation to file a SAR-DI form is set out in SAR-DI form regulations and supervisory guidance. See 12 CFR 208.62 (state member banks); 12 CFR 211.5(k) (Edge and agreement corporations); 12 CFR 211.24(f) (uninsured state branches and agencies of foreign banks); and 12 CFR 225.4(f) (bank holding companies and their nonbank subsidiaries). See SR-07-2 and its attachments and also SR-01-11, "Identity Theft and Pretext Calling."

believes that it may be potentially embarrassed or inconvenienced by doing so.

Standard for providing notice. When a financial institution becomes aware of an incident of unauthorized access to sensitive customer information, the institution should conduct a reasonable investigation to promptly determine the likelihood that the information has been or will be misused. If the institution determines that misuse of its information about a customer has occurred or is reasonably possible, it should notify the affected customer as soon as possible. Customer notice may be delayed if an appropriate law enforcement agency determines that notification will interfere with a criminal investigation and provides the institution with a written request for the delay. However, the institution should notify its customers as soon as notification will no longer interfere with the investigation.

Sensitive customer information. Under the information security standards, an institution must protect against unauthorized access to or use of customer information that could result in substantial harm or inconvenience to any customer. Substantial harm or inconvenience is most likely to result from improper access to *sensitive customer information* because this type of information is most likely to be misused, as in the commission of identity theft. For purposes of the guidance, *sensitive customer information* means a customer's name, address, or telephone number, in conjunction with the customer's Social Security number, driver's license number, account number, credit or debit card number, or a personal identification number or password that would permit access to the customer's account. Sensitive customer information also includes any combination of components of customer information that would allow someone to log onto or access the customer's account, such as a user name and password or a password and an account number.

Affected customers. If a financial institution, on the basis of its investigation, can determine from its logs or other data precisely which customers' information has been improperly accessed, it may limit notification to those customers for whom the institution determines that misuse of their information has occurred or is reasonably possible. However, there may be situations in which the institution determines that a group of files has been accessed improperly but is unable to identify which specific customers' information has been accessed. If the circumstances of the unauthorized access lead the institution to determine that misuse of the information is reasonably possible, it should notify all customers in the group.

Content of customer notice. Customer notice should be given in a clear and conspicuous manner. The notice should describe the incident in general terms and the type of customer information that was the subject of unauthorized access or use. It should also generally describe what the institution has done to protect the customers' information from further unauthorized access. In addition, it should include a telephone number that customers can call for further information and assistance.[17] The notice also should remind customers of the need to remain vigilant over the next 12 to 24 months, and to promptly report incidents of suspected identity theft to the institution. The notice should include the following additional items, when appropriate:

- a recommendation that the customer review account statements and immediately report any suspicious activity to the institution
- a description of fraud alerts and an explanation of how the customer may place a fraud alert in the customer's consumer reports to put the customer's creditors on notice that the customer may be a victim of fraud
- a recommendation that the customer periodically obtain credit reports from each nationwide credit reporting agency and have information relating to fraudulent transactions deleted
- an explanation of how the customer may obtain a credit report free of charge
- information about the availability of the FTC's online guidance regarding steps a consumer can take to protect against identity theft (The notice should encourage the customer to report any incidents of identity theft to the FTC and should provide the FTC's web site address and toll-free telephone number that customers may use to obtain the identity theft guidance

17. The institution should, therefore, ensure that it has reasonable policies and procedures in place, including trained personnel, to respond appropriately to customer inquiries and requests for assistance.

and to report suspected incidents of identity theft.[18]

Financial institutions are encouraged to notify the nationwide consumer reporting agencies before sending notices to a large number of customers when those notices include contact information for the reporting agencies.

Delivery of customer notice. Customer notice should be delivered in any manner designed to ensure that a customer can reasonably be expected to receive it. For example, the institution may choose to contact all affected customers by telephone, by mail, or by electronic mail, in the case of customers for whom it has a valid e-mail address and who have agreed to receive communications electronically.

IDENTITY THEFT RED FLAGS PROGRAM

The federal financial institution regulatory agencies[18a] and the Federal Trade Commission (FTC) have issued joint regulations and guidelines on the *detection, prevention,* and *mitigation* of identity theft in connection with opening of certain accounts or certain existing accounts in response to the Fair and Accurate Credit Transactions Act of 2003 (The FACT Act).[18b] The regulations require debit and credit card issuers to validate notifications of changes of address under certain circumstances. The joint rules also provide guidelines regarding reasonable policies and procedures that a user of consumer reports must employ when a consumer reporting agency sends the user a notice of address discrepancy. Financial institutions or creditors[18c] that offer or maintain one or more "covered accounts" must develop and implement a written Identity Theft Prevention Program (Program).[18d] A Program is to be designed to detect, prevent, and mitigate identity theft in connection with the opening of a covered account or any existing covered account. The Program must be tailored to the entity's size, complexity, and the nature and scope of its operations and activities.

The Board's approval of the rule and guidelines was on October 16, 2007. The effective date for the joint final rules and guidelines is January 1, 2008. The mandatory compliance date for the rules is November 1, 2008. See section 222 of the Board's Regulation V—Fair Credit Reporting (12 CFR 222) and 72 *Fed. Reg.* 63718- 63775, November 9, 2007.

This section incorporates certain financial institution safety and soundness provisions of the rule (Regulation V and its guidelines (Appendix J)). See also the October 10, 2008, Federal Reserve Board letter (SR-08-7/CA 08-10) and its interagency attachments.

Risk Assessment

Prior to the development of the Program, a financial institution must initially and then periodically conduct a risk assessment to determine whether it offers or maintains covered accounts. It must take into consideration: (1) the methods it provides to open its accounts; (2) the methods it provides to access accounts; and (3) its previous experiences with identity theft. If the financial institution has covered accounts, the risk assessment must evaluate its potential vulnerability to identity theft. The institution should also consider whether a reasonably foreseeable risk of identity theft may exist in connection with the accounts it offers or maintains and those that may be opened or accessed remotely, through methods that do not require face-to-face contact, such as through the internet or telephone. Financial institutions that offer or main-

18. The FTC website for the ID theft brochure and the FTC hotline phone number are www.consumer.gov/idtheft/ and 1-877-IDTHEFT. The institution may also refer customers to any materials developed pursuant to section 151(b) of the Fair and Accurate Credit Transactions Act of 2003 (the FACT Act) (educational materials developed by the FTC to teach the public how to prevent identity theft).

18a. The Board of Governors of the Federal Reserve System (FRB), the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), the Federal Deposit Insurance Corporation (FDIC), and the National Credit Union Administration (NCUA).

18b. Section 111 of the FACT Act defines "identity theft" as "a fraud committed or attempted using the identifying information of another person."

18c. The term financial institution should be interpreted to mean a "financial institution or creditors" with regard to the Red Flags Program joint regulations and the accompanying interagency guidance.

18d. "Covered accounts" are (1) accounts that a financial institution offers or maintains, primarily for personal, family, or household purposes, that involves or is designed to permit multiple payments or transactions, and (2) any other account that the financial institution offers or maintains for which there is a reasonably foreseeable risk to customers or to the safety and soundness of the financial institution from identity theft.

tain business accounts that have been the target of identity theft should factor those experiences with identity theft into their determination.

The required risk assessment directs a financial institution to determine whether it will need to have a Program. If the financial institution determines that it needs a Program, the risk assessment will enable the financial institution to identify which of its accounts the Program must address. If a financial institution initially determines that it does not need to have a Program, it must periodically reassess whether it must develop and implement a Program in light of changes in the accounts that it offers or maintains.

Elements of the Program

The elements of the actual Program will vary depending on the size and complexity of the financial institution. A financial institution that determines that it is required to establish and maintain an Identity Theft Prevention Program must (1) identify relevant Red Flags for its covered accounts, (2) detect and respond to the Red Flags that have been incorporated into its Program, and (3) respond appropriately to the detected Red Flags. The Red Flags are patterns, practices, or specific activities that indicate the possible existence of identity theft or the potential to lead to identity theft. A financial institution must ensure that its Program is updated periodically to address the changing risks associated with its customers and their accounts and to the safety and soundness of the financial institution from identity theft.

Guidelines

Each financial institution that is required to implement a written Program must consider the Guidelines for Identity Theft Detection, Prevention, and Mitigation's in Appendix J (12 CFR 222, Appendix J of the rule) (the Guidelines) and include those guidelines that are appropriate in its Program. Section I of the Guidelines, "The Program," discusses a Program's design that may include, as appropriate, existing policies, procedures, and arrangements that control foreseeable risks to the institution's customers or to the safety and soundness of the financial institution from identity theft.

Identification of Red Flags

A financial institution should incorporate relevant Red Flags into the Program from sources such as (1) incidents of identity theft that it has experienced, (2) methods of identity theft that have been identified as reflecting changes in identity theft risks, and (3) applicable supervisory guidance.

Categories of Red Flags

Section II of the Guidelines, "Categories of Red Flags," provides some guidance in identifying relevant Red Flags. A financial institution should include, as appropriate:[18e]

- alerts, notifications, or other warnings received from consumer reporting agencies or service providers, such as fraud detection services
- the presentation of suspicious documents
- the presentation of suspicious personal identifying information, such as a suspicious address change
- the unusual use of, or other suspicious activity related to, a covered account
- a notice received from customers, victims of identity theft, law enforcement authorities, or other persons regarding possible identity theft in connection with covered accounts held by the financial institution

The above categories do not represent a comprehensive list of all types of Red Flags that may indicate the possibility of identity theft. Institutions must also consider specific business lines and any previous exposures to identity theft. No specific Red Flag is mandatory for all financial institutions. Rather, the Program should follow the risk-based, nonprescriptive approach regarding the identification of Red Flags.

Detect the Program's Red Flags

In accordance with Section III of the Guidelines, each financial institution's Program should address the detection of Red Flags in connection with the opening of covered accounts and existing covered accounts. A financial institution is required to detect, prevent, and mitigate identity

18e. Examples of Red Flags from each of these categories are appended as Supplement A to Appendix J.

theft in connection with such accounts. The policies and procedures regarding opening a covered account subject to the Program should explain how an institution could identify information about, and verify the identity of, a person opening an account.[18f] In the case of existing covered accounts, institutions could authenticate customers, monitor transactions, and verify the validity of change of address requests.

Respond Appropriately to any Detected Red Flags

A financial institution should consider precursors to identity theft to stop identity theft before it occurs. Section IV of the Guidelines, "Prevention and Mitigation," states that an institution's procedures should provide for appropriate responses to Red Flags that it has detected that are commensurate with the degree of risk posed. When determining an appropriate response, the institution should consider aggravating factors that may heighten its risk of identity theft. Such factors may include (1) a data security incident that results in unauthorized access to a customer's account, (2) records the financial institution holds or that are held by another creditor or third party, or (3) notice that the institution's customer has provided information related to its covered account to someone fraudulently claiming to represent the financial institution or creditor or to a fraudulent website. Appropriate responses may include the following: (1) monitoring a covered account for evidence of identity theft; (2) contacting the customer; (3) changing any passwords, security codes, or other security devices that permit access to a secured account; (4) reopening a covered account with a new account number; (5) not opening a new covered account; (6) closing an existing covered account; (7) not attempting to collect on a covered account or not selling a covered account to a debt collector; (8) notifying law enforcement; or (9) determining that no response is warranted under the particular circumstances.

Periodically Updating the Program's Relevant Red Flags

Section V of the Guidelines, "Updating the Program," states that a financial institution should periodically update its Program (including its relevant Red Flags) to reflect any changes in risks to its customers or to the safety and soundness of the institution from identity theft, based on (but not limited to) factors such as

- the experiences of the financial institution with identity theft,
- changes in methods of identity theft,
- changes in methods to detect, prevent, and mitigate identity theft,
- changes in the types of accounts that the financial institution offers or maintains, and
- changes in the financial institution's structure, including its mergers, acquisitions, joint ventures, and any business arrangements, such as alliances and service provider arrangements.

Administration of Program

A financial institution that is required to implement an identity theft protection Program must provide for the continued oversight and administration of its Program. The following are the steps that are needed in the administration of a Red Flags Program:

1. *Obtain approval from either the institution's board of directors or any appropriate committee of the board of directors of the initial written Program;*
2. *Involve either the board of directors, a designated committee of the board of directors, or a designated senior-management-level employee in the oversight, development, implementation, and administration of the Program.* This includes
   - assigning specific responsibility for the Program's implementation,
   - reviewing reports prepared by staff regarding the institution's compliance (the reports should be prepared at least annually), and
   - reviewing material changes to the Program as necessary to address changing identity theft risks.
3. *Train staff.* The financial institution must train relevant staff to effectively implement and monitor the Program. Staff members who have already been trained, for example, as a part of the antifraud prevention efforts of the financial institution, do not need to be re-trained initially. Training should be pro-

18f. 31 USC 5318(l) (31 CFR 103.121)

vided as changes are made to the financial institution's Program based on its periodic risk assessment.

4. *Exercise appropriate and effective oversight of service provider arrangements.* Section VI of the Guidelines, "Methods for Administering the Program," indicates a financial institution is ultimately responsible for complying with the rules and guidelines for outsourcing an activity to a third-party service provider. Whenever a financial institution engages a service provider to perform an activity in connection with one or more covered accounts, the institution should ensure that the activity of the service provider is conducted in accordance with reasonable policies and procedures designed to detect, prevent, and mitigate the risk of identity theft. With regard to the institution's oversight of its Program, periodic reports are to be issued on the Program's development, implementation, and administration.

IT EXAMINATION FREQUENCY AND SCOPE

All safety-and-soundness examinations (or examination cycles) of banking organizations conducted by the Federal Reserve should include an assessment and evaluation of IT risks and risk management. The scope of the IT assessment should generally be sufficient to assign a composite rating under the Uniform Rating System for Information Technology (URSIT). URSIT component ratings may be updated at the examiner's discretion, based on the scope of the assessment. The scope would normally be based on factors such as—

- implementation of new systems or technologies since the last examination;
- significant changes in operations, such as mergers or systems conversions;
- new or modified outsourcing relationships for critical operations;
- targeted examinations of business lines whose internal controls or risk-management systems depend heavily on IT; and
- other potential problems or concerns that may have arisen since the last examination or the need to follow up on previous examination or audit issues.

Institutions that outsource core processing functions, although not traditionally subject to IT examinations, are exposed to IT-related risks. For these institutions, some or all components of the URSIT rating may not be meaningful. In these cases, the assessment of IT activities may be incorporated directly into the safety-and soundness rating for the institution, rather than through the assignment of an URSIT rating. The scope of the IT assessment for such institutions should evaluate the adequacy of the institution's oversight of service providers for critical processing activities and should incorporate the results of any relevant supervisory reviews of these service providers. The assessment should also include reviews of any significant in-house activities, such as management information systems and local networks, and the implementation of new technologies, such as Internet banking. As noted above, the assessment of IT should be reflected in the overall safety-and- soundness examination report and in the appropriate components of the safety-and-soundness examination rating assigned to the institution, as well as in the associated risk-profile analysis. (See SR-00-3.)

Targeted IT examinations may be conducted more frequently if deemed necessary by the Reserve Bank. A composite URSIT rating should be assigned for targeted reviews when possible. In addition, institutions for which supervisory concerns have been raised (normally those rated URSIT 3, 4, or 5) should be subject to more frequent IT reviews, until such time as the Reserve Bank is satisfied that the deficiencies have been corrected.

RISK ELEMENTS

To provide a common terminology and consistent approach for evaluating the adequacy of an organization's IT, five IT elements are defined below. These elements may be used to evaluate the IT processes at the functional business level or for the organization as a whole and to determine the impact on the business risks outlined in SR-95-51, as well as their impact on the IT rating (URSIT) discussed below. (See SR-98-9.)

1. *Management processes.* Management processes encompass planning, investment, development, execution, and staffing of IT from a corporate-wide and business-specific

perspective. Management processes over IT are effective when they are adequately and appropriately aligned with and support the organization's mission and business objectives. Management processes include strategic planning; budgeting; management and reporting hierarchy; management succession; and a regular, independent review function. Examiners should determine if the IT strategy for the business activity or organization is consistent with the organization's mission and business objectives and whether the IT function has effective management processes to execute that strategy.

2. *Architecture.* Architecture refers to the underlying design of an automated information system and its individual components. The underlying design encompasses both physical and logical architecture, including operating environments, as well as the organization of data. The individual components refer to network communications, hardware, and software, which includes operating systems, communications software, database-management systems, programming languages, and desktop software. Effective architecture meets current and long-term organizational objectives, addresses capacity requirements to ensure that systems allow users to easily enter data at both normal and peak processing times, and provides satisfactory solutions to problems that arise when information is stored and processed in two or more systems that cannot be connected electronically. When assessing the adequacy of IT architecture, examiners should consider the ability of the current infrastructure to meet operating objectives, including the effective integration of systems and sources of data.
3. *Integrity.* Integrity refers to the reliability, accuracy, and completeness of information delivered to the end-user. Integrity risk could arise from insufficient controls over systems or data, which could adversely affect critical financial and customer information. Examiners should review and consider whether the organization relies on information system audits or independent reviews of applications to ensure the integrity of its systems. Examiners should review the reliability, accuracy, and completeness of information delivered in key business lines.
4. *Security.* Security risk is the risk of unauthorized disclosure or destruction of critical or sensitive information. To mitigate this risk, physical access and logical controls are generally provided to achieve a level of protection commensurate with the value of the information. Security risk is managed effectively when controls prevent unauthorized access, modification, destruction, or disclosure of sensitive information during creation, transmission, processing, maintenance, or storage. Examiners should ensure that operating procedures and controls are commensurate with the potential for and risks associated with security breaches, which may be either physical or electronic, inadvertent or intentional, internal or external.
5. *Availability.* Availability refers to the timely delivery of information and processes to end-users in support of business and decision-making processes and customer services. In assessing the management of availability risk, examiners should consider the capability of IT functions to provide information to the end-users from either primary or secondary sources, as well as consider the ability of back-up systems, as presented in contingency plans, to mitigate business disruption. Contingency plans should set out a process for an organization to restore or replace its information-processing resources; reconstruct its information assets; and resume its business activity from disruption caused by human error or intervention, natural disaster, or infrastructure failure (including loss of utilities and communication lines and the operational failure of hardware, software, and network communications).

UNIFORM RATING SYSTEM FOR INFORMATION TECHNOLOGY

The Uniform Rating System for Information Technology (URSIT) is an interagency examination rating system adopted by the Federal Financial Institutions Examination Council (FFIEC) agencies to evaluate the IT activities of financial institutions. The rating system includes component- and composite-rating descriptions and the explicit identification of risks and assessment factors that examiners consider in assigning component ratings. This rating system helps examiners assess risk and compile examination findings. However, the rating system should not drive the scope of an examination. In particular, not all assessment factors or component-rating areas are required to be assessed at each examination. Examiners should use the rating system to help evaluate the entity's overall risk exposure and risk-management performance and to determine the degree of supervisory attention believed necessary to ensure that weaknesses are addressed and that risk is properly managed. (See SR-99-8.)

The URSIT rating framework is based on a risk evaluation of four general areas: audit, management, development and acquisition, and support and delivery. These components are used to assess the overall IT functions within an organization and arrive at a composite URSIT rating. Examiners evaluate the areas identified within each component to assess the institution's ability to identify, measure, monitor, and control IT risks.

In adopting the URSIT rating system, the FFIEC recognized that management practices vary considerably among financial institutions depending on their size and sophistication, the nature and complexity of their business activities, and their risk profile. For less complex information systems environments, detailed or highly formalized systems and controls are not required to receive the higher composite and component ratings.

URSIT Composite-Rating Definitions

Financial institutions rated URSIT composite 1 exhibit strong performance in every respect and generally have components rated 1 or 2. Weaknesses in IT functions are minor and are easily corrected during the normal course of business. Risk-management processes provide a comprehensive program to identify and monitor risk relative to the size, complexity, and risk profile of the entity. Strategic plans are well defined and fully integrated throughout the organization. This allows management to quickly adapt to the changing market, business, and technology needs of the entity. Management identifies weaknesses promptly and takes appropriate corrective action to resolve audit and regulatory concerns.

Financial institutions rated URSIT composite 2 exhibit safe and sound performance but may demonstrate modest weaknesses in operating performance, monitoring, management processes, or system development. Generally, senior management corrects weaknesses in the normal course of business. Risk-management processes adequately identify and monitor risk relative to the size, complexity, and risk profile of the entity. Strategic plans are defined but may require clarification, better coordination, or improved communication throughout the organization. As a result, management anticipates, but responds less quickly to changes in the market, business, and technological needs of the entity. Management normally identifies weaknesses and takes appropriate corrective action. However, greater reliance is placed on audit and regulatory intervention to identify and resolve concerns. While internal control weaknesses may exist, there are no significant supervisory concerns. As a result, supervisory action is informal and limited.

Financial institutions rated URSIT composite 3 exhibit some degree of supervisory concern due to a combination of weaknesses that may range from moderate to severe. If weaknesses persist, further deterioration in the condition and performance of the institution is likely. Risk-management processes may not effectively identify risks and may not be appropriate for the size, complexity, or risk profile of the entity. Strategic plans are vaguely defined and may not provide adequate direction for IT initiatives. As a result, management often has difficulty responding to changes in the business, market, and technological needs of the entity. Self-assessment practices are weak and generally reactive to audit and regulatory exceptions. Repeat concerns may exist, indicating that management may lack the ability or willingness to resolve concerns. While financial or operational failure is unlikely, increased supervision is necessary. Formal or informal supervisory action may be necessary to secure corrective action.

Financial institutions rated URSIT composite 4 operate in an unsafe and unsound environment that may impair the future viability of the entity. Operating weaknesses are indicative of serious managerial deficiencies. Risk-management processes inadequately identify and monitor risk, and practices are not appropriate given the size, complexity, and risk profile of the entity. Strategic plans are poorly defined and not coordinated or communicated throughout the organization. As a result, management and the board are not committed to, or may be incapable of, ensuring that technological needs are met. Management does not perform self-assessments and demonstrates an inability or unwillingness to correct audit and regulatory concerns. Failure of the financial institution may be likely unless IT problems are remedied. Close supervisory attention is necessary and, in most cases, formal enforcement action is warranted.

Financial institutions rated URSIT composite 5 exhibit critically deficient operating performance and are in need of immediate remedial action. Operational problems and serious weaknesses may exist throughout the organization. Risk-management processes are severely deficient and provide management little or no perception of risk relative to the size, complexity, and risk profile of the entity. Strategic plans do not exist or are ineffective, and management and the board provide little or no direction for IT initiatives. As a result, management is unaware of or inattentive to the technological needs of the entity. Management is unwilling or incapable of correcting audit and regulatory concerns. Ongoing supervisory attention is necessary.

URSIT Component Ratings

Audit

Financial institutions and service providers are expected to provide independent assessments of their exposure to risks and of the quality of internal controls associated with the acquisition, implementation, and use of IT. Audit practices should address the IT risk exposures throughout the institution and the exposures of its service provider(s) in the areas of user and data center operations, client/server architecture, local and wide area networks, telecommunications, information security, electronic data interchange, systems development, and contingency planning. This rating should reflect the adequacy of the organization's overall IT audit program, including the internal and external auditor's abilities to detect and report significant risks to management and the board of directors on a timely basis. It should also reflect the internal and external auditor's capability to promote a safe, sound, and effective operation. The performance of an audit is rated based on an assessment of factors such as—

- the level of independence maintained by audit and the quality of the oversight and support provided by the board of directors and management;
- the adequacy of audit's risk-analysis methodology used to prioritize the allocation of audit resources and to formulate the audit schedule;
- the scope, frequency, accuracy, and timeliness of internal and external audit reports;
- the extent of audit participation in application development, acquisition, and testing, to ensure the effectiveness of internal controls and audit trails;
- the adequacy of the overall audit plan in providing appropriate coverage of IT risks;
- the auditor's adherence to codes of ethics and professional audit standards;
- the qualifications of the auditor, staff succession, and continued development through training;
- the existence of timely and formal follow-up and reporting on management's resolution of identified problems or weaknesses; and
- the quality and effectiveness of internal and external audit activity as it relates to IT controls.

A rating of 1 indicates strong audit performance. Audit independently identifies and reports weaknesses and risks to the board of directors or its audit committee in a thorough and timely manner. Outstanding audit issues are monitored until resolved. Risk analysis ensures that audit plans address all significant IT operations, procurement, and development activities with appropriate scope and frequency. Audit work is performed in accordance with professional auditing standards, and report content is timely, constructive, accurate, and complete. Because audit is strong, examiners may place substantial reliance on audit results.

A rating of 2 indicates satisfactory audit performance. Audit independently identifies and reports weaknesses and risks to the board of directors or audit committee, but reports may be less timely. Significant outstanding audit issues are monitored until resolved. Risk analysis ensures that audit plans address all significant IT operations, procurement, and development activities; however, minor concerns may be noted with the scope or frequency. Audit work is performed in accordance with professional auditing standards; however, minor or infrequent problems may arise with the timeliness, completeness, and accuracy of reports. Because audit is satisfactory, examiners may rely on audit results but because minor concerns exist, examiners may need to expand verification procedures in certain situations.

A rating of 3 indicates less-than-satisfactory audit performance. Audit identifies and reports weaknesses and risks; however, independence may be compromised and reports presented to the board or audit committee may be less than satisfactory in content and timeliness. Outstanding audit issues may not be adequately monitored. Risk analysis is less than satisfactory. As a result, the audit plan may not provide sufficient audit scope or frequency for IT operations, procurement, and development activities. Audit work is generally performed in accordance with professional auditing standards; however, occasional problems may be noted with the timeliness, completeness, or accuracy of reports. Because audit is less than satisfactory, examiners must use caution if they rely on the audit results.

A rating of 4 indicates deficient audit performance. Audit may identify weaknesses and risks, but it may not independently report to the board or audit committee, and report content may be inadequate. Outstanding audit issues may not be adequately monitored and resolved. Risk analysis is deficient. As a result, the audit plan does not provide adequate audit scope or frequency for IT operations, procurement, and development activities. Audit work is often inconsistent with professional auditing standards, and the timeliness, accuracy, and completeness of reports is unacceptable. Because audit is deficient, examiners cannot rely on audit results.

A rating of 5 indicates critically deficient audit performance. If an audit function exists, it lacks sufficient independence and, as a result, does not identify and report weaknesses or risks to the board or audit committee. Outstanding audit issues are not tracked and no follow-up is performed to monitor their resolution. Risk analysis is critically deficient. As a result, the audit plan is ineffective and provides inappropriate audit scope and frequency for IT operations, procurement, and development activities. Audit work is not performed in accordance with professional auditing standards and major deficiencies are noted regarding the timeliness, accuracy, and completeness of audit reports. Because audit is critically deficient, examiners cannot rely on audit results.

Management

The management rating reflects the abilities of the board and management as they apply to all aspects of IT acquisition, development, and operations. Management practices may need to address some or all of the following IT-related risks: strategic planning, quality assurance, project management, risk assessment, infrastructure and architecture, end-user computing, contract administration of third-party service providers, organization and human resources, and regulatory and legal compliance. Generally, directors need not be actively involved in day-to-day operations; however, they must provide clear guidance regarding acceptable risk-exposure levels and ensure that appropriate policies, procedures, and practices have been established. Sound management practices are demonstrated through active oversight by the board of directors and management, competent personnel, sound IT plans, adequate policies and standards, an effective control environment, and risk monitoring. The management rating should reflect the board's and management's ability as it applies to all aspects of IT operations. The performance of management and the quality of risk management are rated based on an assessment of factors such as—

- the level and quality of oversight and support of the IT activities by the board of directors and management;
- the ability of management to plan for and initiate new activities or products in response to information needs and to address risks that may arise from changing business conditions;
- the ability of management to provide information reports necessary for informed planning and decision making in an effective and efficient manner;
- the adequacy of, and conformance with, internal policies and controls addressing the IT operations and risks of significant business activities;
- the effectiveness of risk-monitoring systems;
- the timeliness of corrective action for reported and known problems;
- the level of awareness of and compliance with laws and regulations;
- the level of planning for management succession;
- the ability of management to monitor the services delivered and to measure the organi-

zation's progress toward identified goals effectively and efficiently;

- the adequacy of contracts and management's ability to monitor relationships with third-party servicers;
- the adequacy of strategic planning and risk-management practices to identify, measure, monitor, and control risks, including management's ability to perform self-assessments; and
- the ability of management to identify, measure, monitor, and control risks and to address emerging IT needs and solutions.

A rating of 1 indicates strong performance by management and the board. Effective risk-management practices are in place to guide IT activities, and risks are consistently and effectively identified, measured, controlled, and monitored. Management immediately resolves audit and regulatory concerns to ensure sound operations. Written technology plans, policies and procedures, and standards are thorough and properly reflect the complexity of the IT environment. They have been formally adopted, communicated, and enforced throughout the organization. IT systems provide accurate, timely reports to management. These reports serve as the basis for major decisions and as an effective performance-monitoring tool. Outsourcing arrangements are based on comprehensive planning; routine management supervision sustains an appropriate level of control over vendor contracts, performance, and services provided. Management and the board have demonstrated the ability to promptly and successfully address existing IT problems and potential risks.

A rating of 2 indicates satisfactory performance by management and the board. Adequate risk-management practices are in place and guide IT activities. Significant IT risks are identified, measured, monitored, and controlled; however, risk-management processes may be less structured or inconsistently applied and modest weaknesses exist. Management routinely resolves audit and regulatory concerns to ensure effective and sound operations; however, corrective actions may not always be implemented in a timely manner. Technology plans, policies and procedures, and standards are adequate and formally adopted. However, minor weaknesses may exist in management's ability to communicate and enforce them throughout the organization. IT systems provide quality reports to management which serve as a basis for major decisions and a tool for performance planning and monitoring. Isolated or temporary problems with timeliness, accuracy, or consistency of reports may exist. Outsourcing arrangements are adequately planned and controlled by management, and they provide for a general understanding of vendor contracts, performance standards, and services provided. Management and the board have demonstrated the ability to address existing IT problems and risks successfully.

A rating of 3 indicates less-than-satisfactory performance by management and the board. Risk-management practices may be weak and offer limited guidance for IT activities. Most IT risks are generally identified; however, processes to measure and monitor risk may be flawed. As a result, management's ability to control risk is less than satisfactory. Regulatory and audit concerns may be addressed, but time frames are often excessive and the corrective action taken may be inappropriate. Management may be unwilling or incapable of addressing deficiencies. Technology plans, policies and procedures, and standards exist but may be incomplete. They may not be formally adopted, effectively communicated, or enforced throughout the organization. IT systems provide requested reports to management, but periodic problems with accuracy, consistency, and timeliness lessen the reliability and usefulness of reports and may adversely affect decision making and performance monitoring. Outsourcing arrangements may be entered into without thorough planning. Management may provide only cursory supervision that limits their understanding of vendor contracts, performance standards, and services provided. Management and the board may not be capable of addressing existing IT problems and risks, which is evidenced by untimely corrective actions for outstanding IT problems.

A rating of 4 indicates deficient performance by management and the board. Risk-management practices are inadequate and do not provide sufficient guidance for IT activities. Critical IT risks are not properly identified, and processes to measure and monitor risks are deficient. As a result, management may not be aware of and is unable to control risks. Management may be unwilling or incapable of addressing audit and regulatory deficiencies in an effective and timely manner. Technology plans, policies and procedures, and standards are inadequate and have not been formally adopted or effectively communicated throughout the organization, and management does not effectively enforce them. IT systems do not routinely provide management with accurate, consistent, and reliable reports, thus contributing to ineffective performance monitoring or flawed decision making. Outsourcing arrangements may be entered into without planning or analysis, and management may provide little or no supervision of vendor contracts, performance standards, or services provided. Management and the board are unable to address existing IT problems and risks, as evidenced by ineffective actions and long-standing IT weaknesses. Strengthening of management and its processes is necessary.

A rating of 5 indicates critically deficient performance by management and the board. Risk-management practices are severely flawed and provide inadequate guidance for IT activities. Critical IT risks are not identified, and processes to measure and monitor risks do not exist or are not effective. Management's inability to control risk may threaten the continued viability of the institution. Management is unable or unwilling to correct audit- and regulatory-identified deficiencies, and immediate action by the board is required to preserve the viability of the institution. If they exist, technology plans, policies and procedures, and standards are critically deficient. Because of systemic problems, IT systems do not produce management reports that are accurate, timely, or relevant. Outsourcing arrangements may have been entered into without management planning or analysis, resulting in significant losses to the financial institution or ineffective vendor services.

Development and Acquisition

The rating of development and acquisition reflects an organization's ability to identify, acquire, install, and maintain appropriate IT resources. Management practices may need to address all or parts of the business process for implementing any kind of change to the hardware or software used. These business processes include an institution's purchase of hardware or software, development and programming performed by the institution, purchase of services from independent vendors or affiliated data centers, or a combination of these activities. The business process is defined as all phases taken to implement a change, including researching alternatives available, choosing an appropriate option for the organization as a whole, and converting to the new system or integrating the new system with existing systems. This rating reflects the adequacy of the institution's systems-development methodology and related risk-management practices for acquisition and deployment of IT. This rating also reflects the board and management's ability to enhance and replace IT prudently in a controlled environment. The performance of systems development and acquisition and related risk-management practice is rated based on an assessment of factors such as—

- the level and quality of oversight and support of systems-development and acquisition activities by senior management and the board of directors;
- the adequacy of the organizational and management structures to establish accountability and responsibility for IT systems and technology initiatives;
- the volume, nature, and extent of risk exposure to the financial institution in the area of systems development and acquisition;
- the adequacy of the institution's Systems Development Life Cycle (SDLC) and programming standards;
- the quality of project-management programs and practices that are followed by developers, operators, executive management or owners, independent vendors or affiliated servicers, and end-users;
- the independence of the quality-assurance function and the adequacy of controls over program changes;
- the quality and thoroughness of system documentation;
- the integrity and security of the network, system, and application software;
- the development of IT solutions that meet the needs of end-users; and
- the extent of end-user involvement in the system-development process.

A rating of 1 indicates strong systems-development, acquisition, implementation, and change-management performance. Management and the board routinely demonstrate successfully the ability to identify and implement appropriate IT solutions while effectively managing risk. Project-management techniques and the SDLC are fully effective and supported by written policies, procedures, and project controls that consistently result in timely and efficient project completion. An independent quality-assurance function provides strong controls over testing and program-change management. Technology solutions consistently meet end-user needs. No significant weaknesses or problems exist.

A rating of 2 indicates satisfactory systems-development, acquisition, implementation, and change-management performance. Management and the board frequently demonstrate the ability to identify and implement appropriate IT solutions while managing risk. Project management and the SDLC are generally effective; however, weaknesses may exist that result in minor project delays or cost overruns. An independent quality-assurance function provides adequate supervision of testing and program-change management, but minor weaknesses may exist. Technology solutions meet end-user needs. However, minor enhancements may be necessary to meet original user expectations. Weaknesses may exist; however, they are not significant and are easily corrected in the normal course of business.

A rating of 3 indicates less-than-satisfactory systems-development, acquisition, implementation, and change-management performance. Management and the board may often be unsuccessful in identifying and implementing appropriate IT solutions; therefore, unwarranted risk exposure may exist. Project-management techniques and the SDLC are weak and may result in frequent project delays, backlogs, or significant cost overruns. The quality-assurance function may not be independent of the programming function, which may have an adverse impact on the integrity of testing and program-change management. Technology solutions generally meet end-user needs but often require an inordinate level of change after implementation. Because of weaknesses, significant problems may arise that could result in disruption to operations or significant losses.

A rating of 4 indicates deficient systems-development, acquisition, implementation, and change-management performance. Management and the board may be unable to identify and implement appropriate IT solutions and do not effectively manage risk. Project-management techniques and the SDLC are ineffective and may result in severe project delays and cost overruns. The quality-assurance function is not fully effective and may not provide independent or comprehensive review of testing controls or program-change management. Technology solutions may not meet the critical needs of the organization. Problems and significant risks exist that require immediate action by the board and management to preserve the soundness of the institution.

A rating of 5 indicates critically deficient systems-development, acquisition, implementation, and change-management performance. Management and the board appear to be incapable of identifying and implementing appropriate IT solutions. If they exist, project-management techniques and the SDLC are critically deficient and provide little or no direction for development of systems or technology projects. The quality-assurance function is severely deficient or not present, and unidentified problems in testing and program-change management have caused significant IT risks. Technology solutions do not meet the needs of the organization. Serious problems and significant risks exist, which raise concern for the financial institution's ongoing viability.

Support and Delivery

The rating of support and delivery reflects an organization's ability to provide technology services in a secure environment. It reflects not only the condition of IT operations but also factors such as reliability, security, and integrity, which may affect the quality of the information-delivery system. The factors include user support and training, as well as the ability to manage problems and incidents, operations, system performance, capacity planning, and facility and data management. Risk-management practices should promote effective, safe, and sound IT operations that ensure the continuity of operations and the reliability and availability of data. The scope of this component rating includes operational risks throughout the organization. The rating of IT support and delivery is based on a review and assessment of requirements such as—

- the ability to provide a level of service that meets the requirements of the business;
- the adequacy of security policies, procedures, and practices in all units and at all levels of the financial institution;
- the adequacy of data controls over preparation, input, processing, and output;
- the adequacy of corporate contingency planning and business resumption for data centers, networks, and business units;

- the quality of processes or programs that monitor capacity and performance;
- the adequacy of controls and the ability to monitor controls at service providers;
- the quality of assistance provided to users, including the ability to handle problems;
- the adequacy of operating policies, procedures, and manuals;
- the quality of physical and electronic security, including the privacy of data; and
- the adequacy of firewall architectures and the security of connections with public networks.

A rating of 1 indicates strong IT support and delivery performance. The organization provides technology services that are reliable and consistent. Service levels adhere to well-defined service-level agreements and routinely meet or exceed business requirements. A comprehensive corporate contingency and business-resumption plan is in place. Annual contingency-plan testing and updating is performed, and critical systems and applications are recovered within acceptable time frames. A formal written data-security policy and awareness program is communicated and enforced throughout the organization. The logical and physical security for all IT platforms is closely monitored, and security incidents and weaknesses are identified and quickly corrected. Relationships with third-party service providers are closely monitored. IT operations are highly reliable, and risk exposure is successfully identified and controlled.

A rating of 2 indicates satisfactory IT support and delivery performance. The organization provides technology services that are generally reliable and consistent; however, minor discrepancies in service levels may occur. Service performance adheres to service agreements and meets business requirements. A corporate contingency and business-resumption plan is in place, but minor enhancements may be necessary. Annual plan testing and updating is performed, and minor problems may occur when recovering systems or applications. A written data-security policy is in place but may require improvement to ensure its adequacy. The policy is generally enforced and communicated throughout the organization, for example, through a security-awareness program. The logical and physical security for critical IT platforms is satisfactory. Systems are monitored, and security incidents and weaknesses are identified and resolved within reasonable time frames. Relationships with third-party service providers are monitored. Critical IT operations are reliable and risk exposure is reasonably identified and controlled.

A rating of 3 indicates that the performance of IT support and delivery is less than satisfactory and needs improvement. The organization provides technology services that may not be reliable or consistent. As a result, service levels periodically do not adhere to service-level agreements or meet business requirements. A corporate contingency and business-resumption plan is in place but may not be considered comprehensive. The plan is periodically tested; however, the recovery of critical systems and applications is frequently unsuccessful. A data-security policy exists; however, it may not be strictly enforced or communicated throughout the organization. The logical and physical security for critical IT platforms is less than satisfactory. Systems are monitored; however, security incidents and weaknesses may not be resolved in a timely manner. Relationships with third-party service providers may not be adequately monitored. IT operations are not acceptable, and unwarranted risk exposures exist. If not corrected, weaknesses could cause performance degradation or disruption to operations.

A rating of 4 indicates deficient IT support and delivery performance. The organization provides technology services that are unreliable and inconsistent. Service-level agreements are poorly defined and service performance usually fails to meet business requirements. A corporate contingency and business-resumption plan may exist, but its content is critically deficient. If contingency testing is performed, management is typically unable to recover critical systems and applications. A data-security policy may not exist. As a result, serious supervisory concerns over security and the integrity of data exist. The logical and physical security for critical IT platforms is deficient. Systems may be monitored, but security incidents and weaknesses are not successfully identified or resolved. Relationships with third-party service providers are not monitored. IT operations are not reliable and significant risk exposure exists. Degradation in performance is evident and frequent disruption in operations has occurred.

A rating of 5 indicates critically deficient IT support and delivery performance. The organization provides technology services that are not reliable or consistent. Service-level agreements do not exist, and service performance does not meet business requirements. A corporate contingency and business-resumption plan does not exist. Contingency testing is not performed, and management has not demonstrated the ability to recover critical systems and applications. A data-security policy does not exist, and a serious threat to the organization's security and data integrity exists. The logical and physical security for critical IT platforms is inadequate, and management does not monitor systems for security incidents and weaknesses. Relationships with third-party service providers are not monitored, and the viability of a service provider may be in jeopardy. IT operations are severely deficient, and the seriousness of weaknesses could cause failure of the financial institution if not addressed.

OUTSOURCING INFORMATION TECHNOLOGY

Banking organizations are increasingly relying on services provided by other entities to support a range of banking operations. Outsourcing of information- and transaction-processing activities, either to affiliated institutions or third-party service providers, may help banking organizations manage data processing and related personnel costs, improve services, and obtain expertise not available internally. At the same time, the reduced operational control over outsourced activities may expose an institution to additional risks. The federal banking agencies have established procedures to examine and evaluate the adequacy of institutions' controls over service providers, which can be found in the FFIEC's *IT Handbook* and related guidance. Additional information on specific areas is provided later in this section.

The FFIEC has issued the statement Risk Management of Outsourced Technology Services. (See SR-00-17.) This supplemental bank interagency guidance contains many of the same sound practices and recommendations that are in SR-00-4 (Outsourcing of Information and Transaction Processing) and this section. However, the FFIEC policy provides banking organizations with additional specific information that may be useful when considering their outsourcing risk-management practices. The guidance focuses on the risk-management process of identifying, measuring, monitoring, and controlling the risks associated with outsourcing technology services. While outsourcing can improve banking services, help to control costs, and provide the technical assistance needed to maintain and expand product offerings, it also introduces additional risks that need to be addressed. The guidance includes four key elements to address those risks: risk assessment, service-provider selection, contract provisions and review, and ongoing service-provider monitoring. An appendix to the policy statement provides examples of considerations that may be relevant when performing due diligence in selecting a service provider, contracting with service providers, and conducting ongoing service-provider monitoring. The FFIEC policy statement and its appendix are included as appendix A at the end of this section.

In the development of the examination scope and risk profile, examiners should determine which information- and transaction-processing activities critical to the institution's core operations are outsourced. During the on-site examination, the adequacy of the institution's risk management for these critical service providers should be assessed and evaluated. The overall assessment should be reflected in the relevant components of the URSIT examination rating or the Uniform Financial Institution Rating System, if an information-systems rating is not assigned.

Outsourcing Risks

The outsourcing of information and transaction processing involves operational risks that are similar to those that arise when the functions are performed internally, such as threats to the availability of systems used to support customer transactions, the integrity or security of customer account information, or the integrity of risk-management information systems. Under outsourcing arrangements, however, the risk-management measures commonly used to address these risks, such as internal controls and procedures, are generally under the direct operational control of the service provider. Nevertheless, the serviced institution would bear the associated risk of financial loss, reputational damage, or other adverse consequences.

Some outsourcing arrangements also involve direct financial risks to the serviced institution. For example, in some transaction-processing activities, a service provider has the ability to process transactions that result in extensions of credit on behalf of the serviced institution.[19] A service provider may also collect or disburse funds, exposing the institution to liquidity and credit risks if the service provider fails to perform as expected.

Risk Management

The Federal Reserve expects institutions to ensure that controls over outsourced information- and transaction-processing activities are equivalent to those that would be implemented if the activity were conducted internally. (See SR-00-4.) The institution's board of directors and senior management should understand the key risks associated with the use of service providers for its critical operations, commensurate with the scope and risks of the outsourced activity and its importance to the institution's business. They should ensure that an appropriate oversight program is in place to monitor each service provider's controls, condition, and performance. The following eight areas should be included in this process:

1. *Risk assessment.* Before entering into an outsourcing arrangement, the institution should assess the key risks that may arise and options for controlling these risks. Factors influencing the risk assessment could include how critical the outsourced function is to the institution; the nature of activities to be performed by the service provider, including handling funds or implementing credit decisions; the availability of alternative service providers for the particular function; insurance coverage available for particular risks; and the cost and time required to switch service providers if problems arise.
2. *Selection of service provider.* In selecting a service provider for critical information- or transaction-processing functions, an institution should perform sufficient due diligence to satisfy itself of the service provider's competence and stability, both financially and operationally, to provide the expected services and meet any related commitments.[20]
3. *Contracts.* The written contract between the institution and the service provider should clearly specify, at a level of detail commensurate with the scope and risks of the outsourced activity, all relevant terms, conditions, responsibilities, and liabilities of both parties. These would normally include terms such as—
   - required service levels, performance standards, and penalties;
   - internal controls, insurance, disaster-recovery capabilities, and other risk-management measures maintained by the service provider;
   - data and system ownership and access;
   - liability for delayed or erroneous transactions and other potential risks;
   - provisions for the institution to require and have access to internal or external audits or other reviews of the service provider's operations and financial condition;
   - compliance with any applicable regulatory requirements and access to information and operations by the institution's supervisory authorities; and
   - provisions for handling disputes, contract changes, and contract termination.

   Terms and conditions should be assessed by the institution to ensure that they are appropriate for the particular service being provided and result in an acceptable level of risk to the institution.[21] Contracts for outsourcing of critical functions should be reviewed by the institution's legal counsel.
4. *Policies, procedures, and control.* The service provider should implement internal control policies and procedures, data-security and contingency capabilities, and other operational controls analogous to those that the institution would use if it performed the activity internally. Appropriate controls should be placed on transactions processed or funds handled by the service provider on behalf of the institution. The service provider's policies and procedures should be reviewed by client institutions.

19. For example, an institution may authorize a service provider to originate payments, such as ACH credit transfers, on behalf of customers. The institution is required by law or contract to honor these types of transactions.

20. When the service provider is affiliated with the serviced institution, sections 23A and 23B of the Federal Reserve Act may apply. In particular, section 23B provides that the terms of transactions between a bank and its nonbank affiliate must be comparable to the terms of similar transactions between nonaffiliated parties.

21. Additional information regarding common contract provisions can be found later in this section and in the FFIEC's *IT Handbook*. In addition, FFIEC Supervisory Policy SP-5 requires each serviced institution to evaluate the adequacy of its service provider's contingency plans.

5. *Ongoing monitoring.* The institution should review the operational and financial performance of critical service providers on an ongoing basis to ensure that the service provider is meeting and can continue to meet the terms of the arrangement. The institution's staff should have sufficient training and expertise to review the service provider's performance and risk controls.
6. *Information access.* The institution must ensure that it has complete and immediate access to information that is critical to its operations and that is maintained or processed by a service provider. Records maintained at the institution must be adequate to enable examiners to review its operations fully and effectively, even if a function is outsourced.
7. *Audit.* The institution's audit function should review the oversight of critical service providers. Audits of the outsourced function should be conducted according to a scope and frequency appropriate for the particular function. Serviced institutions should conduct audits of the service provider or regularly review the service provider's internal or external audit scope and findings. Service providers should have an effective internal audit function or should commission comprehensive, regular audits from a third-party organization. The reports of external auditors are commonly based on the AICPA's Statement of Auditing Standards [SAS] No. 70 "Reports on the Processing of Transactions by Service Organizations," as amended by SAS No. 78, "Consideration of Internal Control in a Financial Statement Audit: An Amendment to Statement on Auditing Standards No. 55." These statements contain the external-auditor reporting tools commonly used for service providers. SAS 70 reports, however, should not be relied on to the same extent as an audit. There are two types of SAS 70 reports:
   - *Reports on controls placed in operation* is an auditor's report on a service oganization's description of the controls that may be relevant to a user organization's internal control as it relates to an audit of financial statements. It also reports on whether such controls were suitably designed to achieve specified control objectives. Lastly, it reports on whether the controls had been placed in operation as of a specific date.
   - *Reports on controls placed in operation and tests of operating performance* is an auditor's report on a service organization's controls as described above, but the report also includes information on whether the controls that were tested were operating with sufficient effectiveness to provide reasonable, but not absolute, assurance that the related control objectives were achieved during the period specified.

   Audit results, audit reports, and management responses must be available to examiners upon request.
8. *Contingency plans.* The serviced institution should ensure adequate business-resumption planning and testing by the service provider. When appropriate based on the scope and risks of the outsourced function and the condition and performance of the service provider, the serviced institution's contingency plan may also include plans for the continuance of processing activities, either in-house or with another provider, in the event that the service provider is no longer able to provide the contracted services or the arrangement is otherwise terminated unexpectedly.

International Considerations

In general, the arrangements for outsourcing critical information- or transaction-processing functions to service providers outside the United States should be conducted according to the risk-management guidelines described above. In addition, the Federal Reserve expects that these arrangements will not diminish the ability of U.S. supervisors to effectively review the domestic or foreign operations of U.S. banking organizations and the U.S. operations of foreign banking organizations. (See SR-00-4.) In particular, examiners should evaluate the adequacy of outsourcing arrangements in the following six areas:

1. *Oversight and compliance.* The institution is expected to demonstrate adequate oversight of a foreign service provider, such as through comprehensive audits conducted by the service provider's internal or external auditors, the institution's own auditors, or foreign bank supervisory authorities. The arrangement must not hinder the ability of the institution to comply with all applicable U.S.

laws and regulations, including, for example, requirements for accessibility and retention of records under the Bank Secrecy Act. (See the U.S. Department of the Treasury's rule at 31 CFR 103.18. See also section 208.62 of the Board's Regulation H (12 CFR 208.62) for suspicious-activity reporting and section 208.63 (12 CFR 208.63) for the Bank Secrecy Act compliance program.)

2. *Information access.* The outsourcing arrangement should not hinder the ability of U.S. supervisors to reconstruct the U.S. activities of the organization in a timely manner, if necessary. Outsourcing to jurisdictions where full and complete access to information may be impeded by legal or administrative restrictions on information flows will not be acceptable unless copies of records pertaining to U.S. operations are also maintained at the institution's U.S. office.
3. *Audit.* Copies of the most recent audits of the outsourcing arrangement must be maintained in English at the institution's U.S. office and must be made available to examiners upon request.
4. *Contingency plan.* The institution's contingency plan must include provisions to ensure timely access to critical information and service resumption in the event of unexpected national or geographic restrictions or disruptions affecting a foreign service provider's ability to provide services. Depending on the scope and risks of the outsourced function, this may necessitate backup arrangements with other U.S. or foreign service providers in other geographic areas.
5. *Foreign banking organizations.* With the exception of a U.S. branch or agency of a foreign bank that relies on the parent organization for information- or transaction-processing services, foreign banking organizations should maintain at the U.S. office documentation of the home office's approval of outsourcing arrangements supporting its U.S. operations, whether to a U.S. or foreign service provider. The organization's U.S. office should also maintain documentation demonstrating appropriate oversight of the service provider's activities, such as written contracts, audit reports, and other monitoring tools. When appropriate, the Federal Reserve will coordinate with a foreign banking organization's home-country supervisor to ensure that it does not object to the outsourcing arrangement.
6. *Foreign branches or subsidiaries of U.S. banks and Edge corporations.* Documentation relating to outsourcing arrangements of the foreign operations of U.S. banking organizations with foreign service providers should be made available to examiners upon request.

INFORMATION-PROCESSING ENVIRONMENT

Many factors influence an institution's decision about whether to use internal or external data processing services, including the initial investment, operating costs, and operational flexibility. Historically, small financial institutions, which usually lack the funds or transaction volume to justify an in-house information system, were the chief users of external data processing companies. However, as advances in technology have decreased the cost of data processing, small institutions have become much more willing to invest in an in-house information system. At the same time, some financial institutions with internal information systems have discovered that they can save money by using external data processing companies for certain banking applications. Other financial institutions have engaged national companies or facilities-management organizations to assume their processing operations, while certain holding companies have organized their data processing departments as subsidiaries to centralize operations for their affiliate institutions.

The decision to establish an internal data processing center is a major one. Any bank's board of directors and management considering such a decision should thoroughly review and consider alternatives before proceeding. While a bank may gain a number of competitive advantages from an in-house facility, there are also many risks associated with this decision. Technological advances have reduced the price of small computer networks and made them more affordable, but banks should not use this as the sole justification for an internal data processing center.

A comprehensive feasibility study should precede any decision to develop an in-house system. This study should describe the costs, benefits, and risks and also give management the opportunity to compare current and future needs with existing abilities. The FFIEC's *IT Hand-*

book contains a complete discussion of feasibility studies.

The management of a financial institution must carefully identify the organization's needs for data processing. After these needs are properly identified (including the customers' needs for these services), management must carefully evaluate how the institution can best meet them. The costs and complexity of changing data processing arrangements can be substantial, so management must ensure that all related costs and benefits are identified and considered before deciding on a service. The following are the major external providers of data processing and IT services for financial institutions.

Correspondent Banks

Small financial institutions sometimes receive their IT services from a major correspondent bank. These services may be just one of a host of services available from the correspondent. Historically, the correspondent bank has been the least expensive servicer for many institutions. Correspondent banks may offset some of their own IT costs by using their excess processing capacity to provide services to correspondents.

Affiliated Financial Institutions and Banking Organizations

IT departments in holding companies or subsidiaries are one common form of an affiliated servicer. An affiliated data center may offer cost savings to other affiliates, since all parties are generally using the same software system. The serviced institutions can eliminate the duplication of tasks, and the affiliated data center and the overall organization can realize cost savings through economies of scale. Thus, charges for IT services to affiliates are generally very competitive.

Regulatory guidelines strictly govern IT-servicing arrangements between affiliated institutions. Sections 23A and 23B of the Federal Reserve Act (12 USC 371c and 371c-1) address the question of allowable transactions between affiliates. This statute also states that the terms of transactions between affiliated parties must be comparable to the terms of similar transactions between nonaffiliated parties. An affiliated data center is allowed to set fees to recover its costs or to recover its costs plus a reasonable profit, or to set charges for data processing services that are comparable to those of a nonaffiliated servicer. Other restrictions may also apply.

Independent Service Bureaus

Independent service bureaus are present in most areas, but mergers and acquisitions have caused the number of bureaus to decline. When management investigates a service bureau's operations, it should determine if the servicer is familiar with the IT needs of financial institutions. Determining the percentage of the service bureau's business that comes from financial institutions will help the institution select a vendor that specializes in this type of processing. Independent service bureaus are normally responsive to user requests for specialized programs, since developing these programs for clients is generally a significant source of revenue. Tailoring a software program to a particular institution's needs becomes less attractive to the independent service bureau if the institution accounts for only a small portion of the bureau's workload or if the bureau offers a standardized software package as its primary product. However, some standardized software systems allow a modest amount of processing and report adjustments without requiring servicer modifications. Also, report-generator software, which provides clients with customized reports they can prepare without any help from the service bureau, is sometimes available from service bureaus.

Cooperative Service Corporations

A cooperative service corporation is a data processing facility formed by a group of financial institutions that agrees to share the operating costs. Under the right circumstances, this arrangement works well. For this strategy to succeed, however, all members of the group must be the same approximate size and have similar IT requirements. Typically, each institution owns a share of the facility or bears a share of the costs on a pro rata basis through investment in a bank service corporation. There must be a strong working relationship among the institutions. Although the institutions are not directly involved in the data processing center's daily operations, they are ultimately responsible for the center's success or failure.

One advantage of a cooperative service corporation is that individual institutions have increased control over the design of the data processing operation. Therefore, institutions can tailor computerized applications to meet their own needs. Resource pooling often provides for economies of scale as well, and cooperative ventures normally attract more highly skilled and more experienced employees.

Facilities-Management Providers

Medium- and large-sized financial institutions that already have an in-house data processing facility are the most likely users of facilities-management (FM) contracts. Small institutions typically do not have the work volume that is a prerequisite to hiring an FM company. Service contracts with FM companies are usually for a minimum term of five years, during which time the FM company assumes full responsibility for the institution's data processing operations. The institution pays the FM company a monthly fee to reimburse it for the costs of providing IT services plus a profit. The FM company usually carries out its tasks in the institution's former data processing center.

Financial institutions have various reasons for using FM companies, such as controlling or reducing the growth of data processing costs, ensuring better management of data center personnel, or using more modern software systems. Management of financially strained institutions may enter into FM arrangements to augment their capital position by selling their equipment or facilities to the FM company.

Although an institution's contract with an FM company may provide a quick and easy solution to data processing problems with minimal involvement of senior officials, management should be aware of potential problems. FM contracts can have clauses that require the institution to pay more for services as work volume grows and can also contain provisions for periodic increases. The contract may include a substantial penalty for cancellation. Another risk is that the FM company may make personnel changes that are not advantageous to the institution, such as reassigning its best workers elsewhere or reducing the size of the data processing staff. Bank management should make sure that FM service contracts contain specific quality-measurement clauses and should monitor the quality of data processing services provided.

Other Purchased Services

Computer Time

A financial institution that designed its own data processing system and that maintains its own files only needs to rent computer time from an external servicer. This arrangement usually occurs when the financial institution's equipment or schedule makes it unable to handle some unusual processing task.

Time-Shared Computer Services

Most external providers of time-sharing services have a library of standardized programs available to any user. A user also may generate programs and store them in a reserved library. Financial institutions frequently use time-sharing services for financial analysis rather than recordkeeping. Applications with low input and output requirements and repetitive calculations, such as those required for a securities portfolio, lend themselves to a time-sharing arrangement. The external servicer in this arrangement normally does not maintain the client institution's data files. Financial institutions that store master files on the external servicer's equipment should maintain adequate documentation to facilitate the examination process. Under this arrangement, management should be concerned about ensuring logical and physical access to the terminal and about the availability of audit trails that indicate who has made changes to master files. Management should establish and monitor controls over passwords, terminals, and access to master files. For a complete discussion of controls over passwords and terminals, see the FFIEC's *IT Handbook.*

Satellite Processing

Satellite (remote) processing has become popular with some financial institutions that are located far away from an external servicer and that must process a large volume of transactions. A distinguishing characteristic of satellite processing is that the institution and the data center each perform a portion of the processing. Although the institution collects the data and sometimes prepares reports, the servicer makes the necessary master-file updates. To capture data and print reports, the serviced institution must acquire a terminal-entry device, a printer, an MICR reader/sorter, and a tape or disk unit. Since the system is usually online, the serviced institution must install modems and communications lines linking it to the servicer. The level of skill necessary to perform remote job entry in a satellite system is less sophisticated than the level needed to operate an in-house system. Most of the traditional control functions remain at the institution. The FFIEC's *IT Handbook* contains further information on satellite processing, remote job entry, and distributive processing systems.

Standard Program Packages

Most bank data centers and service bureaus specialize in processing one or more standard software packages. By using the same software for several users, external servicers achieve certain operating economies, which allow them to recover initial development costs more quickly. Most standard software packages are parameter driven, providing the user with some degree of flexibility. For example, in demand deposit and savings applications, standard program modules or common subroutines often allow the user to designate the format and frequency of reports. In addition, the user may select the parameters necessary to generate certain reports, such as the number of inactive days before an account becomes dormant or the minimum dollar amount for checks listed on the large-item report. The user can also be involved in selecting the criteria for interest rates, balance requirements, and other operating values, allowing for a tailored application within a standardized software system.

Tailored Applications

If standard program packages do not meet a financial institution's needs, an external servicer can be hired to design tailored applications to process the institution's data. The institution must clearly describe the proposed system and its operations to the servicer. Internal or external auditor participation in reviewing controls is also advisable. The initial cost of this approach is high, as are the costs of maintaining and updating the tailored applications.

OPERATIONAL AND TECHNOLOGICAL USER CONTROLS

Using computerized programs and networks, banks maintain a large number of accounts and record a high volume of transactions every day. Text-processing systems store vast amounts of correspondence. Transmission of data and funds regularly occurs over public communications links, such as telephone lines and satellite networks. The use of new technologies to transfer funds and records, while improving customer service and the institution's internal operations, has increased the potential for errors and abuse, which can result in loss of funds, lawsuits arising from damaged reputations, improper disclosure of information, and regulatory sanctions.

Controls must be implemented to minimize the vulnerability of all information and to keep funds secure. Bank management must assess the level of control necessary in view of the degree of exposure and the impact of unexpected losses on the institution. Certain practices can strengthen information and financial security. The most basic practices are the implementation of sound policies, practices, and procedures for physical security, separation of duties, internal quality control, hardware and software access controls, and audits. Bank management should institute information security controls that are designed to—

- ensure the integrity and accuracy of management information systems;
- prevent unauthorized alteration during data creation, transfer, and storage;
- maintain confidentiality;
- restrict physical access;
- authenticate user access;
- verify the accuracy of processing during input and output;
- maintain backup and recovery capability; and
- provide environmental protection against damage or destruction of information.

Although security features vary, they are usually available for all computer systems. The controls adopted should apply to information produced and stored by both automated and manual methods.

Written policies are generally recommended and, in most cases, institutions have chosen to establish and communicate security principles in writing. However, if an institution follows sound fundamental principles to control the risks discussed here, a written policy is not necessarily required. If sound principles are not effectively practiced, management may be required to establish written policies to formally communicate risk parameters and controls. Federal Reserve System policy does, however, require written contingency and disaster-recovery plans.

Examiners should regularly conduct reviews of information security. These reviews may include an assessment of—

- the adequacy of security practices,
- compliance with security standards, and
- management supervision of information security activities.

When conducting reviews of controls over information security, examiners must understand the difference between master files and transaction files. A master file is a main reference file of information used in a computer system, such as all mortgage loans. It provides information to be used by the program and can be updated and maintained to reflect the results of the processed operation. A transaction file or detail file contains specific transaction information, such as mortgage loan payments.

Manual Controls

The following discussion covers basic operational controls in a financial institution receiving external IT services. Similar controls should also be applied to information processed by an IT department within a user's own institution.

Separation of Duties

A basic form of operational control is separation of duties. With this control in place, no one person should be able to both authorize and execute a transaction, thereby minimizing the risk of undetected improper activities. Data center personnel should not initiate transactions or correct data except when it is necessary to complete processing in a reasonable time period. If this unusual situation arises, proper authorization should be obtained from data center and bank management. Both the servicer and the serviced institution should maintain documentation of these approvals, including details of the circumstances requiring the action. The same person normally should not perform input and output duties. However, in some instances, staff limitations may make one person responsible for several activities, such as—

- preparing batches and blocks or other input for entry to the system or shipment to the servicer;
- operating data entry equipment, including check reader/sorter machines, proof machines, or data-conversion devices;
- preparing rejects and nonreaders for reentry into the system;
- reconciling output to input or balancing the system;
- distributing output to ultimate users; and
- posting the general ledger and balancing computer output to the general ledger.

Rotation of assignments and periodic scheduled absences may improve internal controls by preventing one person from controlling any one job for an extended time period (and by providing cross-training and backup for all personnel). When vacations are scheduled, management may require staff to take uninterrupted vacations that are long enough to allow pending transactions to clear. These practices are most effective if vacations or other types of absences extend over the end of an accounting period or are for two consecutive weeks. Written policies and procedures may require job rotation.

Application manuals usually consist of a user's guide provided by the servicer that is supplemented by procedures written by the user. Manuals normally cover the preparation and control of source documents, certain control practices for moving documents or electronic images to and from the user and servicer, the daily reconcilement of totals to the general ledger, and master-file changes.

Management should implement dual control over automated systems. Personnel should place supervisory holds on customer accounts requiring special attention. For example, dormant accounts, collateral accounts, and accounts with large uncollected funds balances generally have holds that can be removed only by authorizations from two bank officials. In addition, certain types of transactions (for example, master-file changes) should require authorization from two bank officials by means of special codes or terminal keys. When employees add or remove a hold on an account or when the system completes a transaction requiring supervisory approval, the computer should generate an exception report. Assigned personnel not involved in the transaction should promptly review these reports for unusual or unauthorized activity.

Internal Quality Controls

Generally, there are three basic types of information systems, with many combinations and variations:

- *Inquiry-only system.* This system allows the user to search and review machine-readable records but not to alter them. Controls and security concerns related to this system are few; the major concern is unauthorized access to confidential information.
- *Memo-post system.* More sophisticated than the inquiry-only system, the memo-post system allows the user to create interim records. The servicer performs permanent posting routines using batch-processing systems. Controls for a memo-post system include limiting physical and logical access to the system and restricting certain transactions to supervisory personnel only. Appropriate levels of management should review memo-post reports daily.
- *Online-post system.* This system, sometimes called a real-time system, requires the strictest controls. Online-post systems are vulnerable because all accepted transactions are transferred to machine-readable records. In addition to access controls, system reports should record all activity and exceptions. Appropriate levels of management should review these reports daily.

Internal controls fall into three general categories:

- *Administrative controls.* Administrative controls usually consist of management review of daily operations and output reports. Each application includes basic controls and exception reports that are common to all operations. To be effective, operations personnel must properly use exception reports and controls. This is especially true for controlling dormant accounts, check kiting, draws against uncollected funds, overdrafts, and the posting of computer-generated income and expense entries.
- *Dollar controls.* Dollar controls ensure processing for all authorized transactions. Operations personnel should establish work and control totals before forwarding data records to the data processor. Those same employees should not complete balancing procedures by reconciling trial balances to input, control sheets, and the general ledger. Report distribution should follow a formal procedure. Personnel should account for all rejects corrected and resubmitted.
- *Condoler controls.* Condoler controls are used when dollar values are not present in the data, as in name and address changes. Controls should be established before forwarding work for processing. Management should also implement procedures designed to ensure that its servicer processes all condoler transactions. For example, personnel should check new-account reports against new-account input forms or written customer-account applications to make sure that data are properly entered. To protect data integrity, management should develop procedures to control master-file and program changes. These procedures should also verify that the servicer is making only authorized changes and ensure that data processing employees do not initiate master-file changes.

Technological Controls

Encryption

Encryption is a process by which mathematical algorithms are used to convert plain text into encrypted strings of meaningless symbols and characters. This helps prevent unauthorized viewing and altering of electronic data during transmission or storage. The industry commonly uses the Data Encryption Standard (DES) for encoding personal identification numbers (PINs) on access cards, storing user passwords, and transferring funds on large-dollar payment networks.

Message-Authentication Code

A message-authentication code (MAC) is a code designed to protect against unauthorized alteration of electronic data during transmission or storage. This code is used with data encryption to further secure the transmission of large-dollar payments.

User Passwords

User passwords consist of a unique string of characters that a programmer, computer operator, or user must supply before gaining access to the system or data. These are individual access codes that should be specific to the user and known only to the user. Other security features of passwords should, at a minimum, require the users to change them periodically and store them in encrypted files. In addition, the passwords should be composed of a sufficient number of alphanumeric characters to make them difficult to guess. User passwords should not be displayed during the access process and should not be printed on reports.

Security Software

Security software is software designed to restrict access to computer-based data, files, programs, utilities, and system commands. Some systems can control access by user, transaction, and terminal. The software can generate reports that log actual and attempted security violations as well as access to the system.

Restricted Terminals

Limiting certain types of transactions to certain terminals or groups of terminals can help reduce exposure to loss. The offsetting problem is that loss of the ability to use these terminals can stop processing for an entire application. Bank management should therefore evaluate both the exposure and processing risks.

An automatic time-out feature can minimize the exposure risk. Since unauthorized users may target an unattended terminal, this feature automatically signs off the user when there has been no activity for a certain period of time. Using time-of-day restrictions can also limit unauthorized use of terminals during periods when an entire department or section would be unattended.

Restricted Transactions

Restricted transactions are specialized transactions that can be performed only by supervisory or management personnel. Examples include reversing transactions, dollar adjustments to customer accounts, and daily balancing transactions. Management should periodically review user needs and the appropriateness of restricting the performance of these transactions. System-generated reports can be used to review this activity more frequently.

Activity and Exception Reports

Report output will vary, depending on the sophistication of the data communications and applications software. Management should receive activity reports that detail transactions by terminal, operator, and type. More sophisticated software will produce activity and exception reports on other criteria, such as the number of inquiries by terminal, unsuccessful attempts to access the system, unauthorized use of restricted information, and any unusual activities (that is, infrequently used transactions).

Activity reports are used to monitor system use and may not be printed daily. However, management should periodically review and summarize these reports in an effort to ensure that machines are used efficiently. Exception reports should be produced and reviewed daily by designated personnel who have no conflicting responsibilities. A problem with many reporting systems is that the log contains a record of every event, making it cumbersome and more difficult to identify problems.

Controls over Software-Program-Change Requests

Requests for system changes, such as software-program changes, should be documented on a standard change-request form. The form is used to describe the request and document the review and approval process. It should contain the following information:

- date of the change request
- sequential control number
- program or system identification
- reason for the change
- description of the requested change

- person requesting the change
- benefits contemplated from the change
- projected cost
- signed approval authorizing the change including, at a minimum, the user, IT personnel with the proper authority, and an auditor (at least for significant changes)
- name of programmer assigned to make the change
- anticipated completion date
- user and information systems approval of the completed program change
- implementation procedures (steps for getting the program into the production library)
- audit review of change (if deemed necessary)
- documented sign-off

End-User Computing

End-user computing results from the transfer of information-processing capabilities from centralized data centers onto the user's desktop. End-user computing systems may range in size and computing power from laptop notebook computers to standalone personal computers, client server networks, or small systems with sufficient computing power to process all significant applications for a financial institution. Small systems that are entirely supported by a hardware or software vendor are referred to as turnkey systems. Control considerations discussed throughout this subsection generally apply to all end-user computing systems.

In many cases, end-user systems are linked by distributed processing networks. Linking several microcomputers together and passing information between them is called networking. A system configured in this manner is commonly called a local area network (LAN). The ability to decentralize the data processing function is largely a result of the development of powerful microcomputers or PCs. Microcomputers are now powerful enough to process significant applications when used as standalone systems. These microcomputers can also be connected to a host computer and configured to serve as a data entry or display terminal. In this terminal-emulation mode, information can be passed between the host and the PC with the processing occurring at either machine.

When linked by a network, end-user computing offers several advantages to financial institutions, including—

- low cost compared with other platforms,
- efficiency through the sharing of resources,
- ease of expansion for future growth,
- enhanced communication capabilities,
- portability,
- data availability, and
- ease of use.

While end-user computing systems provide several advantages, they also have greater risks to data integrity and data security, including—

- difficulty in controlling access to the system and in controlling access to confidential information that may be stored on individual personal computers and not on the system (such as payroll records, spreadsheets, budgets, and information intended for the board of directors of the financial institution),
- the lack of sophisticated software to ensure security and data integrity,
- insufficient capabilities to establish audit trails,
- inadequate program testing and documentation,
- lack of segregated duties of data entry personnel.

As the trend toward distributed processing continues, financial institutions should have proper policies, procedures, and reporting to ensure the accurate and timely processing of information. The controls governing access in an end-user computing environment should be no less stringent than those used in a traditional mainframe environment. Strict rules should govern the ability of users to access information. As a general rule, no user should be able to access information that is beyond what is needed to perform the tasks required by his or her job description. In this new environment, management and staff should assume responsibility for the information assets of the organization.

CONTINGENCY PLANNING, RECORD PROTECTION, AND RETENTION

Data communications systems are susceptible to software, hardware, and transmission problems that may make them unusable for extended periods of time. If a financial institution depends on data communication for its daily operations, appropriate back-up provisions are necessary. Back-up is the ability to continue processing applications in the event the communications system fails. Management can provide back-up by various methods, including batch-processing systems, intelligent terminals or PCs operating in an off-line mode, data capture at the controller if transmission lines are lost, redundant data communication lines, and back-up modems.

Regardless of the method used, FFIEC interagency issuances and specific supporting Federal Reserve System policy issuances that address corporate contingency planning require a comprehensive back-up plan with detailed procedures. When using a batch back-up system, operations personnel must convert data to a machine-readable format and transport the data to the servicer. This process may require additional personnel (data-entry operators and messengers) and equipment. An institution's contingency plan should include detailed procedures on how to obtain and use the personnel and equipment. Because on-line systems are updated or improved frequently, a batch back-up may not remain compatible. Institution personnel should perform periodic tests of batch and other back-up capabilities to ensure that protection is available and that employees are familiar with the plan.

Institutions should create computerized back-up copies of the institution's critical records and have alternative methods of processing those records. When IT operations are performed outside the institution, both the servicer and the financial institution should have adequate control over the records. Bank management should determine which records are best protected by the servicer and which are best protected internally. Service contracts should outline the servicer's responsibility for storing bank records. If the servicer does not or will not permit specific reference to record retention in the contract, a general reference may be sufficient. The institution should obtain a copy of the servicer's back-up policy and retention procedures, and bank management should thoroughly understand which records are protected by whom and to what extent.

The bank should also review the servicer's software and hardware back-up arrangements. It should review the service provider's contingency plan and results of routine tests of the contingency plan. The review should determine how often data and software back-ups are made, the location of stored materials, and which materials are stored at that site. Management should also determine the availability of software replacement and vendor support, as well as the amount and location of duplicate software documentation. Software replacement and documentation procedures should be developed for both operating and application systems.

Management should review the servicer's hardware back-up arrangements to determine if (1) the servicer has a contract with a national recovery service and, if so, the amount and type of back-up capacity provided under the contract; (2) the servicer has an alternate data center with sufficient capacity and personnel to provide full service if necessary; or (3) multiple processing sites within the same facility are available for disaster-processing problems and if each site has an alternate power supply. The alternate site should be able to provide continued processing of data and transmission of reports.

Contracts or contingency plans should specify the availability of source documentation in the event of a disaster, including insolvency of the servicer. FFIEC interagency issuances and Federal Reserve System policy statements require financial institutions to evaluate the adequacy of a servicer's contingency plan and to ensure that its own contingency plan is compatible with the servicer's plan.

Since the duplication of records may vary from site to site, most organizations develop schedules for automatic retention of records on a case-by-case basis. The only way to ensure sufficient record protection is to continually review the flow of documents, data, and reports. Some records may be available in both hard-copy and machine-readable formats. In addition to determining the types of back-up records, management should determine whether it is possible to re-create current data from older records. Certain records also have uses apart from their value in reconstructing current data, such as meeting institutional and regulatory reporting requirements. These records usually include month-end, quarter-end, and year-end files.

The location of an external data center is another factor to consider when evaluating retention procedures. If the external data center is located in a building adjacent to the institution, the possibility that a disaster may affect both organizations increases. Such a situation may make off-site storage of back-up materials even more important. If, on the other hand, the serviced institution is located far from the data center, physical shipment of both input and output may become necessary. Management should determine if fast, reliable transportation between the two sites is available.

If a major disaster occurs, an alternate facility may not be available to process duplicated machine-readable media. Management should consider remote record storage that would facilitate the manual processing of records, if necessary. Furthermore, microfilming all items before shipment would protect the institution if any items are lost, misplaced, or destroyed. Optical-disk storage, which involves scanning and storing a document electronically, offers another alternative for storage and retrieval of original data after processing has occurred. The FFIEC's *IS Handbook* and related FFIEC and Federal Reserve System issuances are sources of information about planning for unexpected contingencies.

Processing personnel should regularly copy and store critical institution records in an off-site location that is sufficiently accessible to obtain records in a reasonable time period. These records should include data files, programs, operating systems, and related documentation. This also applies to critical data in hard-copy documents. In addition, an inventory of the stored information should be maintained along with a defined retention period.

AUDITS

Examiners need to determine the appropriateness of the scope and frequency of audit activities related to information systems and the reliability of internal or third-party audits of servicer-processed work. Furthermore, examiners should review the methods by which the board of directors is apprised of audit findings, recommendations, and corrective actions taken. In reviewing audit activities, examiners should consider the following factors (if applicable):

- the practicality of the financial institution's having an internal IT auditor and, if the institution has an internal IT auditor, the auditor's level of training and experience
- the training and experience of the institution's external auditors
- the audit functions performed by the institution's outside auditors, the servicer, the servicer's outside auditor, and supervisory personnel
- internal IT audit techniques currently being followed

The audit function should review controls and operating procedures that help protect the institution from losses caused by irregularities and willful manipulations of the data processing system. Thus, a regular, comprehensive audit of IT activities is necessary. Additionally, designated personnel at each serviced institution should periodically perform ''around-the-computer'' audit examinations, such as:

- developing data controls (proof totals, batch totals, document counts, number of accounts, and prenumbered documents) at the institution before submitting data to the servicer and sampling the controls periodically to ensure their accuracy;
- spot-checking reconcilement procedures to ensure that output totals agree with input totals, less any rejects;
- sampling rejected, unpostable, holdover, and suspense items to determine why they cannot be processed and how they were disposed of (to make sure they were properly corrected and re-entered on a timely basis);

- verifying selected master-file information (such as service-charge codes), reviewing exception reports, and cross-checking loan extensions to source documents;
- spot-checking computer calculations, such as the dollar amounts of loan rebates, interest on deposits, late charges, service charges, and past-due loans, to ensure proper calculations;
- tracing transactions to final disposition to ensure audit trails are adequate;
- reviewing source documents to ascertain whether sensitive master-file change requests were given the required supervisory approval;
- assessing the current status of controls by either visiting the servicer or reviewing independent third-party reviews of the servicer;
- reviewing processing procedures and controls; and
- evaluating other audits of the servicer.

In addition, ''through-the-computer'' audit techniques allow the auditor to use the computer to check data processing steps. Audit software programs are available to test extensions and footings and to prepare verification statements.

Regardless of whether an institution processes data internally or externally, the board of directors must provide an adequate audit program for all automated records. If the institution has no internal IT audit expertise, the nontechnical ''around-the-computer'' methods will provide minimum coverage, but not necessarily adequate coverage. A comprehensive external IT audit, similar to those discussed in the FFIEC's *IS Handbook*, should be carried out to supplement nontechnical methods.

INSURANCE

A financial institution should periodically review its insurance coverage to ensure that the amount of coverage is adequate to cover any exposure that may arise from using an external IT provider. To determine what coverage is needed, the institution should review its internal operations, the transmission or transportation of records or data, and the type of processing performed by the servicer. This review should identify risks to data, namely the accountability for data, at both the user and servicer locations and while in transit. Insurance covering physical disasters, such as fires, floods, and explosions, should be sufficient to cover replacement of the data processing system. Coverage that protects specialized computer and communications equipment may be more desirable than the coverage provided by regular hazard insurance. Expanded coverage protects against water infiltration, mechanical breakdown, electrical disturbances, changes in temperature, and corrosion. The use of an ''agreed-amount'' endorsement can provide for full recovery of covered loss.

Bank management should also review the servicer's insurance coverage to determine if the amounts and types are adequate. Servicer coverage should be similar to what the financial institution would normally purchase if it were performing its data processing internally. Servicer-provided coverage should complement and supplement the bank's coverage.

If a loss is claimed under the user's coverage, the user need only prove that a loss occurred to make a claim. However, if the loss is claimed under the servicer's coverage, the institution must prove that a loss occurred and also that the servicer was responsible for the loss.

Examiners should review the serviced institution's blanket bond coverage, as well as similar coverage provided by the servicer. The coverage period may be stated in terms of a fixed time period. The loss, the discovery, and the reporting of the loss to the insurer must occur during that stated period. Extended discovery periods are generally available at additional cost if an institution does not renew its bond. The dollar amount of the coverage now represents an aggregate for the stated period. Each claim paid, including the loss, court costs, and legal fees, reduces the outstanding amount of coverage, and recoveries do not reinstate previous levels of coverage. Since coverage extends only to locations stated in the policy, the policy must individually list all offices. Additionally, policies no longer cover certain types of documents in transit.

The bank's board of directors should be involved in determining insurance coverage since each board member will be acknowledging the terms, conditions, fees, riders, and exclusions of the policy. Insurance companies consider any provided information as a warranty of coverage. Any omission of substantive information could result in voided coverage.

The bank or servicer should consider buying additional coverage. Media-reconstruction policies defray costs associated with recovering data contained on the magnetic media. Media-replacement policies replace blank media. Extra-expense policies reimburse organizations for expenses incurred over and above the normal cost of operations. In addition, servicers often purchase policies covering unforeseen business interruptions and the liabilities associated with errors and omissions. Both servicer and banking organizations may purchase transit insurance that covers the physical shipment of source documents. Additionally, electronic funds transfer system (EFTS) liability coverage is available for those operations that use electronic transmission.

Several factors may influence an institution's decision to purchase insurance coverage or to self-insure: the cost of coverage versus the probability of occurrence of a loss, the cost of coverage versus the size of the loss of each occurrence, and the cost of coverage versus the cost of correcting a situation that could result in a loss. Some institutions engage risk consultants to evaluate these risks and the costs of insuring against them.

SERVICE CONTRACTS

Contract Practices

A poorly written or inadequately reviewed contract can be troublesome for both the serviced financial institution and the servicer. To avoid or minimize contract problems, bank legal counsel who are familiar with the terminology and specific requirements of a data processing contract should review it to protect the institution's interests. Since the contract likely sets the terms for a multiyear understanding between the parties, all items agreed on during negotiations must be included in the final signed contract. Verbal agreements are generally not enforceable, and contracts should include wording such as ''no oral representations apply'' to protect both parties from future misunderstandings. The contract should also establish baseline performance standards for data processing services and define each party's responsibilities and liabilities, where possible.

Although contracts between financial institutions and external data processing companies are not standardized in a form, they share a number of common elements. For a further discussion of IT contract elements and considerations, see the FFIEC's *IS Handbook*.

Additionally, section 225 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) states, ''An [FDIC-] insured depository institution may not enter into a written or oral contract with any person to provide goods, products or services to or for the benefit of such depository institution if the performance of such contract would adversely affect the safety or soundness of the institution.'' An institution should ascertain during contract negotiations whether the servicer can provide a level of service that meets the needs of the institution over the life of the contract. The institution is also responsible for making sure it accounts for each contract in accordance with GAAP. Regulatory agencies consider contracting for excessive servicing fees and/or failing to properly account for such transactions an unsafe and unsound practice. When entering into service agreements, banks must ensure that the method by which they account for such agreements reflects the substance of the transaction and not merely its form. See FFIEC Supervisory Policy SP-6, ''Interagency Statement on EDP Service Contracts.''

Risk of Termination

Many financial institutions have become so dependent on outside data processing servicers that any extended interruption or termination of service would severely disrupt normal operations. Termination of services generally occurs according to the terms of the service contract. Banks may also experience an interruption of services that is caused by a physical disaster to the servicer, such as a fire or flood, or by bankruptcy. The serviced institution must prepare differently for each type of termination. The contract should allow either party to terminate the agreement by notifying the other party 90 to 180 days in advance of the termination date, which should give a serviced institution adequate time to locate and contract with another servicer.

Termination caused by physical disaster occurs infrequently, but it may present the institution with a more serious problem than termination by contract. However, if the servicer has complied with basic industry standards and maintains a proper contingency plan, disruption of services to users will ordinarily be minimal. The contingency plan must require the servicer to maintain current data files and programs at an alternate site and arrange for back-up processing time with another data center. At a minimum, these provisions should allow the servicer to process the most important data applications. Since equipment vendors can often replace damaged machines within a few days, the servicer should be able to resume processing with little delay. The servicer, not the serviced institution, is responsible for the major provisions of its back-up contingency plan. However, the institution must have a plan that complements the servicer's.

Termination caused by bankruptcy of the servicer is potentially the most devastating to a serviced institution. There may not be advance notice of termination or an effective contingency plan (because servicer personnel may not be available). In this situation, the serviced institution is responsible for finding an alternate processing site.

Although user institutions can ordinarily obtain data files from a bankrupt servicer with little trouble, the programs (source code) and documentation required to process those files are normally owned by the servicer and are not available to the user institutions. These programs are often the servicer's only significant assets. Therefore, a creditor of a bankrupt servicer, in an attempt to recover outstanding debts, will seek to attach those assets and further limit their availability to user institutions. The bankruptcy court may provide remedies to the user institutions, but only after an extended length of time.

An escrow agreement is an alternative to giving vendors sole control of the source code. In this agreement, which should either be part of the service contract or a separate document, the financial institution would receive the right to access source programs under certain conditions, such as discontinued product support or the financial insolvency of the vendor. A third party would retain these programs and related documents in escrow. Periodically, the financial institution should determine that the source code maintained in escrow is up-to-date, for example, an independent party should verify the version number of the software. Without an escrow agreement, a serviced institution has two alternatives: (1) pay off the creditor and hire outside specialists to operate the center or (2) convert data files to another servicer. Either alternative is likely to be costly and cause severe operating delays.

Institutions should normally determine the financial viability of its servicer annually. Once the review is complete, management must report the results to the board of directors or a designated committee. At a minimum, management's review should contain a careful analysis of the servicer's annual financial statement. Management may also use other sources of information to determine a servicer's condition, such as investment analyst reports and bond ratings. Reports of independent auditors and examination reports for certain service providers obtainable from appropriate regulatory agencies may contain useful information.

AUTOMATED CLEARINGHOUSE

Automated clearinghouses (ACHs) form a nationwide electronic payments system used by a large number of depository institutions and corporations. ACH rules and regulations are established by the National Automated Clearing House Association (NACHA) and the local ACH associations, and they are referenced in the ACH operating circulars of the Federal Reserve Banks.

ACH is a value-based system that supports both credit and debit transactions. In ACH credit transactions, funds flow from the depository institution originating the transaction to the institutions receiving the transactions. Examples of credit payments include direct deposits of payroll, dividend and interest payments, Social Security payments, and corporate payments to contractors and vendors. In a debit transaction, funds flow from the depository institutions receiving the transaction instructions to the institution originating the transaction. Examples of ACH debit transactions include collection of insurance premiums, mortgage and loan payments, consumer bill payments, and transactions to facilitate corporate cash management. ACH transactions are deposited in batches at Federal Reserve Banks (or private-sector ACH processors) for processing one or two business days before the settlement date. These transactions are processed and delivered to the receiving institutions through the nightly processing cycle for a given day.

ACH transactions continue to grow significantly. Additional uses of the ACH continue to be developed as depository institutions, corporations, and consumers realize its efficiency and low cost compared with large-dollar payments systems and check payments. One area of growth is the use of debit transactions for the collection of large payments due to the originator, such as the cash concentration of a company's nationwide branch or subsidiary accounts into one central account and other recurring contractual payments.

While several organizations can be involved in processing ACH transactions, the Federal Reserve System is the principal ACH processor. For the Federal Reserve ACH system, depository institutions send ACH transactions to and receive ACH transactions from one of the Federal Reserve processing sites via a communications system linking each location. Access may be by direct computer interface or intelligent terminal connections.

As with any funds-transfer system, the ACH system has inherent risks, including error, credit risk, and fraud. When reviewing ACH activities, examiners should evaluate the following:

- agreements covering delivery and settlement arrangements maintained by the depository institution as an originator or receiver of ACH transactions
- monitoring of the institution's and customer's intraday positions
- balancing procedures of ACH transactions processed
- the credit policy and effectiveness of procedures to control intraday and overnight overdrafts, resulting from extensions of credit to an ACH customer, to cover the value of credit transfers originated (Since ACH transactions may be originated one or two days before the settlement date, the originating institution is exposed to risk from the time it submits ACH credit transfers to the ACH processor to the time its customer funds those transfers.)
- uncollected-funds controls and the related credit policy for deposits created through ACH debit transactions (ACH debits can be returned for insufficient funds in the payor's account or for other reasons, such as a court order.)
- exception reports (that is, large-item and new-account reports)
- control procedures for terminals through which additions, deletions, and other forms of maintenance could be made to customer databases
- the retention of all entries, return entries, and adjustment entries transmitted to and received from the ACH for a period of six years after the date of transmittal

RETAIL FUNDS-TRANSFER SYSTEMS

Automation has enabled banks to electronically perform many retail banking functions formerly handled manually by tellers, bookkeepers, data-entry clerks, and other banking personnel. Accordingly, the need for physical banking facilities and related staff has been reduced. Electronic funds transfer (EFT) and related banking services have also brought access to and control of accounts closer to the consumer through the use of widely distributed unmanned terminals and merchant facilities. EFT-related risk to a financial institution for individual customer transactions is generally low, since the transactions are usually for relatively small amounts. However, weaknesses in controls that could lead to incorrect or improper use of several accounts could lead to significant losses or class action suits against a financial institution. Examinations of retail EFT facilities should focus on the potential large-scale risks of a given product. Examples of retail EFT systems include automated teller machines, point-of-sale networks, debit and "smart" cards, and home banking.

Automated Teller Machines

An automated teller machine (ATM) is a terminal that is capable of performing many routine banking services for the customer. ATMs handle deposits, transfers between savings and checking accounts, balance inquiries, withdrawals, small short-term loans, and loan payments. ATMs may also handle other transactions, such as cash advances on credit cards, statement printing, and postage-stamp dispensing. ATMs usually operate 24 hours a day and are located not only on bank premises but in other locations, such as shopping malls and businesses. Daily withdrawals are usually, and should be, limited to relatively small amounts ($200 to $500). Deposits are processed in the same manner as if they were handled by a teller. ATMs are generally activated through the use of a plastic card encoded with a machine-readable customer identification number and the customer's entry of a corresponding personal identification number (PIN). Some financial institutions may refer to this identification number as the personal identification code (PIC).

ATMs operate in either off-line or on-line mode. Off-line transactions are those that occur when the customer's account balance is not available for verification. This situation can be the result of telecommunication problems between the financial institution and the ATM network. In addition, an off-line transaction can occur when a customer's account balance is not available because the financial institution is updating its files. Financial institutions usually update their files during low-volume periods. In either case, transactions are usually approved up to the daily withdrawal limit, which is a risk to the bank because a customer can withdraw more than is available in the account. On-line systems are directly connected to a financial institution's computer system and the corresponding customer account information. The computer processes each transaction immediately and provides immediate account-balance verification. With either system, a card is normally captured (kept by the ATM) if misuse is indicated (for example, the card has been reported stolen or too many attempts have been made with an invalid PIN).

Financial institutions are usually members of several ATM networks, which can be regional and national. Through these networks, separate institutions allow each other's customers to use their ATM machines. This is known as an interchange system. To be involved in an interchange system, a financial institution must either be an owner or member of the ATM network.

Fraud, robbery, and malfunction are the major risks of ATMs. The use of plastic cards and PINs are a deterrent, but there is still the risk that an unauthorized individual may obtain them. Customers may even be physically accosted while making withdrawals or deposits at ATM locations. Institutions have decreased this risk by installing surveillance cameras and access-control devices. For example, the ATM card can be used as an access-control device, unlocking the door to a separate ATM enclosure and relocking it after the customer has entered. Fraud may also result from risks associated with the issuance of ATM cards, the capture of cards, and the handling of customer PINs. Appropriate controls are needed to prevent the financial institution's personnel from unauthorized access to unissued cards, PINs, and captured cards.

Point-of-Sale Systems

A point-of-sale (POS) system transaction is defined as an electronic transfer of funds from a customer's checking or savings account to a merchant's account to pay for goods or services. Transactions are initiated from POS terminals located in department stores, supermarkets, gasoline stations, and other retail outlets. In an electronic POS system, a customer pays for purchases using a plastic card (such as an ATM, credit, or debit card). The store clerk enters the payment information into the POS terminal, and the customer verifies the transaction by entering a PIN. This results in a debit to the customer's account and a credit to the merchant's account.

POS transactions may be processed through either single-institution unshared systems or multi-institution shared networks. Participants in a shared system settle daily, on a net transaction basis, between each other. In unshared systems, the merchants and customers have accounts with the same financial institution. Thus, the need to settle between banks is eliminated.

As with other EFT systems, POS transactions are subject to the risk of loss from fraud, mistakes, and system malfunction. POS fraud is caused by stolen cards and PINs, counterfeit cards, and unauthorized direct computer access. The system is also susceptible to errors such as debiting or crediting an account by too much or too little, or entering unauthorized transactions. For the most part, POS systems usually deal with these risks by executing bank-merchant and bank-customer contracts that delineate each party's liabilities and responsibilities. Also, consumers are protected by state and federal statutes limiting their liability if they give notice of a lost, stolen, or mutilated card within a specified time period. Other risks inherent in POS systems are computer malfunction or downtime. Financial institutions offering POS services should provide for back-up of their records through adequate contingency planning. Internal control guidelines for POS systems should address the following:

- confidentiality and security of customer-account information, including protection of PINs
- maintenance of contracts between banks and merchants, customers and banks, and banks and networks
- policies and procedures for credit and check

authorization, floor limits, overrides, and settlement and balancing
- maintenance of transaction journals to provide an adequate audit trail
- generation and review of daily exception reports with provisions for follow-up of exception items
- provisions for back-up and contingency planning
- physical security surrounding POS terminals

Internal Controls for Retail EFT Systems

Regardless of the EFT system employed, financial institutions should ensure that adequate internal controls are in place to minimize errors, discourage fraud, and provide an adequate audit trail. Recommended internal-control guidelines for all systems include:

- establishing measures to establish proper customer identification (such as PINs) and maintain their confidentiality
- installing a dependable file-maintenance and retention system to trace transactions
- producing, reviewing, and maintaining exception reports to provide an audit trail

The most critical element of EFT systems is the need for undisputed identification of the customer. Particular attention should be given to the customer-identification systems. The most common control is the issuance of a unique PIN that is used in conjunction with a plastic card or, for noncard systems, an account number. The following PIN control guidelines, as recommended by the American Bankers Association, are encouraged.

Storage:

- PINs should not be stored on other source instruments (for example, plastic cards).
- Unissued PINs should never be stored before they are issued. They should be calculated when issued, and any temporary computer storage areas used in the calculation should be cleared immediately after use.
- PINs should be encrypted on all files and databases.

Delivery:

- PINs should not appear in printed form where they can be associated with customers' account numbers.
- Bank personnel should not have the capability to retrieve or display customers' PIN numbers.
- All the maintenance to PINs stored in databases should be restricted. Console logs and security reports should be reviewed to determine any attempts to subvert the PIN security system.
- PIN mailers should be processed and delivered with the same security accorded the delivery of bank cards to cardholders. (They should never be mailed to a customer together with the card).

Usage:

- The PIN should be entered only by the cardholder and only in an environment that deters casual observation of entries.
- The PIN should never be transmitted in unencrypted form.
- PIN systems should record the number of unsuccessful PIN entries and should restrict access to a customer's account after a limited number of attempts.
- If a PIN is forgotten, the customer should select a new one rather than have bank personnel retrieve the old one, unless the bank has the ability to generate and mail a hard copy of the PIN directly to the customer without giving bank personnel the ability to view the PIN.

Control and security:

- Systems should be designed, tested, and controlled to preclude retrieval of stored PINs in any form.
- Application programs and other software containing formulas, algorithms, and data used to calculate PINs must be subject to the highest level of access control for security purposes.
- Any data-recording medium, for example, magnetic tape and removable disks, used in the process of assigning, distributing, calculating, or encrypting PINs must be cleared immediately after use.
- Employees with access to PIN information must be subject to security clearance and must be covered by an adequate surety bond.

System design:

- PIN systems should be designed so that PINs can be changed without reissuing cards.
- PINs used on interchange systems should be designed so that they can be used or changed without any modification to other participants' systems.
- Financial institutions electing to use encryption as a security technique for bank card systems are strongly encouraged to consider the data encryption standards established by the National Institute of Standards and Technology.

In addition, institutions should consider controls over other aspects of the process. Control guidelines appropriate for plastic cards include those covering procurement, embossing or encoding, storage, and mailing. Controls over terminal sharing and network switching are also appropriate. Institutions should address backup procedures and practices for retail funds-transfer systems and insurance coverage for these activities.

APPENDIX A—RISK MANAGEMENT OF OUTSOURCED TECHNOLOGY SERVICES

The following guidance was issued by the Federal Financial Institutions Examination Council on November 28, 2000. (See SR-00-17.)

Purpose and Background

This statement focuses on the risk-management process of identifying, measuring, monitoring, and controlling the risks associated with outsourcing technology services.[1] Financial institutions should consider the guidance outlined in this statement and the attached appendix in managing arrangements with their technology service providers.[2] While this guidance covers a broad range of issues that financial institutions should address, each financial institution should apply those elements based on the scope and importance of the outsourced services as well as the risk to the institution from the services.

Financial institutions increasingly rely on services provided by other entities to support an array of technology-related functions. While outsourcing to affiliated or nonaffiliated entities can help financial institutions manage costs, obtain necessary expertise, expand customer product offerings, and improve services, it also introduces risks that financial institutions should address. This guidance covers four elements of a risk-management process: risk assessment, selection of service providers, contract review, and monitoring of service providers.[3]

Risk Assessment

The board of directors and senior management are responsible for understanding the risks associated with outsourcing arrangements for technology services and ensuring that effective risk-management practices are in place. As part of this responsibility, the board and management should assess how the outsourcing arrangement will support the institution's objectives and strategic plans and how the service provider's relationship will be managed. Without an effective risk-assessment phase, outsourcing technology services may be inconsistent with the institution's strategic plans, too costly, or introduce unforeseen risks.

Outsourcing of information and transaction processing and settlement activities involves risks that are similar to the risks that arise when these functions are performed internally. Risks include threats to security, availability and integrity of systems and resources, confidentiality of information, and regulatory compliance. In addition, the nature of the service provided, such as bill payment, funds transfer, or emerging

1. The FFIEC Information Systems Examination Handbook is a reference source that contains further discussion and explanation of a number of concepts addressed in this FFIEC guidance.

2. Technology service providers encompass a broad range of entities including but not limited to affiliated entities, nonaffiliated entities, and alliances of companies providing products and services. This may include but is not limited to core processing; information and transaction processing and settlement activities that support banking functions such as lending, deposit-taking, funds transfer, fiduciary, or trading activities; Internet-related services; security monitoring; systems development and maintenance; aggregation services; digital certification services; and call centers.

3. The federal banking agencies have authority to regulate and examine services provided to insured depository institutions under 12 USC 1867(c), 12 USC 1786(a), and 12 USC 1464(d)(7).

electronic services, may result in entities performing transactions on behalf of the institution, such as collection or disbursement of funds, that can increase the levels of credit, liquidity, transaction, and reputation risks.[4]

Management should consider additional risk-management controls when services involve the use of the Internet. The broad geographic reach, ease of access, and anonymity of the Internet require close attention to maintaining secure systems; intrusion detection and reporting systems; and customer authentication, verification, and authorization. Institutions should also understand that the potential risks introduced are a function of a system's structure, design, and controls and not necessarily the volume of activity.

An outsourcing risk assessment should consider the following:

- strategic goals, objectives, and business needs of the financial institution
- ability to evaluate and oversee outsourcing relationships
- importance and criticality of the services to the financial institution
- defined requirements for the outsourced activity
- necessary controls and reporting processes
- contractual obligations and requirements for the service provider
- contingency plans, including availability of alternative service providers, costs, and resources required to switch service providers
- ongoing assessment of outsourcing arrangements to evaluate consistency with strategic objectives and service-provider performance
- regulatory requirements and guidance for the business lines affected and technologies used

Due Diligence in Selecting a Service Provider

Once the institution has completed the risk assessment, management should evaluate service providers to determine their ability, both operationally and financially, to meet the institution's needs. Management should convey the institution's needs, objectives, and necessary controls to the potential service provider. Management also should discuss provisions that the contract should contain. The appendix to this statement contains some specific factors for management to consider in selecting a service provider.

Contract Issues

Contracts between the institution and service provider should take into account business requirements and key risk factors identified during the risk-assessment and due-diligence phases. Contracts should be clearly written and sufficiently detailed to provide assurances for performance, reliability, security, confidentiality, and reporting. Management should consider whether the contract is flexible enough to allow for changes in technology and the financial institution's operations. Appropriate legal counsel should review contracts prior to signing.

Institutions may encounter situations where service providers cannot or will not agree to terms that the institution requests to manage the risk effectively. Under these circumstances, institutions should either not contract with that provider or supplement the service provider's commitments with additional risk-mitigation controls. The appendix to this statement contains some specific considerations for management in contracting with a service provider.

Service-Provider Oversight

Institutions should implement an oversight program to monitor each service provider's controls, condition, and performance. Responsibility for the administration of the service-provider relationship should be assigned to personnel with appropriate expertise to monitor and manage the relationship. The number of personnel, functional responsibilities, and the amount of time devoted to oversight activities will depend, in part, on the scope and complexity of the services outsourced. Institutions should document the administration of the service-provider relationship. Documenting the process is important for contract negotiations, termination issues, and contingency planning. The appendix to this statement contains some specific factors to consider regarding oversight of the service provider.

4. For example, emerging electronic services may include aggregation. Aggregation is a service that gathers online account information from many web sites and presents that information in a consolidated format to the customer.

Summary

The board of directors and management are responsible for ensuring adequate risk-mitigation practices are in place for effective oversight and management of outsourcing relationships. Financial institutions should incorporate an outsourcing risk-management process that includes a risk assessment to identify the institution's needs and requirements; proper due diligence to identify and select a provider; written contracts that clearly outline duties, obligations, and responsibilities of the parties involved; and ongoing oversight of outsourcing technology services.

Appendix—Risk Management of Outsourced Technology Services

Due Diligence in Selecting a Service Provider

Some of the factors that institutions should consider when performing due diligence in selecting a service provider are categorized and listed below. Institutions should review the service provider's due-diligence process for any of its significant supporting agents (i.e., subcontractors, support vendors, and other parties). Depending on the services being outsourced and the level of in-house expertise, institutions should consider whether to hire or consult with qualified independent sources. These sources include consultants, user groups, and trade associations that are familiar with products and services offered by third parties. Ultimately, the depth of due diligence will vary depending on the scope and importance of the outsourced services as well as the risk to the institution from these services.

Technical and industry expertise.

- Assess the service provider's experience and ability to provide the necessary services and supporting technology for current and anticipated needs.
- Identify areas where the institution would have to supplement the service provider's expertise to fully manage risk.
- Evaluate the service provider's use of third parties or partners that would be used to support the outsourced operations.
- Evaluate the experience of the service provider in providing services in the anticipated operating environment.
- Consider whether additional systems, data conversions, and work are necessary.
- Evaluate the service provider's ability to respond to service disruptions.
- Contact references and user groups to learn about the service provider's reputation and performance.
- Evaluate key service-provider personnel that would be assigned to support the institution.
- Perform on-site visits, where necessary, to better understand how the service provider operates and supports its services.

Operations and controls.

- Determine adequacy of the service provider's standards, policies, and procedures relating to internal controls, facilities management (e.g., access requirements, sharing of facilities, etc.), security (e.g., systems, data, equipment, etc.), privacy protections, maintenance of records, business-resumption contingency planning, systems development and maintenance, and employee background checks.
- Determine if the service provider provides sufficient security precautions, including, when appropriate, firewalls, encryption, and customer-identity authentication, to protect institution resources as well as detect and respond to intrusions.
- Review audit reports of the service provider to determine whether the audit scope, internal controls, and security safeguards are adequate.
- Evaluate whether the institution will have complete and timely access to its information maintained by the provider.
- Evaluate the service provider's knowledge of regulations that are relevant to the services they are providing (e.g., Regulation E, privacy and other consumer protection regulations, Bank Secrecy Act, etc.).
- Assess the adequacy of the service provider's insurance coverage including fidelity, fire, liability, data losses from errors and omissions, and protection of documents in transit.

Financial condition.

- Analyze the service provider's most recent audited financial statements and annual report as well as other indicators (e.g., publicly

traded bond ratings), if available.
- Consider factors such as how long the service provider has been in business and the service provider's market share for a given service and how it has fluctuated.
- Consider the significance of the institution's proposed contract on the service provider's financial condition.
- Evaluate technological expenditures. Is the service provider's level of investment in technology consistent with supporting the institution's activities? Does the service provider have the financial resources to invest in and support the required technology?

Contract Issues

Some considerations for contracting with service providers are discussed below. This listing is not all-inclusive, and the institution may need to evaluate other considerations based on its unique circumstances. The level of detail and relative importance of contract provisions varies with the scope and risks of the services outsourced.

Scope of service. The contract should clearly describe the rights and responsibilities of parties to the contract. Considerations include—

- time frames and activities for implementation and assignment of responsibility (implementation provisions should take into consideration other existing systems or interrelated systems to be developed by different service providers (e.g., an Internet banking system being integrated with existing core applications or systems customization));
- services to be performed by the service provider including duties such as software support and maintenance, training of employees, or customer service;
- obligations of the financial institution;
- the contracting parties' rights in modifying existing services performed under the contract; and
- guidelines for adding new or different services and for contract renegotiation.

Performance standards. Institutions should generally include performance standards defining minimum service-level requirements and remedies for failure to meet standards in the contract. For example, common service-level metrics include percent system uptime, deadlines for completing batch processing, or number of processing errors. Industry standards for service levels may provide a reference point. The institution should periodically review overall performance standards to ensure consistency with its goals and objectives.

Security and confidentiality. The contract should address the service provider's responsibility for security and confidentiality of the institution's resources (e.g., information, hardware). The agreement should prohibit the service provider and its agents from using or disclosing the institution's information, except as necessary to or consistent with providing the contracted services, to protect against unauthorized use (e.g., disclosure of information to institution competitors). If the service provider receives nonpublic personal information regarding the institution's customers, the institution should notify the service provider to assess the applicability of the privacy regulations. Institutions should require the service provider to fully disclose breaches in security resulting in unauthorized intrusions into the service provider that may materially affect the institution or its customers. The service provider should report to the institution when material intrusions occur, the effect on the institution, and corrective action to respond to the intrusion.

Controls. Consideration should be given to contract provisions addressing control over operations such as—

- internal controls to be maintained by the service provider;
- compliance with applicable regulatory requirements;
- records to be maintained by the service provider;
- access to the records by the institution;
- notification by the service provider to the institution and the institution's approval rights regarding material changes to services, systems, controls, key project personnel allocated to the institution, and new service locations;
- setting and monitoring of parameters relating to any financial functions, such as payments processing and any extensions of credit on behalf of the institution; and
- insurance coverage to be maintained by the service provider.

Audit. The institution should generally include in the contract the types of audit reports the institution is entitled to receive (e.g., financial, internal control, and security reviews). The contract can specify audit frequency, cost to the institution associated with the audits if any, as well as the rights of the institution and its agencies to obtain the results of the audits in a timely manner. The contract may also specify rights to obtain documentation regarding the resolution of audit-disclosed deficiencies and inspect the processing facilities and operating practices of the service provider. Management should consider, based upon the risk-assessment phase, the degree to which independent internal audits completed by service-provider audit staff can be used and the need for external audits and reviews (e.g., SAS 70 type I and II reviews).[5]

For services involving access to open networks, such as Internet-related services, special attention should be paid to security. The institution may wish to include contract terms requiring periodic audits to be performed by an independent party with sufficient expertise. These audits may include penetration testing, intrusion detection, and firewall configuration. The institution should receive sufficiently detailed reports on the findings of these ongoing audits to adequately assess security without compromising the service provider's security. It can be beneficial to both the service provider and the institution to contract for such ongoing tests on a coordinated basis given the number of institutions that may contract with the service provider and the importance of the test results to the institution.

Reports. Contractual terms should discuss the frequency and type of reports the institution will receive (e.g., performance reports, control audits, financial statements, security, and business-resumption testing reports). Guidelines and fees for obtaining custom reports should also be discussed.

Business-resumption and contingency plans. The contract should address the service provider's responsibility for backup and record protection, including equipment, program and data files, and maintenance of disaster-recovery and contingency plans. Responsibilities should include testing of the plans and providing results to the institution. The institution should consider interdependencies among service providers when determining business-resumption testing requirements. The service provider should provide the institution with operating procedures the service provider and institution are to implement in the event business-resumption contingency plans are implemented. Contracts should include specific provisions for business-recovery time frames that meet the institution's business requirements. The institution should ensure that the contract does not contain any provisions that would excuse the service provider from implementing its contingency plans.

Subcontracting and multiple-service-provider relationships. Some service providers may contract with third parties in providing services to the financial institution. To provide accountability, it may be beneficial for the financial institution to seek an agreement with and designate a primary contracting service provider. The institution may want to consider including a provision specifying that the contracting service provider is responsible for the service provided to the institution regardless of which entity is actually conducting the operations. The institution may also want to consider including notification and approval requirements regarding changes to the service provider's significant subcontractors.

Cost. The contract should fully describe fees and calculations for base services, including any development, conversion, and recurring services, as well as any charges based upon volume of activity and for special requests. Cost and responsibility for purchase and maintenance of hardware and software may also need to be addressed. Any conditions under which the cost structure may be changed should be addressed in detail including limits on any cost increases.

Ownership and license. The contract should address ownership and allowable use by the service provider of the institution's data, equipment/hardware, system documentation, system and application software, and other intellectual property rights. Other intellectual property rights may include the institution's name and logo, its trademark or copyrighted material,

5. AICPA Statement of Auditing Standards 70, "Reports of Processing of Transactions by Service Organizations," known as SAS 70 reports, are one commonly used form of external review. Type I SAS 70 reports review the service provider's policies and procedures. Type II SAS 70 reports provide tests of actual controls against policies and procedures.

domain names, web site designs, and other work products developed by the service provider for the institution. The contract should not contain unnecessary limitations on the return of items owned by the institution. Institutions that purchase software should consider establishing escrow agreements. These escrow agreements may provide for the following: institution access to source programs under certain conditions (e.g., insolvency of the vendor), documentation of programming and systems, and verification of updated source code.

Duration. Institutions should consider the type of technology and current state of the industry when negotiating the appropriate length of the contract and its renewal periods. While there can be benefits to long-term technology contracts, certain technologies may be subject to rapid change and a shorter-term contract may prove beneficial. Similarly, institutions should consider the appropriate length of time required to notify the service provider of the institutions' intent not to renew the contract prior to expiration. Institutions should consider coordinating the expiration dates of contracts for interrelated services (e.g., web site, telecommunications, programming, network support) so that they coincide, where practical. Such coordination can minimize the risk of terminating a contract early and incurring penalties as a result of necessary termination of another related service contract.

Dispute resolution. The institution should consider including in the contract a provision for a dispute-resolution process that attempts to resolve problems in an expeditious manner as well as provide for continuation of services during the dispute-resolution period.

Indemnification. Indemnification provisions generally require the financial institution to hold the service provider harmless from liability for the negligence of the institution and vice versa. These provisions should be reviewed to reduce the likelihood of potential situations in which the institution may be liable for claims arising as a result of the negligence of the service provider.

Limitation of liability. Some service-provider standard contracts may contain clauses limiting the amount of liability that can be incurred by the service provider. If the institution is considering such a contract, consideration should be given to whether the damage limitation bears an adequate relationship to the amount of loss the financial institution might reasonably experience as a result of the service provider's failure to perform its obligations.

Termination. The extent and flexibility of termination rights sought can vary depending upon the service. Contracts for technologies subject to rapid change, for example, may benefit from greater flexibility in termination rights. Termination rights may be sought for a variety of conditions including change in control (e.g., acquisitions and mergers), convenience, substantial increase in cost, repeated failure to meet service levels, failure to provide critical services, bankruptcy, company closure, and insolvency.

Institution management should consider whether or not the contract permits the institution to terminate the contract in a timely manner and without prohibitive expense (e.g., reasonableness of cost or penalty provisions). The contract should state termination and notification requirements with time frames to allow the orderly conversion to another provider. The contract must provide for return of the institution's data, as well as other institution resources, in a timely manner and in machine-readable format. Any costs associated with transition assistance should be clearly stated.

Assignment. The institution should consider contract provisions that prohibit assignment of the contract to a third party without the institution's consent, including changes to subcontractors.

Oversight of Service Provider

Some of the oversight activities management should consider in administering the service-provider relationship are categorized and listed below. The degree of oversight activities will vary depending upon the nature of the services outsourced. Institutions should consider the extent to which the service provider conducts similar oversight activities for any of its significant supporting agents (i.e., subcontractors, support vendors, and other parties) and the extent to which the institution may need to perform oversight activities on the service provider's significant supporting agents.

Monitor financial condition and operations.

- Evaluate the service provider's financial condition periodically.
- Ensure that the service provider's financial obligations to subcontractors are being met in a timely manner.
- Review audit reports (e.g., SAS 70 reviews, security reviews) as well as regulatory examination reports, if available, and evaluate the adequacy of the service provider's systems and controls including resource availability, security, integrity, and confidentiality.[6]
- Follow up on any deficiencies noted in the audits and reviews of the service provider.
- Periodically review the service provider's policies relating to internal controls, security, systems development and maintenance, and backup and contingency planning to ensure they meet the institution's minimum guidelines, contract requirements, and are consistent with the current market and technological environment.
- Review access control reports for suspicious activity.
- Monitor changes in key service-provider project personnel allocated to the institution.
- Review and monitor the service provider's insurance policies for effective coverage.
- Perform on-site inspections in conjunction with some of the reviews performed above, where practicable and necessary.
- Sponsor coordinated audits and reviews with other client institutions.

Assess quality of service and support.

- Regularly review reports documenting the service provider's performance. Determine if the reports are accurate and allow for a meaningful assessment of the service provider's performance.
- Document and follow up on any problem in service in a timely manner. Assess service-provider plans to enhance service levels.
- Review system-update procedures to ensure appropriate change controls are in effect and ensure authorization is established for significant system changes.
- Evaluate the provider's ability to support and enhance the institution's strategic direction including anticipated business-development goals and objectives, service-delivery requirements, and technology initiatives.
- Determine adequacy of training provided to financial institution employees.
- Review customer complaints on the products and services provided by the service provider.
- Periodically meet with contract parties to discuss performance and operational issues.
- Participate in user groups and other forums.

Monitor contract compliance and revision needs.

- Review invoices to ensure proper charges for services rendered, the appropriateness of rate changes, and new service charges.
- Periodically review the service provider's performance relative to service-level agreements, determine whether other contractual terms and conditions are being met, and whether any revisions to service-level expectations or other terms are needed given changes in the institution's needs and technological developments.
- Maintain documents and records regarding contract compliance, revision, and dispute resolution.

Maintain business-resumption contingency plans.

- Review the service provider's business-resumption contingency plans to ensure that any services considered mission critical for the institution can be restored within an acceptable time frame.
- Review the service provider's program for contingency-plan testing. For many critical services, annual or more frequent tests of the contingency plan are typical.
- Ensure service-provider interdependencies are considered for mission-critical services and applications.

6. Some services provided to insured depository institutions by service providers are examined by the FFIEC member agencies. Regulatory examination reports, which are only available to clients/customers of the service provider, may contain information regarding a service provider's operations. However, regulatory reports are not a substitute for a financial institution's due diligence in oversight of the service provider.

APPENDIX B—INTERAGENCY GUIDELINES ESTABLISHING INFORMATION SECURITY STANDARDS

Sections II and III of the information security standards are provided below. For more information, see the Interagency Guidelines Establishing Information Security Standards, in Regulation H, section 208, appendix D-2 (12 CFR 208, appendix D-2). The guidelines were previously titled Interagency Guidelines Establishing Standards for Safeguarding Customer Information. The information security standards were amended, effective July 1, 2005, to implement section 216 of the Fair and Accurate Credit Transactions Act of 2003 (the FACT Act). To address the risks associated with identity theft, the amendments generally require financial institutions to develop, implement, and maintain, as part of their existing information security program, appropriate measures to properly dispose of consumer information derived from consumer reports. The term *consumer information* is defined in the revised rule.

II. Standards for Safeguarding Customer Information

A. Information Security Program

Each bank is to implement a comprehensive written information security program that includes administrative, technical, and physical safeguards appropriate to the size and complexity of the bank and the nature and scope of its activities. While all parts of the bank are not required to implement a uniform set of policies, all elements of the information security program are to be coordinated. A bank is also to ensure that each of its subsidiaries is subject to a comprehensive information security program. The bank may fulfill this requirement either by including a subsidiary within the scope of the bank's comprehensive information security program or by causing the subsidiary to implement a separate comprehensive information security program in accordance with the standards and procedures in sections II and III that apply to banks.

B. Objectives

A bank's information security program shall be designed to—

1. ensure the security and confidentiality of customer information;
2. protect against any anticipated threats or hazards to the security or integrity of such information;
3. protect against unauthorized access to or use of such information that could result in substantial harm or inconvenience to any customer; and
4. ensure the proper disposal of customer information and consumer information.

III. Development and Implementation of Information Security Program

A. Involve the Board of Directors

The board of directors or an appropriate committee of the board of each bank is to—

1. approve the bank's written information security program; and
2. oversee the development, implementation, and maintenance of the bank's information security program, including assigning specific responsibility for its implementation and reviewing reports from management.

B. Assess Risk

Each bank is to—

1. identify reasonably foreseeable internal and external threats that could result in unauthorized disclosure, misuse, alteration, or destruction of customer information or customer information systems;
2. assess the likelihood and potential damage of these threats, taking into consideration the sensitivity of customer information;
3. assess the sufficiency of policies, procedures, customer information systems, and other arrangements in place to control risks; and
4. ensure the proper disposal of customer information and consumer information.

C. Manage and Control Risk

Each bank is to—

1. Design its information security program to control the identified risks, commensurate with the sensitivity of the information as well as the complexity and scope of the bank's activities. Each bank must consider whether the following security measures are appropriate for the bank and, if so, adopt those measures the bank concludes are appropriate:
   a. access controls on customer information systems, including controls to authenticate and permit access only to authorized individuals and controls to prevent employees from providing customer information to unauthorized individuals who may seek to obtain this information through fraudulent means
   b. access restrictions at physical locations containing customer information, such as buildings, computer facilities, and records storage facilities to permit access only to authorized individuals
   c. encryption of electronic customer information, including while in transit or in storage on networks or systems to which unauthorized individuals may have access
   d. procedures designed to ensure that customer information system modifications are consistent with the bank's information security program
   e. dual control procedures, segregation of duties, and employee background checks for employees with responsibilities for or access to customer information
   f. monitoring systems and procedures to detect actual and attempted attacks on or intrusions into customer information systems
   g. response programs that specify actions to be taken when the bank suspects or detects that unauthorized individuals have gained access to customer information systems, including appropriate reports to regulatory and law enforcement agencies
   h. measures to protect against destruction, loss, or damage of customer information due to potential environmental hazards, such as fire and water damage or technological failures
2. Train staff to implement the bank's information security program.
3. Regularly test the key controls, systems, and procedures of the information security program. The frequency and nature of such tests should be determined by the bank's risk assessment. Tests should be conducted or reviewed by independent third parties or staff independent of those that develop or maintain the security programs.
4. Develop, implement, and maintain, as part of its information security program, appropriate measures to properly dispose of customer information and consumer information in accordance with each of the requirements in this section III.

D. Oversee Service-Provider Arrangements

Each bank is to—

1. exercise appropriate due diligence in selecting its service providers;
2. require its service providers by contract to implement appropriate measures designed to meet the objectives of the information security standards; and
3. where indicated by the bank's risk assessment, monitor its service providers to confirm that they have satisfied their obligations with regard to the requirements for overseeing provider arrangements. As part of this monitoring, a bank should review audits, summaries of test results, or other equivalent evaluations of its service providers.

E. Adjust the Program

Each bank is to monitor, evaluate, and adjust, as appropriate, the information security program in light of any relevant changes in technology, the sensitivity of its customer information, internal or external threats to information, and the bank's own changing business arrangements, such as mergers and acquisitions, alliances and joint ventures, outsourcing arrangements, and changes to customer information systems.

F. Report to the Board

Each bank is to report to its board or an appropriate committee of the board at least annually. This report should describe the overall status of the information security program and the bank's compliance with the information security standards. The reports should discuss material matters related to its program, addressing issues such as risk assessment; risk management and control decisions; service-provider arrangements; results of testing; security breaches or violations and management's responses; and recommendations for changes in the information security program.

G. Implement the Standards

(For the effective dates, see 12 CFR 208, appendix D-2, section III.G.)

1. To explicitly consider IT when developing risk assessments and supervisory plans.
2. To assess the types and levels of risks associated with information technology.
3. To exercise appropriate judgment in determining the level of review, given the characteristics, size, and business activities of the organization.
4. To develop a broad understanding of the organization's approach, strategy, and structure for IT activities within and across business lines.
5. To assess the adequacy of IT architecture and the ability of the current infrastructure to meet operating objectives, including the effective integration of systems and sources of data.
6. To assess the adequacy of the system of controls to safeguard the integrity of the data processed in critical information systems.
7. To determine if the board has developed, implemented, and tested contingency plans that will ensure the continued operation of the institution's critical information systems.
8. To ensure that operating procedures and controls are commensurate with the potential for and risks associated with security breaches, which may be either physical or electronic, inadvertent or intentional, or internal or external.
9. To determine the scope and adequacy of the IT audit function.
10. To evaluate IT outsourcing risk and outsourcing arrangements involving major lines of business.
11. To determine if the institution is complying with its written information security program and the minimum governing interagency standards on information security; the guidelines on the proper disposal of consumer information; and all applicable laws, rules, and regulations.
12. To find out if the financial institution (the bank and its respective operating subsidiaries) has developed, implemented, and maintained a written Identity Theft Prevention Program (Program) for its new and existing accounts that are covered by the Fair and Accurate Transactions Act of 2003 (FACT Act) and the Federal Reserve Board's rules on Fair Credit Reporting, section 222, Subpart J—Identity Theft Red Flags (12 CFR 222, Subpart J), which implements provisions of the FACT Act.
13. To make a determination of whether the financial institution's Program is
    a. designed to detect, prevent, and mitigate identity theft in connection with the opening of a new, or an existing, covered account and that the Program includes the detection of relevant Red Flags;[1] and
    b. appropriate to the size and complexity of the financial institution and the nature and scope of its activities.
14. To ascertain whether the financial institution assesses the validity of change of address notifications that it receives for the credit and debit cards that it has issued to customers.
15. To prepare comments for the report of examination on significant deficiencies and recommended corrective action.
16. To assign a Uniform Rating System for Information Technology (URSIT) rating or determine the impact of IT risks on the CAMELS or risk ratings.
17. To update the workpapers with any information that will facilitate future examinations.

1. Red Flag means a pattern, practice, or specific activity that indicates the possible existence of identity theft.

1. Determine the role and importance of IT to the organization and whether any unique IT characteristics or issues exist. Identify and list or update the major automated banking applications. For those applications processed by outside service providers, indicate the name and location of each service provider.
2. Incorporate an analysis of IT activities into risk assessments, supervisory plans, and scope memoranda, considering the size, activities, and complexity of the organization, as well as the degree of reliance on these systems across particular business lines.
3. Assess the organization's critical IT systems—those that support its major business activities—and the degree of reliance those activities have on IT systems. (See the *FFIEC Information Systems Examination Handbook* for more information on reviewing the IT function.)
4. Determine if the systems are delivering the services necessary for the organization to conduct its business in a safe and sound manner.
5. Determine whether the board of directors and senior management are adequately identifying, measuring, monitoring, and controlling risks associated with IT for the overall organization and its major business activities.
6. Determine if the IT strategy for the significant business activities or the organization is consistent with the organization's mission and business objectives. Determine whether the IT function has effective management processes to execute that strategy.
7. Review the reliability, accuracy, and completeness of information delivered in key business lines.
8. Review the bank's information security program. Assess the adequacy of the organization's policies, procedures, and controls, as well as its compliance with them.
9. Determine the capability of backup systems, as presented in contingency plans, to mitigate business disruption.
10. Ascertain the quality and adequacy of the internal or external IT audit function or any independent application reviews to ensure the integrity, security, and availability of the organization's systems.
11. Complete or update the information technology internal control questionnaire (section 4060.4) for the specific applications identified in step 1 of these procedures, noting any of the following:
    a. internal control exceptions and noncompliance with written policies, practices, and procedures
    b. violations of law
    c. exceptions to IT-servicing contracts
    d. overall evaluation of services provided to the bank, including any problems experienced with the servicer
12. Complete or update the "Establishing Information Security Standards" portion of the internal control questionnaire. (See section 4060.4.) Examiners should use this information to assess an institution's compliance with the interagency information security standards and the guidelines for the proper disposal of consumer information. Depending on the nature of the institution's operations and the extent of prior supervisory review, all questions may not need to be answered fully. Other examination resources may also be used (for example, the *FFIEC Information Systems Examination Handbook*). Examiners should conduct a review that is a sufficient basis for evaluating the overall written information security program of the institution and its compliance with the interagency guidelines.
13. Verify that the financial institution has determined initially, and periodically thereafter, whether it offers or maintains accounts covered by the Fair and Accurate Transactions Act of 2003 (FACT Act) and section 222, Subpart J—Identity Theft Red Flags of the Board's rules on Fair Credit Reporting (12 CFR 222, Subpart J).
14. Determine if the financial institution has adequately developed and maintains a written Identity Theft Prevention Program (Program) that is designed to detect, prevent, and monitor transactions to mitigate identity theft in connection with the opening of certain new and existing accounts covered by the FACT Act.

15. Evaluate whether the Program includes reasonable policies and procedures to
    a. identify and detect relevant Red Flags[1] for the financial institution's covered accounts and whether it incorporated those Red Flags into its Program;
    b. respond appropriately to any detected Red Flags to prevent and mitigate identity theft; and
    c. ensure that the program is updated periodically to reflect changes in identity theft risks to customers and the safety and soundness of the financial institution.
16. If a required Program has been established by the financial institution, ascertain if it has provided for the Program's continued administration, including
    a. involving the board of directors, an appropriate committee thereof, or a designated employee at the level of senior management in the continued oversight, development, implementation, and administration of the Program;
    b. training staff, as necessary, to effectively implement the Program; and
    c. appropriate and effective oversight of service provider arrangements; and
17. If the financial institution has established and maintains a required Program that applies to its covered accounts, determine if the institution's Program includes the relevant and appropriate guidelines within the rule's appendix J (12 CFR 222, appendix J).
18. Determine whether the institution's controls over outsourcing information- and transaction-processing activities are adequate. Evaluate the adequacy of controls over outsourcing arrangements in the following areas:
    a. outsourcing risk assessment
    b. selection of service providers
    c. contracts
    d. policies, procedures, and controls
    e. ongoing monitoring
    f. information access
    g. audit
    h. contingency plan
19. Determine whether the bank has properly notified the Federal Reserve Bank of new outsourced services in accordance with the Bank Service Corporation Act (12 USC 1865).
20. Review any recent IT reports of examination on the institution's service providers performed by the Federal Reserve or other regulatory authorities, and note any deficiencies. Obtain a listing of any deficiencies noted in the latest audit review. Determine that all deficiencies have been properly corrected.
21. For banks with material in-house processing, use the Uniform Rating System for Information Technology (URSIT) rating system to help evaluate the entity's overall risk exposure and risk-management performance. Evaluate the areas identified within each relevant URSIT component to assess the institution's ability to identify, measure, monitor, and control IT risks.
22. Determine the extent of supervisory attention needed to ensure that IT weaknesses are addressed and that associated risk is properly managed. Determine the impact on CAMELS, the operational-risk rating, and any other risk ratings.
23. Prepare comments for the report of examination on any significant deficiencies and recommended corrective action.
24. Update the workpapers with any information that will facilitate future examinations.

1. Red Flag means a pattern, practice, or specific activity that indicates the possible existence of identity theft.

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

SERVICER SELECTION

1. Before entering into any service arrangement, did management consider—
   a. alternative servicers and related costs?
   b. the financial stability of the servicer?
   c. the control environment at the data center?
   d. emergency backup provisions?
   e. the ability of the servicer to handle future processing requirements?
   f. requirements for termination of service?
   g. the quality of reports?
   h. insurance requirements?
2. Is there an annual reevaluation of the servicer's performance that includes—
   a. its financial condition?
   b. costs?
   c. its ability to meet future needs?
   d. its quality of service?

CONTRACTS

*1. Is each automated application covered by a written contract?
*2. Were contracts reviewed by legal counsel?
3. Does each service contract cover the following areas:
   a. ownership and confidentiality of files and programs?
   b. liability limits for errors and omissions?
   c. frequency, content, and format of input and output?
   d. the fee structure, including—
      • current fees?
      • provisions for changing fees?
      • fees for special requests?
   e. provisions for backup and record protection?
   f. the notice required (by either party) for termination of service and the return of customer records in a machine-readable form?
   g. time schedules for receipt and delivery of work, including processing priorities?
   h. the insurance carried by the servicer?
   i. liability for documents in transit?
   j. audit responsibility?
   k. a provision to supply the serviced institution with yearly financial statements (preferably audited with both consolidated and unconsolidated figures when applicable)?

INSURANCE

*1. Does the serviced institution's insurance coverage include the following provisions:
   a. extended blanket bond fidelity coverage to employees of the servicer?
   b. insurance on documents in transit, including the cash letter?
   c. if the serviced institution is relying on the servicer or an independent courier for the insurance described above, is adequate evidence of that coverage on file?

OPERATIONAL CONTROLS

*1. Are duties adequately separated for the following functions:
   a. input preparation?
   b. operation of data-entry equipment?
   c. preparation of rejects and unposted items for reentry?
   d. reconcilement of output to input?
   e. output distribution?
   f. reconcilement of output to general ledger?
   g. posting general ledger?
2. Are employee duties periodically rotated for control and training purposes?
3. Do supervisors or officers—
   a. adequately review exception reports?
   b. approve adjusting entries?

4. Are servicer personnel prohibited from initiating transactions or correcting data?
5. Are individuals prohibited from initiating or authorizing a transaction and then executing it?
6. Are employees at the serviced institution required to be absent from their duties (by vacation or job rotation) for two consecutive weeks?
7. Are master-file changes—
   a. requested in writing?
   b. approved by a supervisor?
   c. verified as correct after processing?

*8. Are exception reports prepared for—
   a. unposted and rejected items?
   b. supervisory-override transactions?
   c. master-file changes (before and after)?
   d. dormant-account activity?

*9. Does each user department—
   a. establish dollar and nondollar control totals before they are sent for processing?
   b. receive all scheduled output reports even when the reports contain no activity?
   c. review all output and exception reports?

*10. Are current user manuals available for each application, and do employees use them?

11. Does each user manual cover—
    a. preparation and control of source documents?
    b. control, format, and use of output?
    c. settlement and reconcilement procedures?
    d. error-correction procedures?
12. Are users satisfied with the servicer's performance and output reports? (If not, explain.)
13. Are computer-generated entries subsequently reviewed and approved by appropriate officials?

*14. Does the serviced institution copy all source documents, including cash letters, on microfilm before they leave the premises? If so—
   a. is the microfilm stored in a secure location with limited access?
   b. is an inventory and usage log maintained?

COMMUNICATION CONTROLS

*1. Is user access to the data communication network controlled by—
   a. user number?
   b. physical keys?
   c. passwords?
   d. other safeguards (explain)?

2. Are periodic changes made to numbers, keys, or passwords, and are they adequately controlled?
3. Are identification numbers or passwords suppressed on all printed output and video displays?
4. Are terminals controlled as to—
   a. what files can be accessed?
   b. what transactions can be initiated?
   c. specific hours of operations?
5. Do controls over restricted transactions and overrides include—
   a. supervisory approval?
   b. periodic management review?

*6. Are there exception reports that indicate—
   a. all transactions made at a terminal?
   b. all transactions made by an operator?
   c. restricted transactions?
   d. correcting and reversing entries?
   e. dates and times of transactions?
   f. unsuccessful attempts to gain access to the system or to restricted information?
   g. unusual activity?

7. Overall, are there adequate procedures in effect that prevent unauthorized use of the data communication systems?
8. To back up online systems—
   a. are offline capabilities available (explain)?
   b. are the offline capabilities periodically tested?

AUDITING

1. Is there an internal auditor or member of management not directly involved in EDP activities who has been assigned responsibility for the audit function?
2. Does that individual have any specialized audit or EDP training?
3. Are there written internal audit standards and procedures that require—
   a. review of all automated applications?
   b. reports to the board of directors?
   c. audit workpapers?
4. Does the person responsible for the

audit function perform the following procedures:
   a. test the balancing procedures of all automated applications, including the disposition of rejected and unposted items?
   b. periodically sample master-file information to verify it against source documents?
   c. spot-check computer calculations, such as interest on deposits, loans, securities, loan rebates, service charges, and past-due loans?
   d. verify output report totals?
   e. check accuracy of exception reports?
   f. review master-file changes for accuracy and authorization?
   g. trace transactions to final disposition to determine the adequacy of audit trails?
   h. review controls over program-change requests?
   i. perform customer confirmations?
   j. other (explain)?
5. Does the serviced institution obtain and review the servicer's internal or external audits or third-party reviews? (If yes, detail exceptions and corrective action.)
6. Has the serviced institution used an independent auditor to evaluate EDP servicing (if yes, detail exceptions and corrective action)?
7. Is the overall audit program for serviced applications considered adequate?

ESTABLISHMENT OF INFORMATION SECURITY STANDARDS

1. Does the bank have a written information security program or policy that complies with the Interagency Guidelines Establishing Information Security Standards, in Regulation H, appendix D-2 (12 CFR 208, appendix D-2)? Has the board of directors or an appropriate designated committee of the board approved the written information security program?
2. Is the written information security program appropriate given the size and complexity of the organization and its operations? Does the program contain the objectives of the program, assign responsibility for implementation, and provide methods for compliance and enforcement?
3. Does the bank periodically update its information security program to reflect changes in the bank's operations and systems, as well as changes in threats or risks to the bank's customer information?
4. Does the examination review of the bank's process for assessing risk to its customer information address the following questions:
   a. Has the bank identified the locations, systems, and methods for storing, processing, transmitting, and disposing of its customer information?
   b. Has the bank identified reasonably foreseeable internal and external threats that could result in unauthorized disclosure, misuse, alteration, or destruction of customer information or customer information systems, and has the bank assessed the likelihood of these threats and their potential damage to the bank and its customers?
5. With respect to the bank's risk-management processes for implementing effective measures to protect customer information, does the bank adopt and review appropriate risk-based internal controls and procedures for the following:
   a. accessing controls on computer systems containing customer information in order to prevent access by unauthorized staff or other individuals?
   b. preventing employees from providing customer information to unauthorized individuals, including "pretext calling," that is, someone calling a bank and posing as a customer to fraudulently obtain an individual's personal information? (See SR-01-11.)
   c. providing access restrictions at physical locations containing customer information, such as buildings, computer facilities, and records-storage facilities, in order to permit access to authorized individuals only?
   d. encrypting electronic customer information, including information that is in transit or in storage on networks or systems, when unauthorized individuals are able to gain access to it?
   e. ensuring that modifications to customer information systems are consistent with the bank's information security program?

f. maintaining dual-control procedures, segregation of duties, and background checks for employees with access to customer information to minimize the risk of internal misuse of customer information?
g. monitoring systems and procedures to detect unauthorized access to customer information systems that could compromise the security of customer information?
h. maintaining and complying with the minimum requirements for response programs that specify actions to be taken when the bank suspects or detects that unauthorized individuals have gained access to customer information systems? (These programs include appropriate reports, such as Suspicious Activity Reports by Depository Institutions (SAR-DI), disseminated to regulatory and law enforcement agencies.) See SR-07-2 and the attached June 2007 SAR-DI form, the requirements for suspicious-activity reporting in section 208.62 of the Board's Regulation H (12 CFR 208.62), and the Bank Secrecy Act compliance program in section 208.63 (12 CFR 208.63).
i. providing measures to protect against destruction, loss, or damage of customer information due to potential environmental hazards, such as fire and water damage or technological failures?
j. providing measures to ensure the proper disposal of consumer information derived from consumer reports?

6. Have the bank's employees been trained to implement the information security program?
7. Does the bank regularly test the effectiveness of the key controls, systems, and procedures of its information security program? These tests may include, for example, tests of operational contingency plans, system security audits or "penetration" tests, and tests of critical internal controls over customer information. Are tests conducted and reviewed independently by the bank's designated staff?
8. Does the bank provide customer information to any service providers, or do any service providers have access to customer information as a result of providing services directly to the bank? If so—
   a. has the bank conducted appropriate due diligence in selecting its service providers, taking into consideration information security?
   b. do the bank's contracts with its service providers require implementation of appropriate information security programs and measures?
   c. where appropriate and based on risk, does the bank monitor its service providers to confirm that they are maintaining appropriate security measures to safeguard the bank's customer information? Does the bank, for example, conduct or review the results of audits, security reviews or tests, or other evaluations?
9. Does the bank's management report at least annually to the board of directors, or to a designated appropriate board committee, on the overall status of the information security program and the extent of the bank's compliance with the standards and guidelines?

IDENTITY THEFT RED FLAGS

1. Did the bank (financial institution) determine initially, and has it periodically determined, whether it offers or maintains accounts covered by the Fair and Accurate Transactions Act of 2003 (FACT Act) and section 222, Subpart J—Identity Theft Red Flags of the Board's rules on Fair Credit Reporting (12 CFR 222, Subpart J)?
2. Has the financial institution adequately developed and maintained a written Identity Theft Prevention Program (Program) that is designed to detect, prevent, and mitigate identity theft in connection with the opening of new and existing accounts that are covered by the FACT Act?
3. Did the financial institution evaluate whether its Program includes reasonable policies and procedures to
   a. identify relevant Red Flags[1] for the financial institution's covered accounts and has it incorporated those Red Flags into its Program;

1. Red Flag means a pattern, practice, or specific activity that indicates the possible existence of identity theft.

b. respond appropriately to prevent and mitigate identity theft detected by any Red Flags; and
c. ensure that the Program is updated periodically to reflect changes in identity theft risks to customers and to the safety and soundness of the financial institution?

4. Has the Program included Red Flags from sources such as
   a. incidents that the financial institution has experienced;
   b. methods of identity theft that the financial institution has identified that reflects changes in identity theft risks; and
   c. applicable supervisory guidance?
5. Does the Program include relevant Red Flags from the following categories (see supplement A to appendix J):
   a. alerts, notifications, or other warnings received from consumer reporting agencies or service providers, such as a fraud detection services;
   b. the presentation of suspicious documents;
   c. the presentation of suspicious personal identifying information, such as a suspicious address change;
   d. the unusual use of, or other suspicious activity related to, a covered account; and
   e. notice from customers, victims of identity theft, law enforcement authorities, or other persons regarding possible identity theft in connection with covered accounts held by the financial institution or creditor?
6. If the financial institution has established and maintained a required Program, has the institution's Program included the relevant and appropriate guidelines that are found in the Board's rule's appendix J (12 CFR 222, appendix J)?
7. Were the examples of factors in appendix J's guidelines considered initially, and periodically, to determine the relevancy and appropriateness of the Program's Red Flags, such as
   a. the types of accounts it offers or maintains;
   b. the methods it provides to open its covered accounts;
   c. the methods it provides to access its covered accounts;
   d. its previous experiences with identity theft; and
   e. changes in the financial institution's business arrangements, including its mergers, acquisitions, and joint ventures, and its alliances and service provider arrangements?
8. Does the Program's policies and procedures address the detection of Red Flags in connection with the financial institution's opening of covered accounts and existing covered accounts such as by
   a. obtaining identifying information about, and verifying the identity of, a person opening a covered account; and
   b. authenticating customers, monitoring transactions; and verifying the validity of change of address requests?
9. If a required Program has been established by the financial institution, has it provided for the Program's continued administration by
   a. involving the board of directors, an appropriate committee thereof, or a designated employee at the level of senior management in the continued oversight, development, implementation, and administration of the Program?
   b. training staff, as necessary, to effectively implement the Program?
   c. providing appropriate and effective oversight of its service provider arrangements?

CONCLUSION

1. Does the foregoing information constitute an adequate basis for evaluating internal control (that is, no significant deficiencies in areas not covered in this questionnaire impair any controls)? Explain negative answers briefly and indicate any additional examination procedures deemed necessary.
2. On the basis of a composite evaluation, as evidenced by answers to the foregoing questions, is internal control considered adequate or inadequate?

Electronic and Internet banking products and services have been widely adopted by financial institutions and are now a regular component of the business strategies at most institutions. Electronic and Internet delivery of services can have many far-reaching benefits for financial institutions and their customers. In some cases, however, these activities can have implications for a financial institution's financial condition, risk profile, and operating performance.

EXAMINATION APPROACH

In general, examiners should review electronic and Internet banking activities when these services are newly implemented, particularly in institutions that may not have significant experience or expertise in this area or when an institution is conducting novel activities that may pose a heightened risk. Periodic reviews should be conducted thereafter based on any significant changes to the scope of services or nature of the operations, as indicated by an assessment of risk to the institution.

Clearly, electronic and Internet banking concerns could affect an institution's operational-risk profile. Yet, these activities could also affect other financial and business risks, depending on the specific circumstances. Accordingly, examiners should consider an institution's electronic and Internet banking activities when developing risk assessments and supervisory plans. Although electronic and Internet banking may be assessed within the context of an information technology review, the nontechnical aspects of an electronic banking operation should be reviewed and coordinated closely with other examination areas. Rather than conduct detailed technical reviews, examiners should assess the overall level of risk any electronic and Internet banking activities pose to the institution and the adequacy of its approach to managing these risks.

To determine the scope of supervisory activities, close coordination is needed with information technology specialist examiners and consumer compliance examiners during the risk-assessment and planning phase, as well as during on-site examinations. Given the variability of electronic and Internet banking environments, the level of technical expertise required for a particular examination will differ across institutions and should be identified during the planning phase of the examination. When the bank has developed the electronic and Internet banking products or services internally or when a direct connection exists between the institution's electronic and Internet banking systems and its core data processing system, consideration should be given to involving an information technology specialist examiner in the on-site review. The determination of the examination scope should be based on factors such as the following:

- implementation of significant new electronic banking products and services since the last examination
- significant changes in the composition or level of customers, earnings, assets, or liabilities generated or affected by the electronic banking activities
- new or significantly modified systems or outsourcing relationships for activities related to electronic banking
- the need for targeted examinations of business lines that rely heavily on the electronic banking systems or activities
- other potential problems or concerns that may have arisen since the last examination or the need to follow up on previous examination or audit issues

Many resources are available to examiners for reviewing electronic and Internet banking activities. In addition to the procedures in this section, further information can be found in section 4060.1, "Information Technology," and in the *Federal Financial Institutions Examination Council (FFIEC) Information Systems Examination Handbook.* Other federal banking agencies have issued examination guidance relating to electronic and Internet banking, information technology, and information security that may be helpful to examiners in reviewing electronic banking activities. Consumer compliance issues are not addressed in this section.[1]

1. See the Federal Reserve regulations, FFIEC, and other interagency supervisory guidance. See also the FFIEC's "Guidance on Electronic Financial Services and Consumer Compliance" (July 15, 1998), for further information regarding compliance with consumer laws and regulations.

OVERVIEW OF ELECTRONIC BANKING SERVICES

Types of Services

Electronic banking services (including Internet banking services) are designed to provide banking customers with the capability to conduct banking business remotely through personal computers and other electronic devices. Electronic banking comprises personal computer (PC) banking through traditional proprietary communication channels; retail and corporate Internet banking services; telephone banking; and, potentially, other forms of remote electronic access to banking services.

Both large and small institutions are now offering a variety of Internet-based financial services. Many financial institutions are using the Internet to enhance their service offerings to existing customers. Other organizations may choose to expand their customer base to a wider geographic area by accepting online applications for loan and deposit products. A very small number of banking organizations are focusing on the Internet as their primary delivery channel, whether or not they maintain physical branches.

Current electronic banking products and services typically allow customers to obtain information on bank products and services through the bank's Internet web sites, apply online for new products and services, view loan- and deposit-account balances and transactions, transfer funds between accounts, and perform other banking functions. Most electronic banking services now operate using standard Internet browser software installed on the customer's personal computer and do not require that the customer have any additional software or hardware. While electronic banking services have been oriented toward retail customers, many banking organizations are now offering small-business applications and corporate cash-management services through the Internet. These services typically include payroll, automated clearinghouse (ACH), and wire transfers. Wholesale banking services, which have been conducted electronically for many years, are also beginning to move from proprietary networks and communications channels to the Internet.

Information-only web sites provide the most basic and common form of electronic banking service. Most institutions contract with an Internet service provider (ISP) to provide Internet access and "host," or maintain and operate, the institution's web site. In some cases, the web site is maintained on the institution's own computers (web servers). Even if access to account information is not possible through the web site, institutions may receive e-mail inquiries from customers through their web site.

Transactional Internet banking sites allow customers to obtain online access to their account information and initiate transactions over the Internet. With most Internet banking services, the customer interacts with a stand-alone Internet banking system that has been preloaded with the customer's account balances, transaction history, and other information. Transactions initiated through the Internet banking system are processed by a separate Internet banking application and periodically posted to the institution's general ledger, deposit, and loan accounting systems. Interface or connection with the financial institution's core data processing and accounting systems typically occurs through either (1) a direct connection to the core processing system over a network or (2) a manual download or transfer of transaction data to a diskette or other portable media, which is then uploaded or sent to the core processing system. Most standardized Internet banking software packages now available have been designed with standard interfaces between Internet banking systems and common core-processing systems and software.

Electronic bill-payment services are typically provided to customers as part of most standard electronic banking services. These services generally include capabilities to pay any third party the customer designates, as well as pay companies designated for routine bill payments, such as utilities and credit card issuers. Electronic bill-presentment services, which are much less common, involve the electronic transmission of billing statements to the customer through e-mail or a web site, for subsequent payment through the electronic banking service. Other more innovative Internet retail-payment mechanisms are being developed, but these typically involve very small-dollar transactions.

Telephone banking, a fairly conventional form of electronic banking, is provided by many institutions. Telephone banking services generally allow customers to check account balances and transactions and to pay bills through touch-tone or voice-response systems. A few banking organizations are also beginning to offer consumer products and services through wireless devices, such as cellular telephones, pagers, personal digital assistants, handheld computers, or other devices that can provide wireless access to an institution's services, either directly or through the Internet. Account aggregation is a web-based service offered by some financial institutions that consolidates customer-account information from multiple financial or commercial web sites and presents it on a single web site. Aggregated information may include information from financial and nonfinancial accounts held by the customer. Some institutions have established "portals," web sites that link customers to a variety of third-party sites, and alliances with other companies to provide banking or nonbanking services.

Operations

There are a variety of operational methods for providing electronic banking services. Banking organizations may perform their core data processing internally but outsource the Internet banking activities to a different vendor or service provider. A dedicated workstation at the financial institution is often used to transmit transaction data files between the institution's core processing system and the Internet application; the workstation also allows the financial institution to update parameters and perform other maintenance. Alternatively, the service provider for Internet banking may interface directly with the bank's core-processing service provider, if that function is also outsourced. In addition, many banking organizations now purchase Internet banking services from their primary core-processing service provider, eliminating the need for external data transmissions. Even with this last structure, the institution maintains a local workstation to provide access to customer information or perform other administrative and maintenance functions for the Internet banking system.

Other institutions operate an electronic banking system in their own computer facilities by purchasing an "off-the-shelf" or turnkey electronic banking software application from a software vendor and then installing the software on their own system. Turnkey options vary from a bank's purchase and use of templates or modules, in which the bank chooses from a selection of standard services, to more complex situations in which the software vendor designs and develops the electronic banking software application to the bank's specifications. Turnkey vendors often provide hardware, software, and ongoing system service and maintenance.

Bill-payment processing is generally conducted through a specialized third-party processor. The payment processor receives payment instructions from the financial institution or the Internet banking service provider, initiates an ACH debit to the account of the customer, and credits the account of the payee. Payments to payees not set up to receive ACH payments, such as individuals and smaller companies, are transmitted by mailing a paper check to the payee.

RISK MANAGEMENT

Board and Management Oversight

Financial institutions commonly implement electronic banking services as a means of delivering existing banking products and services to existing customers. As a result, not all institutions have established a distinct risk-management program for electronic banking. In many cases, policies and procedures for electronic banking activities will be incorporated into existing policies and procedures, such as those governing deposit accounts, payments processing, information security, and lending functions.

Bank management should assess the financial impact of the implementation and ongoing maintenance of electronic banking services. For example, ongoing maintenance and marketing costs of Internet banking operations can be substantial, particularly for smaller banks, depending on the institution's business plan. Bank management should consider the potential impact on the institution's customer base, loan quality and composition, deposit volume, volatility, liquidity sources, and transaction volume, as well as the impact on other relevant factors that may be affected by the adoption of new delivery channels. These areas should be monitored and analyzed on an ongoing basis to ensure that any impact on the institution's financial condition resulting from electronic banking services is appropriately managed and controlled.

In addition, bank management may wish to review periodic reports tracking customer usage, problems such as complaints and downtime, unreconciled accounts or transactions initiated through the electronic banking system, and system usage relative to capacity. Management should also consider the expertise of internal or external auditors to review electronic banking activities and the inclusion of electronic banking activities within audit plans. Insurance policies may need to be updated or expanded to cover losses due to system security breaches, system downtime, or other risks from electronic banking activities.[2]

A change in an institution's business strategy to an Internet-only or Internet-focused operation is generally considered a significant change in business plan.[3] In addition, certain technology operations, such as providing ISP services to the general public, may not be considered permissible banking activities or may be considered permissible by the institution's chartering authority only within certain limitations.

A financial institution should also consider legal ownership of its Internet address (for example, www.bankname.com), also known as its "domain name." Contracts with third-party vendors may specially address any arrangements to have the third-party vendor register the domain name on behalf of the institution.

Operational and Internal Controls

Web Site Information Maintenance

Because an institution's web site is available on an ongoing basis to the general public, appropriate procedures should be established to ensure the accuracy and appropriateness of its information. Key information changes and updates, such as loan rates, are normally subject to documented authorization and dual verification. Establishing procedures and controls to frequently monitor and verify web site information may help prevent any inadvertent or unauthorized modifications or content, which could lead to reputational damage or violations of advertising, disclosure, or other compliance requirements.

In addition, some institutions provide financial-calculator, financial-management, tax-preparation, and other interactive programs to customers. Institutions may provide online resources for customers to research available options associated with savings products, mortgages, investments, insurance, or other products and services. To protect the institution from potential liability or reputational harm, the bank should test or otherwise verify the accuracy and appropriateness of these tools.

Banks should carefully consider how links to third-party Internet web sites are presented. Hyperlinks to other web pages provide customers with convenient access to related or local information, as well as provide a means for targeted cross-marketing through agreements between the institution and other web site operators. However, such linkages may imply an endorsement of third-party products, services, or information that could lead to implicit liability for the institution. As a result, institutions commonly provide disclaimers when such links take the customer to a third-party web site. Institutions should ensure that they clearly understand any potential liabilities arising out of any cross-marketing arrangements or other agreements with third parties. Any links to sites offering nondeposit investment or insurance products must comply with relevant interagency guidelines.[4] Links to other sites should be verified regularly for their accuracy, functionality, and appropriateness.

Electronic Banking Accounts, Customer Authentication, and Administrative Controls

Many banks use the same account-opening procedures for electronic applications as they do for mailed or in-person applications. Procedures for accepting electronic account applications generally address areas such as—

2. See section 4040.1, "Management of Insurable Risks," for further information about fraud and computer-related insurance that may be applicable to electronic banking activities.

3. Regulation H sets forth the requirements for membership of state-chartered banks in the Federal Reserve System and imposes certain conditions of membership on applicant banks. A member bank must "at all times conduct its business and exercise its powers with due regard to safety and soundness" and "may not, without the permission of the Board, cause or permit any change in the general character of its business or in the scope of the corporate powers it exercises at the time of admission to membership" (12 CFR 208.3(d)(1) and(2)).

4. See section 4170.3, "Examination Procedures—Retail Sales of Nondeposit Investment Products," and the consumer protection rules for sales of insurance (65 *Fed. Reg.* 75,822 (December 4, 2000)).

- the type of funding accepted for initial deposits;
- funds-availability policies for deposits in new accounts;
- the timing of account-number, check, and ATM-card issuance;
- the minimum customer information required to open new accounts;
- single-factor, tiered single-factor, and multifactor authentication procedures for verification of information provided by the applicant (for example, verifying customer information against credit bureau reports); and
- screening for prior fraudulent account activity, typically using fraud-detection databases.[5]

Authentication procedures. Strong customer-authentication practices are necessary to help institutions detect and reduce fraud, detect and reduce identity theft, and enforce anti-money-laundering measures.[6] Customer interaction with institutions is migrating from physical recognition and paper-based documentation to remote electronic access and transaction initiation. Significant risks potentially arise when an institution accepts new customers through the Internet or other purely electronic channels because of the absence of the physical cues that bankers traditionally use to identify individuals. The risks of doing business with unauthorized or incorrectly identified individuals in an electronic banking environment could result in financial loss and reputation damage.

In addition to limiting unauthorized access, effective authentication provides institutions with the appropriate foundation for electronic agreements and transactions. First, effective authentication provides the basis for the validation of parties to the transaction and their agreement to its terms. Second, authentication is a necessary element to establish the *authenticity* of the records evidencing the electronic transaction if there is ever a dispute. Third, authentication is a necessary element for establishing the *integrity* of the records evidencing the electronic transaction. Because state laws vary, management should involve legal counsel in the design and implementation of authentication systems.

The success of a particular authentication method depends on more than the technology. Success also depends on an institution's having appropriate policies, procedures, and controls. An effective authentication method has the following characteristics: customer acceptance, reliable performance, scalability to accommodate growth, and interoperability with existing systems and future plans.

Institutions can use a variety of authentication tools and methodologies to authenticate customers. These tools include the use of passwords and personal identification numbers (PINs), digital certificates using a public key infrastructure (PKI), physical devices such as smart cards or other types of ''tokens,'' database comparisons, and biometric identifiers. The level of risk protection afforded by each of these tools varies and is evolving as technology changes.

Existing authentication methodologies involve three basic ''factors'':

- something the user *knows* (a password or PIN)
- something the user *possesses* (an ATM card or a smart card)
- something the user *is* (a biometric characteristic, such as a fingerprint or retinal pattern)

Authentication methods that depend on more than one factor typically are more difficult to compromise than single-factor systems. Accordingly, properly designed and implemented multifactor authentication methods are more reliable indicators of authentication and are stronger fraud deterrents. For example, the use of a log-on ID or password is single-factor authentication (something the user knows), whereas a transaction using an ATM typically requires two-factor authentication (something the user

5. For information on practices that my help prevent fraudulent account activity, see SR-01-11, ''Identity Theft and Pretext Calling.''

6. The FFIEC issued the October 12, 2005, ''Guidance on Authentication in an Internet Banking Environment,'' which was adopted by the federal banking and thrift regulatory agencies. As discussed in this section, the guidance addresses the need for risk-based assessments, customer awareness, and enhanced security measures to authenticate customers using Internet-based products and services that process high-risk transactions involving access to customer information or the movement of funds to other parties. Single-factor authentication, as the only control mechanism, is inadequate for high-risk transactions involving access to customer information or the movement of funds to other parties. Financial institutions will be expected to have achieved conformance with the guidance by year-end 2006. (See SR-05-19.) This interagency guidance updates the August 8, 2001, FFIEC guidance, ''Authentication in an Electronic Banking Environment.'' To assist the banking industry and examiners, the Board, the FFIEC, and the other federal banking and thrift agencies issued frequently asked questions (FAQs) on August 15, 2006. (See SR-06-13.) The FAQs are designed to assist the financial institutions and their technology service providers in conforming to the guidance by addressing common questions on the scope, risk assessments, timing, and other issues.

possesses—the card—combined with something the user knows—the PIN). In general, multifactor authentication methods should be used on higher-risk systems. Further, institutions should be sensitive to the fact that proper implementation is key to the reliability and security of any authentication system. For example, a poorly implemented two-factor system may be less secure than a properly implemented single-factor system.

Risk assessment. An effective authentication program should be implemented on an enterprise-wide basis to ensure that controls and authentication tools are adequate among all products, services, and lines of business. Authentication processes should be designed to maximize interoperability and should be consistent with the financial institution's overall strategy for electronic banking and e-commerce customer services. The level of authentication a financial institution uses in a particular application should be appropriate to the level of risk in that application.

The implementation of appropriate authentication methods starts with an assessment of the risk posed by the institution's electronic banking systems. The risk should be evaluated in light of the type of customer (retail or commercial), the institution's transactional capabilities (bill payment, wire transfer, or loan origination), the sensitivity and value of the stored information to both the institution and the customer, the ease of using the authentication method, and the size and volume of transactions. The Federal Reserve expects financial institutions to assess the risks to the institution and its customers and to implement appropriate authentication methods to effectively manage risk.

An enterprise-wide approach to authentication requires development of and adherence to corporate standards and architecture, integration of authentication processes within the overall information security framework, risk assessments within the institution's lines of business that support the selection of authentication tools, and a central authority for oversight and risk monitoring. The authentication process should be consistent and support the financial institution's overall security and risk-management programs.

The method of authentication used in a specific electronic application should be appropriate and ''commercially reasonable'' in light of the reasonably foreseeable risks in that application. Because the standards for implementing a commercially reasonable system may change over time as technology and other procedures develop, financial institutions and service providers should periodically review authentication technology and ensure appropriate changes are implemented.

Single-factor authentication tools, including passwords and PINs, have been widely accepted as commercially reasonable for a variety of retail e-banking activities, including account inquiry, bill payment, and account aggregation. However, financial institutions should assess the adequacy of existing authentication techniques in light of changing or new risks (for example, the increasing ability of hackers to compromise less robust single-factor techniques). Financial institutions are cautioned that single-factor authentication alone may not be commercially reasonable or adequate for high-risk applications and transactions. Instead, multifactor techniques may be necessary. Institutions should recognize that a single-factor system may be ''tiered'' to enhance security without implementing a two-factor system. A tiered single-factor authentication system would include the use of multiple levels of a single factor (for example, the use of two or more passwords or PINs employed at different points in the authentication process).

Account origination and customer verification. Institutions need to use reliable methods for originating new customer accounts online. Customer-identity verification during account origination is important in reducing the risk of identity theft, fraudulent account applications, and unenforceable account agreements or transactions. In an electronic banking environment, reliance on traditional forms of paper-based authentication is decreased substantially. Accordingly, financial institutions need to use reliable alternative methods. For example, verification of personal information could include the following:

- *Positive verification* to ensure that material information provided by an applicant matches information available from trusted third-party sources. More specifically, an institution can verify a potential customer's identity by comparing the applicant's answers to a series of detailed questions against information in a trusted database (for example, a reliable credit report) to see if the information supplied by the applicant matches information in the database. As the questions become more specific and detailed, correct answers provide the institution with an increasing level of confidence that the applicants are who they say they are.

- *Logical verification* to ensure that information provided is logically consistent. (For example, do the telephone area code, ZIP code, and street address match?)
- *Negative verification* to ensure that information provided has not previously been associated with fraudulent activity. For example, applicant information can be compared against fraud databases to determine whether any of the information is associated with known incidents of fraudulent behavior. In the case of commercial customers, however, a sole reliance on online electronic database comparison techniques is not adequate since certain documents needed to establish an individual's right to act on a company's behalf (for example, bylaws) are not available from databases. Institutions must still rely on traditional forms of personal identification and document validation combined with electronic verification tools.

Transaction initiation and authentication of established customers. Once an institution has successfully verified a customer's identity during the account-origination process, it should authenticate customers who wish to gain access to the online banking system. Institutions can use a variety of methods to authenticate existing customers. These methods include the use of passwords, PINs, digital certificates and a PKI, physical devices such as tokens, and biometrics.

Minimizing fraud risk. An institution's policies and procedures should address the management of existing customers' accounts to minimize the risk of fraudulent activity. For example, the customer's ability to expand an existing account relationship through the electronic banking system may warrant added controls, such as sending a separate notification to a customer's physical address when online account access is first requested or when PINs, e-mail addresses, or other key parameters are changed.

To mitigate fraud risk, institutions may establish dollar limits on transactions initiated through the electronic banking application, or they may monitor transactions above specified limits, depending on the type of account (for example, consumer versus corporate). These limits or a similar monitoring system may help detect unusual account activity, which could indicate fraudulent transactions or other suspicious activity.

Funds transfer systems and Internet banking. Any manual interface between the electronic banking system and funds transfer systems, such as capabilities for uploading ACH or Fedwire transactions initiated through the electronic banking system to Fedline terminals, should be subject to system-access controls and appropriate internal controls, such as segregation of duties. Some institutions also permit electronic banking customers to initiate electronic (ACH) debits against accounts held at other institutions; reliable controls to verify that the customer is entitled to draw funds from the particular account are needed if this feature is offered.

Electronic bill-payment services are commonly provided as a component of electronic banking services. The institution should have a direct agreement with bill-payment providers, which may be subcontractors of the provider for the institution's Internet banking services. In this situation, it may be difficult for the institution or its customers to obtain timely and accurate information regarding the status of payment requests. As a result, contracts with service providers that encompass bill-payment services should generally address how payments are made, when payments are debited from a customer account, the treatment of payments when the account has insufficient funds on the settlement date, reconcilement procedures, and problem-resolution procedures.

Even when Internet banking operations are outsourced to a service provider, institutions will generally have access to the electronic banking system through a dedicated desktop computer or workstation. This hardware allows the institution to upload and download transaction information; review transaction logs or audit trails; print daily reports; or, in some cases, reset customer passwords, resolve errors, or respond to customer inquiries. These workstations should be located in secure areas and be subject to normal authorization and access controls and transaction audit trails.

Information Security

Electronic banking activities should be

addressed in an institution's information security program, which should include compliance with the federal banking agencies' information security standards.[7] Institutions need to pay particular attention to the security of customer information, given the heightened security concerns associated with providing access to customer information over the Internet. An institution's written information security policies and procedures should include electronic banking activities. Institutions should implement prudent controls that limit the risk of unauthorized access to key systems, including password-administration controls, firewalls, encryption of sensitive information while it is in transit or being stored, maintenance of all current updates and security patches to software and operating systems, and controls to prevent insider misuse of information. Sound information security practices include procedures and systems to detect changes to software or files, intrusion-detection systems, and security-vulnerability assessments.

While the technical aspect of information security considerations for electronic banking activities is complex, widely used turnkey software applications for Internet banking generally conform to accepted industry standards for technical security. Detailed assessments of the technical security of specific systems are the responsibility of the institution and its qualified engineers and internal and external auditors. Examiners should focus on the institution's implementation of key security controls for the particular software application.

Any security breaches of an institution's electronic banking service or web site that may lead to potential financial losses or disclosure of sensitive information should be reported to an appropriate management level within the institution. If necessary, the appropriate suspicious-activity report should be filed. Institutions should ensure that their service providers notify them of any computer security breaches in their operations that may affect the institution. Institutions should determine the cause of any such intrusions and develop an appropriate plan to limit any resulting financial losses to the bank and its customers and to prevent recurrence.

7. See section 4060.1 under "Standards for Safeguarding Customer Information" for further details and examination procedures. See also SR-01-25.

Passwords and System-Access Controls

Most institutions use identifiers such as account numbers or ATM card numbers, together with passwords or PINs, to verify the authorization of users accessing the retail electronic banking system. (Wholesale or corporate cash-management systems may use more secure methods, such as smart cards that contain customer credentials, real-time passwords (passwords that can be immediately changed online), or dedicated terminals, to authenticate users.) Prudent password-administration procedures generally require that customer passwords be changed if compromised and that passwords do not automatically default to easily guessed numbers or names. Passwords and PINs are (1) generally encrypted while in transit or storage on insecure networks or computers, (2) suppressed on screen when entered on a keyboard, and (3) suspended after a predetermined number of failed log-in attempts. Institutions should establish clear policies and procedures for retrieving or resetting customer passwords when customers lose or forget their password to minimize the risk that passwords are disclosed to unauthorized individuals.[8]

Firewalls

A firewall is a security control consisting of hardware, software, and other security measures established to protect the bank's internal data and networks, as well as its web sites, from unauthorized external access and use through the Internet. A number of banks and their vendors use various firewall products that meet industry standards to secure their Internet banking services, web sites, and other bank networks. For a firewall to adequately protect a bank's internal networks and systems, it must be properly installed and configured. Firewalls are most effective when all updates and patches to the firewall systems are installed and when the firewall configuration is reassessed after every system change or software update.

Viruses

Computer viruses can pose a threat to information systems and networks that are connected to

8. See SR-05-19 for further information on password-administration practices.

the Internet. In addition to destroying data and possibly causing system failure, viruses can potentially establish a communication link with an external network, allow unauthorized system access, or even initiate unauthorized data transmission. Widely used protection measures include using anti-virus products that are installed and are resident on a computer or network or providing for virus scanning during downloads of information or the execution of any program. Bank employees and electronic banking customers should be educated about the risks posed to systems by viruses and other malicious programs, as well as about the proper procedures for accessing information to help avoid these threats.

Encryption of Communications

Information transmitted over the Internet may be accessible to parties other than the sender and receiver. As a result, most retail electronic commerce services use industry-standard secure sockets layer (SSL) technology to encrypt sensitive transactional information between the customer and the web site to minimize the risk of unauthorized access to this information while it is in transit. Although stronger encryption techniques may be warranted for higher-value corporate or wholesale transactions, SSL is generally considered adequate for retail Internet banking transactions.[9]

In addition, many banks accept communications through standard Internet e-mail; in some cases, account applications containing sensitive customer data may be sent to the bank. These communications are generally not protected by SSL or a similar technology but are open to potential unauthorized access. If the electronic banking system does not provide for encrypted e-mail, the bank should ensure that customers (and customer-service representatives) are alerted not to send confidential information by unencrypted e-mail.

Security Testing and Monitoring

Assessments of information security vulnerability, penetration testing, and monitoring help ensure that appropriate security precautions have been implemented and that system security configurations are appropriate. Some institutions contract with third-party security experts to provide these services. Vulnerability assessments provide an overall analysis of system security and report any system vulnerabilities. Such assessments can detect known security flaws in software and hardware, determine system susceptibility to known threats, and identify vulnerabilities such as settings that are contrary to established security policies.

Penetration testing and vulnerability assessments identify an information system's vulnerability to intrusion. Penetration tests examine system security by mimicking external intrusion attempts to circumvent the security features of a system. However, a penetration test is only a snapshot in time and does not guarantee that the system is secure.

Intrusion detection is an ongoing process that monitors the system for intrusions and unusual activities. Intrusion-detection systems, which can be installed on individual computers and at locations on a network, can be configured to alert appropriate system personnel to potential intrusions at the time they occur. In addition, the detection systems provide ongoing reporting and monitoring of unusual events such as potential intrusions or patterns of misuse.

Contingency Planning

Periodic downtime and outages are common with online services. But when the duration or disruption of these outages is significant, it can lead to reputational risk for the institution. For many institutions, short disruptions of electronic banking services may not have a material effect on their operations or customers, as other delivery channels are available. Nevertheless, electronic banking services should be covered by an institution's business-continuity plans. Institutions should assess their disaster-recovery needs by considering the length of time that electronic banking services could be unavailable to customers or for internal processing, and then design backup capabilities accordingly. In some cases, institutions may need to establish the capability to move processing to a different network or data center, or to move electronic banking services to a backup web site.

Typically, the electronic banking system includes capabilities to generate backup files on tapes, diskettes, or other portable electronic

9. The industry is moving toward a standard of 128-bit encryption for SSL communications.

media containing key transaction and customer data. Web site information should also be subject to periodic backup. Security and internal controls at backup locations should be as sophisticated as those in place at the primary site. If a bank outsources electronic banking operations to a service provider, the institution should have a full understanding of the service provider's contingency and business-recovery commitments.[10]

Outsourcing Arrangements

Many institutions outsource electronic banking operations to an affiliate or third-party vendor. In addition to operating the Internet banking software application, service providers may provide services such as web site hosting and development, Internet access, and customer service or call-center maintenance. As with other areas of a bank's operations, examiners should evaluate the adequacy of the institution's oversight of its critical service providers.[11]

Banking organizations should consider requiring Internet banking service providers to obtain periodic security reviews performed by an independent party. The client institution should receive reports summarizing the findings.

10. For additional information on business resumption and contingency planning in relation to outsourcing, see section 4060.1, ''Information Technology,'' and the *FFIEC Information Systems Examination Handbook*.

11. See section 4060.1, ''Information Technology,'' and the *FFIEC Information Systems Examiniation Handbook* for information on risk management for outsourcing arrangements.

1. To develop an understanding of the significance of the bank's electronic banking activities within and across business lines.
2. To assess the types and levels of risks associated with the bank's electronic banking activities.
3. To exercise appropriate judgment when determining the level of review, given the characteristics, size, and business activities of the organization.
4. To assess the current and potential impact of electronic banking activities on the institution's financial profile and condition.
5. To assess the adequacy of risk management and oversight of electronic banking activities, including outsourced activities.
6. To determine if the institution is complying with other applicable laws, rules and regulations.
7. To prepare examination report comments on significant deficiencies and recommended corrective action.
8. To determine the impact, if any, of electronic banking risks on the CAMELS rating, information technology rating, and risk-management ratings.
9. To update the workpapers with any information that will facilitate future examinations.

1. Identify the bank's current and planned electronic banking activities and review the bank's public Internet web sites. Consider whether the bank provides the following types of services:
   a. telephone banking
   b. retail Internet banking services
   c. corporate or wholesale Internet banking services
   d. Internet service provider (ISP)
   e. brokerage services over the Internet
   f. insurance services over the Internet
   g. trust services over the Internet
   h. account aggregation
   i. electronic bill payment
   j. other activities (for example, web portals, financial calculators, cross-marketing arrangements and alliances, or unique services)
2. Review prior examination findings and workpapers related to electronic banking, including consumer compliance, information technology, and other examination areas that may be relevant.
3. Determine if material changes have been made to electronic banking products, services, or operations since the last examination and if any significant changes are planned in the near future.
4. Determine the significance of the bank's electronic banking activities. Consider the following areas:
   a. approximate percentages and numbers of customers (for example, loan and deposit) that regularly use electronic banking products and services
   b. lending and deposit volumes generated from Internet applications
   c. the current monthly transaction and dollar volume for electronic banking services
   d. costs and fees to operate the system and related services or marketing programs
5. Incorporate an analysis of electronic banking activities into risk assessments, supervisory plans, and scope memoranda, considering the size, activities, and complexity of the organization, as well as the significance of the activities across particular business lines.
6. Assess the level of risk and the current or potential impact of electronic banking activities on the organization's earnings, liquidity, asset quality, operational risk, and consumer compliance. Communicate any concerns to examiners reviewing these areas.
7. Determine if the bank operates its web sites, electronic banking systems, or core data processing systems internally and whether any activities are outsourced to a vendor. If outsourced, all activities should be supported by written agreements that have been reviewed by the bank's legal counsel. Identify the location of the following operations:
   a. design and maintenance of the bank's public web site or home page
   b. computer or server for the bank's public web site
   c. development and maintenance of the bank's electronic banking systems
   d. computer or server for the bank's electronic banking systems
   e. customer service (for example, a call center) for electronic banking services
   f. electronic bill-payment processing or other ancillary services
8. If the bank operates the electronic banking system or core data processing system in-house, review the topology (schematic diagram) of the systems and networks, and determine whether there is a direct, online connection between the bank's core processing systems and the electronic banking system.
9. If the bank operates the electronic banking system or core data processing system in-house, review the transaction-processing flows between the electronic banking system and the bank's core processing systems and identify key control points. Determine whether information is exchanged in a real-time, batch (overnight), or hybrid-processing mode.
10. Review any available audits or third-party reviews of vendors or service providers the bank uses, such as SAS 70 reports.[1] Review any Federal Financial Institutions Examina-

1. The American Institute of Certified Public Accountants (AICPA) Statement of Auditing Standards (SAS) No. 70 ''Reports on the Processing of Transactions by Service Organizations,'' as amended by SAS No. 78, ''Consideration of Internal Control in a Financial Statement Audit: An Amendment to Statement on Auditing Standards No. 55.''

tion Council (FFIEC) Shared Application Software Review (SASR) reports or any FFIEC or other supervisory examination reports of service providers that the institution uses.

11. Determine the adequacy of risk management for electronic banking activities (including single-factor and tiered single-factor or multifactor authentication methods for prospective and existing customers), given the level of risk these activities pose to the institution.[2] Complete or update relevant portions of the electronic banking internal control questionnaire as needed for the specific electronic banking activities identified in the previous steps of these procedures to evaluate the adequacy of—
    a. policies and procedures governing electronic banking activities,
    b. internal controls and security for electronic banking activities,
    c. audit coverage for electronic banking activities,
    d. monitoring and compliance efforts,
    e. vendor and outsourcing management, and
    f. board and management oversight.
12. Perform additional analysis and review, consulting with information technology specialists, consumer compliance specialists, or other subject-matter experts as needed, on areas of potential concern.
13. Determine the impact of any electronic banking activities or internal-control deficiencies on the financial condition of the organization.
14. Determine the extent of supervisory attention needed to ensure that any weaknesses are addressed and that associated risk is adequately managed.
15. Determine the impact of any deficiencies on the CAMELS rating, information technology rating, operational-risk rating, and any other relevant supervisory ratings.
16. Prepare comments for the examination report on any significant deficiencies and recommended corrective action.
17. Update the workpapers with any information that will facilitate future examinations.

2. See SR-05-19, ''FFIEC Guidance on Authentication in an Internet Banking Environment.''

Review the bank's internal controls, policies, practices, and procedures for electronic banking activities. Complete those questions necessary to assess whether any potential concerns warrant further review.

POLICIES AND PROCEDURES

1. Are updates and changes to the bank's public web sites—
   a. made only by authorized staff?
   b. subject to dual verification?
2. Are web site information and links to other web sites regularly verified and reviewed by the bank for—
   a. accuracy and functionality?
   b. potential reputational, compliance, and legal risk?
   c. appropriate disclaimers?
3. Do operating policies and procedures include—
   a. procedures for and controls over the opening of new customer accounts submitted through electronic channels in order to verify potential customer identity and financial condition?
   b. single-factor and tiered single-factor or multifactor procedures for authenticating the identity of prospective and existing customers when administering access to the electronic banking system (for example, customer passwords, personal identification numbers (PINs), or account numbers)?
   c. requirements for review of or controls over wire transfers or other large transfers initiated through the electronic banking system, to watch for potentially suspicious activity?
   d. appropriate authorizations for electronic debits initiated against accounts at other institutions, if such transfers are allowed?
   e. depending on the type of account, dollar limits on transactions over a given time period initiated through the electronic banking service?
   f. reconcilement and accounting controls over transactions initiated through the electronic banking system, including electronic bill-payment processing?
4. Do written information security policies and procedures address electronic banking products and services?
5. Are business-recovery procedures adequate? Do the procedures address—
   a. events that could affect the availability of the electronic banking system, such as system outages, natural disasters, or other disruptions?
   b. planned recovery times that are consistent with how important electronic banking activities are to the institution?
6. Has management established an adequate incident-response plan to handle and report potential system security breaches, web site disruptions, malicious tampering with the web site, or other problems?

AUDIT AND INDEPENDENT REVIEW

1. Do the bank's internal and external audit programs address electronic banking activities and systems?
2. Is the level of audit review commensurate with the risks in electronic banking activities and systems?
3. Do audits address—
   a. the review and testing of the bank's internal controls relating to electronic banking?
   b. the review of service-provider performance relative to contract terms, if services are outsourced?
   c. the review of the service providers' internal or external audits or third-party reviews, if services are outsourced?
4. Is management's response to any audit recommendations timely and appropriate?

INTERNAL CONTROLS AND SECURITY

1. Has the bank or service provider implemented a firewall to protect the bank's web site?
2. Are ongoing monitoring and maintenance arrangements for the firewall in place to ensure that it is properly maintained and configured?

3. If the bank uses a turnkey electronic banking software package or outsources to a service provider—
   a. are bank staff familiar with key controls detailed by the vendor's security and operating manuals and training materials?
   b. are workstations that interface with the service provider's system for administrative procedures or for the transfer of files and data kept in a secure location with appropriate password or other access control, dual-verification procedures, and other controls?
4. Does the bank's control of customer access to the electronic banking system include—
   a. procedures to ensure that only appropriate staff are authorized to access electronic banking systems and data, including access to any workstations connected to a remote system located at a service provider?
   b. levels of authentication methods that are commensurate with the level of risk in the bank's electronic banking applications?
   c. the length and composition of passwords and PINs?
   d. encryption of passwords and PINs in transit and storage?
   e. the number of unsuccessful log-on attempts before the password is suspended?
   f. procedures for resetting customer passwords and PINs?
   g. automatic log-off controls for user inactivity?
5. Have security-vulnerability assessments and penetration tests of electronic banking systems been conducted? Has the bank reviewed the results?
6. Has the bank or its service provider established—
   a. an intrusion-detection system for electronic banking applications?
   b. procedures to detect changes in electronic banking files and software?
   c. measures to protect the electronic banking system from computer viruses?
   d. procedures for ensuring on an ongoing basis that electronic banking applications, operating systems, and the related security infrastructure incorporate patches and upgrades that are issued to address known security vulnerabilities in these systems?
7. If e-mail is used to communicate with customers, are communications encrypted or does the bank advise customers not to send confidential information through e-mail?

MONITORING AND COMPLIANCE

1. Are adequate summary reports made available to management to allow for monitoring of—
   a. web site usage?
   b. transaction volume?
   c. system-problem logs?
   d. exceptions?
   e. unreconciled transactions?
   f. other customer or operational issues?
2. Has management established adequate procedures for monitoring and addressing customer problems with electronic banking products and services?
3. Does management accurately report its primary public web-site address on its Consolidated Report of Condition and Income?
4. Have required Suspicious Activity Report by Depository Institutions (SAR-DI) forms involving electronic banking, including any computer intrusions, been filed? See SR-07-2 and the attached June 2007 SAR-DI form, the requirements for suspicious-activity reporting in section 208.62 of the Board's Regulation H (12 CFR 208.62), and the Bank Secrecy Act compliance program in section 208.63 (12 CFR 208.63).

VENDORS AND OUTSOURCING

1. Is each significant vendor, service provider, consultant, or contractor relationship that is involved in the development and maintenance of electronic banking services covered by a written, signed contract? Depending on the nature and criticality of the services, do contracts specify—
   a. minimum service levels and remedies or penalties for nonperformance?
   b. liability for failed, delayed, or erroneous transactions processed by the service provider and for other transactions in which losses may be incurred (for example, insufficient funds)?
   c. contingency plans, recovery times in the event of a disruption, and responsibility

for backup of programs and data?
   d. data ownership, data usage, and compliance with the bank's information security policies?
   e. bank access to the service provider's financial information and results of audits and security reviews?
   f. insurance to be maintained by the service provider?
2. Has legal counsel reviewed the contracts to ensure they are legally enforceable and that they reasonably protect the bank from risk?
3. Has the bank ensured that any service provider responsible for hosting or maintaining the bank's web site has implemented—
   a. controls to protect the bank's web site from unauthorized alteration and malicious attacks?
   b. procedures to notify the bank in the event of such incidents?
   c. regular backup of the bank's web site information?
4. Depending on the nature and criticality of the services, does the bank conduct initial and periodic due-diligence reviews of service providers, including—
   a. reviewing the service provider's standards, policies, and procedures relating to internal controls, security, and business contingency to ensure they meet the bank's minimum standards?
   b. monitoring performance relative to service-level agreements and communicating any deficiencies to the service provider and to bank management?
   c. reviewing reports provided by the service provider on response times, availability and downtime, exception reports, and capacity reports, and communicating any concerns to bank management and the vendor?
   d. periodically reviewing the financial condition of the service provider and determining whether backup arrangements are warranted as a result?
   e. reviewing third-party audits, SAS 70 reports, and regulatory examination reports on the service provider, if available, and following up on any findings with the service provider?
   f. conducting on-site audits of the service provider, if appropriate based on the level of risk?
   g. participating in user groups?
   h. ensuring the bank's staff receives adequate training and documentation from the vendor or service provider?
5. If the bank operates a turnkey electronic banking software package—
   a. is software held under an escrow agreement?
   b. has the bank established procedures to ensure that relevant program files and documentation held under the software escrow agreement are kept current and complete?
6. If a vendor maintains the bank's electronic banking system, does the bank monitor the on-site or remote access of its systems by the vendor, through activity logs or other measures?

BOARD AND MANAGEMENT OVERSIGHT

1. Does the board or an appropriate committee approve the introduction of new electronic banking products and services on the basis of a written business plan and risk analysis that are commensurate with the proposed planned activity?
2. Has the bank considered—
   a. whether the service is designed to provide information on existing services to existing customers or to attract new customers?
   b. whether financial incentives will be offered to attract customers through the electronic banking service? What is the financial impact of such incentives on the bank?
   c. the potential impact of electronic banking products and services on the composition of the bank's customer base?
   d. the projected financial impact of the new service, including up-front and operating costs and any impact on fees or other revenue or expenses?
   e. internal controls appropriate for the new product or service?
   f. whether adequate management reports are provided and subject to periodic review?
   g. whether any new nonbanking activities are permissible under applicable state and federal banking laws?
   h. the extent of outsourcing and responsi-

bilities for managing vendor and service-provider relationships?

3. Has the bank evaluated the adequacy of its insurance coverage to cover operational risks in its electronic banking activities?
4. Has the bank's legal counsel been involved in the development and review of electronic banking agreements (for example, agreements with third-party vendors)? Has the bank's legal counsel also been involved in the development and review of its authentication methods to ensure that the methods provide a foundation to enforce agreements and transactions and to validate the parties involved, consistent with applicable state laws?

Dividends are distributions of earnings to owners.[1] Dividends can influence an investor's willingness to purchase corporate stock since the investor generally expects reasonable investment returns. Although dividends usually are declared and paid in either cash or stock, occasionally they are used to distribute real or personal property. Dividend payments may reduce capital in some banks to the point of supervisory concern. Accordingly, on November 14, 1985, the Federal Reserve Board issued a policy statement on the payment of dividends by state member banks and bank holding companies. (See *Federal Reserve Regulatory Service* at 4–877.) In addition, certain statutory limitations apply to the payment of dividends.

Examiners should also be aware of a bank's parent company cash-flow needs. In addition to the payment of dividends, the parent company may need cash for debt service or to fund its operations. When establishing dividend levels from a bank subsidiary, the parent company should not set a dividend rate that will place undue pressure on the bank's ability to maintain an adequate level of capital.

Declaration of a dividend requires formal action by the board of directors to designate the medium of payment, dividend rate, shareholder record date, and date of payment. Dividends may be declared at the discretion of the board.[2] Dividends are recorded on the bank's books as a liability (dividends payable) on the date of declaration.

1. Other payments not called dividends may also be distributions of earnings to owners. These distributions or ''constructive dividends'' may be termed fees, bonuses, or other payments. Constructive dividends are distinct from legitimate fees, bonuses, and other payments, which are reasonable, adequately documented, and for valuable goods and services provided to the bank. Constructive dividends may create a potential tax liability and indicate control issues or insider self-dealing, and they may portend shareholder lawsuits against insiders, board members, and the bank.

2. At a minimum, board of directors minutes approving declaration and payment of a dividend should include three components: (1) the ''as of'' date to identify shareholders of record to receive the dividend (date of record), (2) an amount or description of the dividend, and (3) identification of the date on which the dividend payment is to take place (date of payment). There may also be additional legal requirements that should be documented, depending on state laws and the nature of the dividend.

SUMMARY OF POLICY STATEMENT ON PAYMENT OF DIVIDENDS

Adequate capital is critical to the health of individual banking organizations and to the safety and stability of the banking system. A major determinant of a financial institution's capital adequacy is earnings strength and whether earnings are retained or paid to shareholders as cash dividends. Dividends are the primary way that banking organizations provide return to shareholders on their investment.

During profitable periods, dividends represent a return of a portion of a banking organization's net earnings to its shareholders. During less profitable periods, dividend rates are often reduced or sometimes eliminated. The payment of cash dividends that are not fully covered by earnings, in effect, represents the return of a portion of an organization's capital at a time when circumstances may indicate instead the need to strengthen capital and concentrate financial resources on resolving the organization's problems.

As a matter of prudent banking, therefore, a bank or bank holding company generally should continue its existing rate of cash dividends on common stock only if—

- the organization's net income available to common shareholders over the past year has been sufficient to fully fund the dividends; and
- the prospective rate of earnings retention appears consistent with the organization's capital needs, asset quality, and overall financial condition.

Any banking organization whose cash dividends are inconsistent with either of these criteria should seriously consider reducing or eliminating its dividends. Such an action will help conserve the organization's capital base and help it weather a period of adversity.

A banking organization that is experiencing financial problems or that has inadequate capital should not borrow to pay dividends; this would result in increased leverage at the very time the organization needs to reduce its debt or conserve its capital. Similarly, the payment of dividends based solely or largely on gains resulting from unusual or nonrecurring events may be imprudent. Unusual or nonrecurring events may include the sale of assets, the effects of accounting changes, the postponement of large expenses to future periods, or negative provisions to the allowance for loan and lease losses.

STATUTORY LIMITATIONS

Three major federal statutory limitations govern the payment of dividends by banks. These limitations, included in sections 1831o, 56, and 60 of title 12 of the United States Code (12 USC 1831o, 56, and 60), apply to cash dividends or property dividends paid with assets other than cash. However, common stock dividends (dividends payable in common stock to all the common shareholders of the bank) may be paid regardless of the statutory limitations since such dividends do not reduce the bank's capital. In addition, the examiner needs to be aware of any state laws governing dividend payments.

Prompt Corrective Action

Section 1831o, also referred to as the prompt-corrective-action (PCA) provision, was adopted in 1991 as part of the Federal Deposit Insurance Corporation Improvement Act. Section 1831o applies to all insured depository institutions, including state member banks, and is implemented through section 208.40 of Regulation H. This regulatory section prohibits the payment of dividends when a bank is deemed to be undercapitalized or when the payment of the dividend would make the bank undercapitalized in accordance with the PCA framework. An organization that is undercapitalized for purposes of PCA must cease paying dividends for as long as it is deemed to be undercapitalized. Once earnings have begun to improve and an adequate capital position has been restored, dividend payments may resume in accordance with federal and state statutory limitations and guidelines.

Sections 56 and 60

Sections 56 and 60 (sections 5204 and 5199 of the Revised Statutes) were first adopted as part of the National Bank Act more than 100 years ago. Although these sections were made applicable to national banks, they also apply to state member banks under the provisions of section 9 of the Federal Reserve Act.[3] These sections are implemented through section 208.5 of Regulation H.

Under section 56, prior regulatory and shareholder approval must be obtained if the dividend would exceed the bank's undivided profits (retained earnings), as reportable in its Reports of Condition and Income (call reports).[4] In addition, the bank may include amounts contained in its surplus account, if the amounts reflect transfers made in prior periods of undivided profits and if regulatory approval for the transfer back to undivided profits is obtained.

Under section 60, prior regulatory approval to declare a dividend must be obtained if the total of all dividends declared during the calendar year, including the proposed dividend, exceeds the (1) sum of the net income earned during the year-to-date and (2) the retained net income of the prior two calendar years as reported in the bank's call reports. In determining this limitation, any dividends declared on common or preferred stock during the period and any required transfers to surplus or a fund for the retirement of any preferred stock must be deducted from net earnings to determine the net income and retained net income.[5]

The statutory limitations are tied to the declaration date of the dividend because, at that time, shareholders expect the dividends will be paid, a liability is recorded, and the bank's capital is reduced. If the bank's board of directors wishes to declare a dividend between call report dates, the earnings or losses incurred since the last call report date should be considered in the calculation. Thus, if a bank's dividend-paying capacity might be limited under sections 56 or 60, the bank should ensure it has

3. State-chartered banks that are not members of the Federal Reserve System (state nonmember banks) are not subject to sections 56 and 60. However, they may be subject to similar dividend restrictions under state law.

4. Although the language of section 56 could imply that a dividend cannot be declared in excess of the limit even if regulatory approval were obtained, a ''return of capital'' to shareholders is allowed under section 59 if the bank obtains prior regulatory approval and the approval of at least two-thirds of each class of shareholders.

5. In rare circumstances when the surplus of a state member bank is less than what applicable state law requires the bank to maintain relative to its capital stock account, the bank may be required to transfer amounts from its undivided profits account to surplus. This may arise, for example, because some states require surplus to equal or exceed 100 percent of the capital stock account. Such required transfers would reduce the section 60 calculation.

sufficient capacity to declare the dividend by maintaining sufficient documentation to substantiate its earnings or losses on an accrual basis for the period since the last call report date.

REQUEST FOR REGULATORY APPROVAL

When regulatory approval is required for dividend payments under section 56 or 60, the request should be submitted to the appropriate Federal Reserve Bank. In section 265.11(e)(4) of the Rules Regarding Delegation of Authority, the Reserve Banks have been delegated authority to permit a state member bank to declare dividends in excess of section 60 limits. Before approving the request, the Reserve Bank should consider if the proposed dividend is consistent with the bank's capital needs, asset quality, strength of management, and overall financial condition.

If applicable, examiners should verify that prior approval was obtained from the Federal Reserve Bank, and, if required, at least two-thirds of each class of stockholders before the dividend was paid. Violations of law or nonconformance with the Federal Reserve Board's policy statement should be discussed with bank management and noted in the examination report.

1. To determine if the policies, practices, procedures, and internal controls regarding dividends are adequate and whether they are being followed.
2. To determine if bank directors, officers, and employees are operating in compliance with the established guidelines.
3. To evaluate the propriety and consistency of the bank's present and planned dividend policy in light of existing conditions and future plans.
4. To determine that the scope of the audit function is adequate.
5. To determine if any dividends declared exceed the section 1831o limitation, and, if so, to inform the enforcement section of the Federal Reserve Bank.
6. To determine if any dividends declared exceed the section 56 and 60 limitations, and, if so, whether the respective required approvals from the Federal Reserve Bank and shareholders were obtained.
7. To determine whether the dividend payments comply with the Board's policy statement concerning dividend payments of banks and bank holding companies.
8. To determine compliance with other applicable laws and regulations.
9. To initiate corrective action when policies, procedures, or internal controls are deficient or when violations of laws or regulations have been noted.

1. If selected for use, complete or update the internal control questionnaire.
2. Based on the evaluation of internal controls and the work performed by internal or external auditors, determine the scope of the examination.
3. Test for compliance with policies, practices, procedures, and internal controls. Also obtain a listing of any deficiencies noted in the latest internal or external auditor reports from the examiner who is assigned to internal control. Determine if appropriate corrective action has been taken.
4. a. If dividends were declared since the last examination, complete the dividend-limitations worksheets to determine whether the bank was in compliance with the following sections of the U.S. Revised Statutes, as they are interpreted by section 208.5 of Regulation H:
      - section 5199 (12 USC 60), which establishes a restriction based on the current and prior two years' retained net income, as adjusted for required transfers to surplus or transfers to a fund for the retirement of any preferred stock. Table 1 on the next page may be used for the calculation.
      - section 5204 (12 USC 56), which establishes a restriction on dividends based on the bank's retained earnings (undivided profits), as adjusted for any surplus transferred, with prior regulatory approval, as needed, back to undivided profits and the excess, if any, of statutory bad debts over the allowance for loan and lease losses (ALLL).[1]

   b. For the calculations in table 1, determine whether the dividend exceeded the section 56 or 60 limits and, if so, whether the dividend received prior approval. Dividends declared in excess of the section 56 limitation must receive prior Federal Reserve approval and approval by at least two-thirds of the shares of each class of stock outstanding, pursuant to 12 USC 59. Dividends declared in excess of the section 60 limitation must receive prior Federal Reserve approval.
5. Review the examination findings with the examiner-in-charge in preparation for discussion with appropriate management.
6. Prepare examination-report comments on the bank's dividend practices, including any deficiencies noted.
7. Update the workpapers with the current dividend-limitations worksheets, as well as any information that will facilitate future examinations.

1. Although section 56 seems to require that a bank deduct its statutory bad debts from its undivided profits, this adjustment is not generally necessary. Under generally accepted accounting principles, banks are required to reserve for bad debts in the ALLL, which reduces the bank's undivided profits. Banks are thus required to deduct only the excess of statutory bad debts of the bank's ALLL, and such excess rarely occurs. Statutory bad debts represent matured obligations due a bank on which the interest is past due and unpaid for six months or more, unless the debts are well secured and in the process of collection. The second part of table 1 illustrates the section 56 dividend-limitation calculation.

Table 1—Dividend-Limitation Computations

References to schedules in this table are to the schedules in the Consolidated Reports of Condition and Income (bank call reports).

Section 60 Computation

	*Year 20_*	*20_*	*20_*	*Total*
Net income (loss) (schedule RI, item 12)	—	—	—	—
Less: Required transfers to surplus under state law (generally zero) or transfers to a fund for the retirement of any preferred stock	—	—	—	—
Less: Common and preferred stock dividends declared (schedule RI-A, item 8 + item 9)	—	—	—	—
Retained net profits available for dividends before adjustments	—	—	—	—
Adjustments for dividends in excess of income (if any)[1]	—	—	—	—
Retained net profits available for dividends after adjustments	—	—	—	—[2]

1. Any excess may be attributed to the prior two years by first applying the excess to the earlier year, and then the immediately preceding year, net of any previous-year adjustments. See section 208.5 of Regulation H for further guidance.
2. This is the section 60 limitation.

Section 56 Computation

	*Year 20_*
Retained earnings (undivided profits) (schedule RC, item 26a)	—
Add: Surplus in excess of state regulatory requirements that was earned and is transferred, with prior regulatory approval, back to undivided profits	—
Less: Excess of statutory bad debts over the allowance for loan and lease losses (generally zero)	—
Section 56 limitation	—

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

GENERAL

1. Does the bank employ the services of an independent dividend paying agent?

*2. Has the board of directors passed a resolution designating those officers who are authorized to sign dividend checks?

*3. Are unused dividend checks under dual control?

*4. Does the bank's system require separation of duties regarding custody, authorization, preparation, signing and distribution of dividend checks?

*5. Are dividend checks reconciled in detail before mailing?

*6. Is control maintained over the use of serially numbered dividend checks to ensure that they are issued sequentially?

CONCLUSION

1. Does the foregoing information provide an adequate basis for evaluating internal control? If significant deficiencies in areas not included in this questionnaire impair controls, indicate additional examination procedures deemed necessary.
2. Based on a composite evaluation, as evidenced by answers to the foregoing questions, is internal control considered adequate?

Employee benefit trusts are specialized trusts most commonly established to provide retirement benefits to employees. However, they may also be established for employee stock ownership or thrift purposes, or to provide medical, accident, and disability benefits. There are qualified and unqualified plans. Retirement plans are qualified under section 401 of the Internal Revenue Code (IRC), and employee benefit trusts are tax exempt under section 501(a) of the IRC. The major types of qualified plans are profit sharing, money purchase, stock bonus, employee stock ownership plans (ESOPS), 401(k) plans, and defined benefit pension plans.

Since 1974, state jurisdiction of employee benefit trusts and their administration has been largely preempted by a comprehensive scheme of federal laws and regulations under the Employee Retirement Income Security Act of 1974 (ERISA). ERISA is divided into four titles: Title I, ''Protection of Employee Benefit Rights,'' includes the fiduciary responsibility provisions (in part 4) that are interpreted and enforced by the U.S. Department of Labor (DOL). Title II, ''Amendments to the Internal Revenue Code Relating to Retirement Plans,'' is similar to Title I, but the Internal Revenue Service (IRS) is responsible for its enforcement. Title III, ''Jurisdiction, Administration, Enforcement,'' grants jurisdiction and powers for administration to various governmental units. Title IV, ''Plan Termination Insurance,'' establishes the Pension Benefit Guaranty Corporation (PBGC). The PBGC ensures that defined benefit plans have sufficient resources to provide minimum levels of benefits to participants. In addition to the PBGC, the primary agencies that have promulgated necessary regulations and interpretations pursuant to ERISA are the DOL and IRS. However, state and federal banking agencies also have a recognized role under this statute.

Numerous laws affecting employee benefit plans have been enacted since the adoption of ERISA; however, the most sweeping changes were imposed by the Tax Reform Act of 1986. These changes include (1) imposing numerous excise taxes on employers and employees for failure to meet new plan contribution and distribution rules, (2) lowering the maximum amount of contributions and benefits allowed under qualified defined contribution and defined benefit plans, (3) lowering the amount an individual can contribute to a 401(k) plan, and (4) providing new nondiscrimination rules covering plan contributions and distributions. Virtually all qualified plans had to be amended to comply with this law.

A specific statutory provision of ERISA mandates the exchange of information among federal agencies. Accordingly, the federal banking agencies have entered into an agreement with the DOL whereby a banking agency noting any possible ERISA violations that meet certain specific criteria will refer the matter to the DOL.

ERISA imposes very complex requirements on banks acting as trustees or in other fiduciary capacities for employee benefit trusts. Severe penalties can result from violations of statutory obligations. With respect to a bank's own employees' retirement plan, the bank (or ''plan sponsor''), regardless of whether it is named trustee, is still a ''party-in-interest'' pursuant to the statute. Therefore, unless a transaction qualifies for narrowly defined statutory exemptions (or unless it is the subject of a specific ''individual'' exemption granted by the DOL), any transaction involving the purchase or sale of an asset of the plan from or to the bank, any affiliate, officer, or employee could constitute a prohibited transaction under ERISA.

The current and projected costs of employee benefit plans should be analyzed for their impact on the expenses and overall financial condition of the bank. Excessive pension or profit-sharing benefits, large expense accounts, employment contracts, or bonuses for officers or directors (especially if they are also large shareholders) could prove detrimental and even lead to civil liability for the bank or its board.

Depending on the type of plan and the allocations of its fiduciary duties, certain reporting, disclosure, and plan design requirements are imposed on the plan sponsor and/or its designated supervising committee. Therefore, a bank should have appropriate expertise, policies, and procedures to properly administer the type of employee benefit accounts established for its employees.

If an examiner, as part of any examination assignment, detects possible prohibited transactions, self-dealing, or other questionable activities involving the bank's employee benefit plan, an appropriate investigation should be undertaken. Substantial conversions of existing defined benefit plans or plan assets into holdings of bank or affiliate stock, under certain circumstances, could involve ERISA violations. An examiner should refer a complicated question arising out of any of these situations to the examiner-in-charge for resolution or submission to the Reserve Bank.

Part I of the following examination procedures (section 4080.3) should be completed for every commercial bank examination; part II should also be completed if the employee benefit plan is not trusteed by the bank or by an affiliate bank subject to supervision by a federal banking agency. Parts I and II may be completed by a trust specialist, if available. When a bank trust department is named as trustee, the examiner should determine whether compliance with ERISA was reviewed during the previous trust examination. If not, then part II should be completed.

Employee Benefit Trusts
Examination Objectives
Effective date May 1996

1. To determine if the policies, practices, procedures, internal controls, and available expertise regarding employee benefit trusts are adequate.
2. To determine if bank officers are operating in conformance with the established guidelines.
3. To evaluate the impact of employee benefit plans and related benefits on the financial condition of the bank.
4. To determine compliance with laws, regulations, and instrument provisions.
5. To initiate corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws, regulations, or the governing instruments have been noted.

PART I

1. If selected for implementation, complete or update the Employee Benefit Trusts section of the Internal Controls Questionnaire.
2. Test for compliance with policies, practices, procedures and internal controls in conjunction with performing the remaining examination procedures. Also obtain a listing of any deficiencies noted in the latest review done by internal/external auditors from the examiner assigned ''Internal Control,'' and determine if appropriate corrections have been made.
3. Determine the approximate number, size and types of employee benefit plans held for the benefit of the bank's officers and employees.
4. Obtain plan instruments or amendments thereto (if any) and summarize key features for the work papers. As appropriate, add or update the following information:
   a. Date of adoption of new plan or amendment and brief summary of the plan or amendment.
   b. Parties or committees named trustee and (if different) person(s) responsible for making investment decisions.
   c. Individuals, committees or outside parties named as responsible for plan administration.
   d. Basic investment/funding characteristics (e.g., ''non-contributory profit-sharing, up to 100% in own BHC stock;'' ''contributory defined benefit pension plan, purchasing diversified securities,'' etc.).
   e. Latest Form 5500 (IRS) filed for plan (may be omitted if plan administrator is an affiliate bank or bank holding company).

   Example: First Bank established a non-contributory profit sharing trust in 1975 for all officers and employees. Latest amendment, as of December 31, 19XX, made technical alterations to the vesting and forfeiture provisions. The most recent available valuation of the trust's assets, dated June 30, 19XX, indicated total assets of $22,093,000 (market value). Assets were comprised of U.S. government securities (42%), listed stocks (53%) and cash equivalents. Bank of __________, as trustee, has sole investment responsibility.
5. If a plan is a defined benefit pension plan, ascertain the actuarily-determined amount of unfunded pension liability, if any, and the bank's arrangements for amortization. (Note: Unfunded pension liability represents a contingent liability per instructions for the Report of Condition.)
6. Determine if the current and projected costs of the employee benefit plan(s) is reasonable in light of the bank's financial condition.

Complete part II of these procedures, if applicable, then continue to step 7, below. Part II is to be completed when a plan for the bank's employees is administered by the bank or a bank committee and is not trusteed by the bank itself or an affiliate bank subject to supervision by a federal banking agency.

7. Determine whether any instances of possible violations of ERISA have been noted, and that as to each such instance, full information has been developed for current workpapers to support a referral to DOL pursuant to SR-81-697/TR-81-46.

   Note: While the final decision on whether or not to make a referral to the DOL is to be made by the Board's staff after receipt of the report of examination, complete information should always be obtained regarding possible ERISA violations in the event the decision is made to refer the matter. If gathering certain of the information would impose an undue burden upon the resources of the examiners or the bank, Board's staff (Trust Activities Program) should be consulted. Where a significant prohibited transaction such as self dealing has taken place, the bank should be clearly informed that it is expected to undertake all such corrective and/or remedial actions as are necessary under the circumstances. One measure would be for the bank to apply to the DOL for a retroactive exemption under ERISA section 408(a).
8. Reach a conclusion concerning:
   a. The adequacy of policies, practices and

procedures relating to employee benefit trusts.
   b. The manner in which bank officers are operating in conformance with established policy.
   c. The accuracy and completeness of any schedules obtained.
   d. Internal control deficiencies or exceptions.
   e. The quality of departmental management.
   f. Other matters of significance.
9. Prepare in appropriate report format, and discuss with appropriate officer(s):
   a. Violations of laws and regulations.
   b. Recommended corrective action when policies, practices or procedures are deficient.
10. Update the workpapers with any information that will facilitate future examinations.

PART II

1. Review plan asset listings, valuations, or printouts obtained for any instances of possible prohibited transactions (ERISA sections 406(a) and (b)). The listings should include holdings of:
   a. Loans.
   b. Leases.
   c. Real Estate.
   d. Employer stock or other securities or obligations.
   e. Own bank time deposits.
   f. Other assets which might constitute, or result from, prohibited transactions.
2. Review transaction(s)/holding(s) in the previous step for conformity to:
   a. ERISA provisions regarding employer securities or real estate (sections 407(a), (b) and (c)) and related regulations.
   b. Statutory exemptions of ERISA (section 408(b)).
   c. ''Exclusive benefit,'' prudence and diversification requirements of ERISA (sections 404(a) and (b)).

Review the bank's internal controls, policies, practices and procedures for employee benefit accounts. The bank's system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used and other pertinent information. Part I should be completed as part of every examination; both parts I and II should be completed whenever the plan, administered by the bank or a bank committee, is *not* trusteed by the bank itself or by an affiliate bank subject to supervision by a federal banking agency.

PART I

1. Are new employee benefit plans, significant amendments thereto, and related costs and features approved by the bank's board of directors?

*2. Does the institution obtain and maintain on file the following minimum documentation:
   a. The plan and the corporate resolution adopting it?
   b. IRS ''determination'' or ''opinion'' letter substantiating the tax-exempt status of the plan?
   c. The trust agreement and the corporate resolution appointing the trustee(s), if applicable? (On occasion, fully insured plans may have no named trustee.)
   d. Amendments to the plan or trust documents?

3. If the bank or a committee of its officers and employees acts as plan administrator for any plan(s), does it have internal procedures and/or has it arranged by contract for external administrative expertise sufficient to assure compliance with reporting, disclosure and other administrative requirements of ERISA and related regulations?
4. Have the bank, its officers, directors or employees, or any affiliate(s) entered into any transactions to buy or sell assets to the bank's employee benefit plan(s)?
5. Do plan investments conform to instrument investment provisions?

PART II

1. When exercising fiduciary responsibility in the purchase or retention of employer securities or employer real estate, does the bank have procedures to assure conformity with ERISA section 407 and related provisions?

   Note: The requirements of ERISA and the associated DOL regulation with respect to ''employer securities and employer real estate'' include:

   a. A plan may not acquire or hold any but ''qualifying employer securities and employer real estate.''
   b. A defined benefit plan may hold no more than 10 percent of the fair market value of its assets in qualifying employer securities and/or qualifying employer real property, except as provided by ERISA sections 407(a)(3) or 414(c)(1) and (2), and adopted regulations.
   c. Any dispositions of such property from a plan to a party-in-interest shall conform to ERISA sections 414(c)(3) and (5) and adopted regulations, but certain acquisitions and sales may be made pursuant to the section 408(a) exemption.
   d. The plan instrument, for an eligible individual account plan which is to hold in excess of 10 percent of the fair market value of its assets in qualifying employer securities or real property, shall provide explicitly the extent to which such plan may hold such assets. [ERISA sections 407(b)(1) and (d)(3)]

2. Does the bank have procedures to ensure conformance to the following statutory exemptions (and associated regulations) from the prohibited transactions provisions of ERISA:
   a. Loans made by the plan to parties-in-interest who are participants or beneficiaries? [ERISA section 408(b)(1)]
   b. Investment in deposits which bear a reasonable rate of interest of a bank which is a fiduciary of the plan? [ERISA section 408(b)(4)]

   Note: Other statutory exemptions which may on occasion be applicable are:

   c. Arrangements for office space or legal, accounting or other necessary services? [ERISA section 408(b)(2)]
   d. Loans to employee stock ownership trusts? [ERISA section 408(b)(3)]

e. Transactions between a plan and a collective trust fund maintained by a party-in-interest which is a bank or trust company? [section 408(b)(8)]
f. Providing of any ancillary service by a bank or trust company which is a fiduciary of the plan? [ERISA section 408(b)(6)]

3. If exercising or sharing fiduciary responsibility, does the bank have procedures designed:
    a. To ensure that duties are executed for the exclusive benefit of plan participants and beneficiaries, in accordance with the ''prudent man'' standard? [ERISA sections 404(a)(1)(A) and (B)]
    b. To ensure that investments are diversified, unless it is clearly prudent not to do so or otherwise excepted by other provisions of ERISA? [ERISA section 404(a)(1)(C)]

Interest-rate risk (IRR) is the exposure of an institution's financial condition to adverse movements in interest rates. Accepting this risk is a normal part of banking and can be an important source of profitability and shareholder value. However, excessive levels of IRR can pose a significant threat to an institution's earnings and capital base. Accordingly, effective risk management that maintains IRR at prudent levels is essential to the safety and soundness of banking institutions.

Evaluating an institution's exposure to changes in interest rates is an important element of any full-scope examination and, for some institutions, may be the sole topic for specialized or targeted examinations. Such an evaluation includes assessing both the adequacy of the management process used to control IRR and the quantitative level of exposure. When assessing the IRR management process, examiners should ensure that appropriate policies, procedures, management information systems, and internal controls are in place to maintain IRR at prudent levels with consistency and continuity. Evaluating the quantitative level of IRR exposure requires examiners to assess the existing and potential future effects of changes in interest rates on an institution's financial condition, including its capital adequacy, earnings, liquidity, and, where appropriate, asset quality. To ensure that these assessments are both effective and efficient, examiner resources must be appropriately targeted at those elements of IRR that pose the greatest threat to the financial condition of an institution. This targeting requires an examination process built on a well-focused assessment of IRR exposure before the on-site engagement, a clearly defined examination scope, and a comprehensive program for following up on examination findings and ongoing monitoring. This section provides examiner guidance for assessing both the adequacy of an institution's IRR management process and the quantitative level of its IRR exposure. The section begins with a description of the sources and effects of IRR, followed by a discussion of sound practices for managing IRR. The section then outlines examination considerations in assessing the quantitative level of IRR exposure. Finally, the section discusses key elements of the examination process used to assess IRR, including the role and importance of a preexamination risk assessment, proper scoping of the examination, and the testing and verification of both the management process and internal measures of the level of IRR exposure.[1]

SOURCES AND EFFECTS OF IRR

Sources of IRR

As financial intermediaries, banks encounter IRR in several ways. The primary and most discussed source of IRR is differences in the timing of the repricing of bank assets, liabilities, and off-balance-sheet (OBS) instruments. Repricing mismatches are fundamental to the business of banking and generally occur from either borrowing short-term to fund longer-term assets or borrowing long-term to fund shorter-term assets. Such mismatches can expose an institution to adverse changes in both the overall level of interest rates (parallel shifts in the yield curve) and the relative level of rates across the yield curve (nonparallel shifts in the yield curve).

Another important source of IRR, commonly referred to as "basis risk," is the imperfect correlation in the adjustment of the rates earned and paid on different instruments with otherwise similar repricing characteristics (for example, a three-month Treasury bill versus a three-month LIBOR). When interest rates change, these differences can change the cash flows and earnings spread between assets, liabilities, and OBS instruments of similar maturities or repricing frequencies.

An additional and increasingly important source of IRR is the options in many bank asset, liability, and OBS portfolios. An option pro-

1. This section incorporates and builds on the principles and guidance provided in SR-96-13, "Joint Policy Statement on Interest Rate Risk." It also incorporates, where appropriate, fundamental risk-management principles and supervisory policies and approaches identified in SR-93-69, "Examining Risk Management and Internal Controls for Trading Activities of Banking Organizations"; SR-95-51, "Rating the Adequacy of Risk Management Processes and Internal Controls at State Member Banks and Bank Holding Companies"; SR-96-14, "Risk-Focused Examinations and Inspections"; and SR-00-14, "Enhancements to the Interagency Program for Supervising the U.S. Operations of Foreign Banking Organizations."

vides the holder with the right, but not the obligation, to buy, sell, or in some manner alter the cash flow of an instrument or financial contract. Options may be distinct instruments, such as exchange-traded and over-the-counter contracts, or they may be embedded within the contractual terms of other instruments. Examples of instruments with embedded options include bonds and notes with call or put provisions (e.g., callable U.S. agency notes), loans that give borrowers the right to prepay balances without penalty (e.g., residential mortgage loans), and various types of nonmaturity deposit instruments that give depositors the right to withdraw funds at any time without penalty (e.g., core deposits). If not adequately managed, the asymmetrical payoff characteristics of options can pose significant risk to the banking institutions that sell them. Generally, the options, both explicit and embedded, held by bank customers are exercised to the advantage of the holder, not the bank. Moreover, an increasing array of options can involve highly complex contract terms that may substantially magnify the effect of changing reference values on the value of the option and, thus, magnify the asymmetry of option payoffs.

Effects of IRR

Repricing mismatches, basis risk, options, and other aspects of a bank's holdings and activities can expose an institution's earnings and value to adverse changes in market interest rates. The effect of interest rates on accrual or *reported earnings* is the most common focal point. In assessing the effects of changing rates on earnings, most banks focus primarily on their net interest income—the difference between total interest income and total interest expense. However, as banks have expanded into new activities to generate new types of fee-based and other non-interest income, a focus on overall net income is becoming more appropriate. The non-interest income arising from many activities, such as loan servicing and various asset-securitization programs, can be highly sensitive to changes in market interest rates. As non-interest income becomes an increasingly important source of bank earnings, both bank management and supervisors need to take a broader view of the potential effects of changes in market interest rates on bank earnings.

Market interest rates also affect the *value* of a bank's assets, liabilities, and OBS instruments and, thus, have a direct effect on the value of an institution's equity capital. The effect of rates on the *economic value* of an institution's holdings and equity capital is a particularly important consideration for shareholders, management, and supervisors alike. The economic value of an instrument is an assessment of the present value of its expected net future cash flows, discounted to reflect market rates.[2] By extension, an institution's economic value of equity (EVE) can be viewed as the present value of the expected cash flows on assets minus the present value of the expected cash flows on liabilities plus the net present value of the expected cash flows on OBS instruments. Economic values, which may differ from reported book values due to GAAP accounting conventions, can provide a number of useful insights into the current and potential future financial condition of an institution. Economic values reflect one view of the ongoing worth of the institution and can often provide a basis for assessing past management decisions in light of current circumstances. Moreover, economic values can offer comprehensive insights into the potential future direction of earnings performance since changes in the economic value of an institution's equity reflect changes in the present value of the bank's future earnings arising from its current holdings.

Generally, commercial banking institutions have adequately managed their IRR exposures and few have failed solely as a result of adverse interest-rate movements. Nevertheless, changes in interest rates can have negative effects on bank profitability and must be carefully managed, especially given the rapid pace of financial innovation and the heightened level of competition among all types of financial institutions.

SOUND IRR MANAGEMENT PRACTICES

As is the case in managing other types of risk,

2. For some instruments, economic values may be the same as fair value—especially when prices from active markets are available. The fair value of an instrument is generally considered to be the amount at which the instrument could be exchanged in a current transaction between willing parties other than in a forced or liquidation sale. Even then, the economic values of instruments and firms may differ from fair values due to unique insights on the intrinsic value of instruments derived on a going-concern basis.

sound IRR management involves effective board and senior management oversight and a comprehensive risk-management process that includes the following elements:

- effective policies and procedures designed to control the nature and amount of IRR, including clearly defined IRR limits and lines of responsibility and authority
- appropriate risk-measurement, monitoring, and reporting systems
- systematic internal controls that include the internal or external review and/or audit of key elements of the risk-management process

The formality and sophistication used in managing IRR depends on the size and sophistication of the institution, the nature and complexity of its holdings and activities, and the overall level of its IRR. Adequate IRR management practices can vary considerably. For example, a small institution with noncomplex activities and holdings, a relatively short-term balance-sheet structure presenting a low IRR profile, and senior managers and directors who are actively involved in the details of day-to-day operations may be able to rely on relatively simple and informal IRR management systems.

More complex institutions and those with higher interest-rate risk exposures or holdings of complex instruments may require more elaborate and formal IRR management systems to address their broader and typically more complex range of financial activities, as well as provide senior managers and directors with the information they need to monitor and direct day-to-day activities. The more complex interest-rate risk management processes often employed at these institutions may require more formal internal controls, such as internal and external audits, to ensure the integrity of the information senior officials use to oversee compliance with policies and limits.

Individuals involved in the risk-management process should be sufficiently independent of business lines to ensure adequate separation of duties and avoid potential conflicts of interest. The degree of autonomy these individuals have may be a function of the size and complexity of the institution. In smaller and less complex institutions with limited resources, it may not be possible to completely remove individuals with business-line responsibilities from the risk-management process. In these cases, focus should be directed towards ensuring that risk-management functions are conducted effectively and objectively. Larger, more complex institutions may have separate and independent risk-management units.

Board and Senior Management Oversight

Effective oversight by a bank's board of directors and senior management is critical to a sound IRR management process. The board and senior management should be aware of their responsibilities related to IRR management, understand the nature and level of interest-rate risk taken by the bank, and ensure that the formality and sophistication of the risk-management process is appropriate for the overall level of risk.

Board of Directors

The board of directors has the ultimate responsibility for the level of IRR taken by the institution. The board should approve business strategies and significant policies that govern or influence the institution's interest-rate risk. It should articulate overall IRR objectives and should ensure the provision of clear guidance on the level of acceptable IRR.[3] The board should also approve policies and procedures that identify lines of authority and responsibility for managing IRR exposures.

Directors should understand the nature of the risks to their institution and ensure that management is identifying, measuring, monitoring, and controlling these risks. Accordingly, the board should monitor the performance and IRR profile of the institution and periodically review information that is timely and sufficiently detailed to allow directors to understand and assess the IRR facing the institution's key portfolios and the institution as a whole. The frequency of these reviews depends on the sophistication of the institution, the complexity of its holdings, and the materiality of changes in its holdings between reviews. Institutions holding significant positions in complex instruments or with significant changes in the composition of holdings would be expected to have more frequent reviews. In addition, the board should periodically review

3. For example, objectives for IRR could be set in terms of enhancement to income, liquidity, and value, while IRR limits could be expressed as acceptable levels of volatility in these same areas.

significant IRR management policies and procedures, as well as overall business strategies that affect the institution's IRR exposure.

The board of directors should encourage discussions between its members and senior management, as well as between senior management and others in the institution, regarding the institution's IRR exposures and management process. Board members need not have detailed technical knowledge of complex financial instruments, legal issues, or sophisticated risk-management techniques. However, they are responsible for ensuring that the institution has personnel available who have the necessary technical skills and that senior management fully understands the risks incurred by the institution and is sufficiently controlling them.

A bank's board of directors may meet its responsibilities in a variety of ways, including the identification of selected board members to become directly involved in risk-management activities by participating on board committees or by otherwise gaining a sufficient understanding and awareness of the institution's risk profile through periodic briefings and management reports. Information provided to board members should be presented in a format that members can readily understand and that will assist them in making informed policy decisions about acceptable levels of risk, the nature of risks in current and proposed new activities, and the adequacy of the institution's risk-management process. In short, regardless of the structure of the organization and the composition of its board of directors or delegated board committees, board members must ensure that the institution has the necessary technical skills and management expertise to conduct its activities prudently and consistently within the policies and intent of the board.

Senior Management

Senior management is responsible for ensuring that the institution has adequate policies and procedures for managing IRR on both a long-range and day-to-day basis and that it maintains clear lines of authority and responsibility for managing and controlling this risk. Management should develop and implement policies and procedures that translate the board's goals, objectives, and risk limits into operating standards that are well understood by bank personnel and that are consistent with the board's intent. Management is also responsible for maintaining (1) adequate systems and standards for measuring risk, (2) standards for valuing positions and measuring performance, (3) a comprehensive IRR reporting and monitoring process, and (4) effective internal controls and review processes.

IRR reports to senior management should provide aggregate information as well as sufficient supporting detail so that management can assess the sensitivity of the institution to changes in market conditions and other important risk factors. Senior management should also periodically review the organization's IRR management policies and procedures to ensure that they remain appropriate and sound. Senior management should also encourage and participate in discussions with members of the board and—when appropriate to the size and complexity of the institution—with risk-management staff regarding risk-measurement, reporting, and management procedures.

Management should ensure that analysis and risk-management activities related to IRR are conducted by competent staff whose technical knowledge and experience is consistent with the nature and scope of the institution's activities. The staff should have enough knowledgeable people to serve as backup to key personnel.

Policies, Procedures, and Limits

Institutions should have clear policies and procedures for limiting and controlling IRR. These policies and procedures should (1) delineate lines of responsibility and accountability over IRR management decisions, (2) clearly define authorized instruments and permissible hedging and position taking strategies, (3) identify the frequency and method for measuring and monitoring IRR, and (4) specify quantitative limits that define the acceptable level of risk for the institution. In addition, management should define the specific procedures and approvals necessary for exceptions to policies, limits, and authorizations. All IRR risk policies should be reviewed periodically and revised as needed.

Clear Lines of Authority

Whether through formal written policies or clear operating procedures, management should define the structure of managerial responsibilities and oversight, including lines of authority and responsibility in the following areas:

- developing and implementing strategies and tactics used in managing IRR
- establishing and maintaining an IRR measurement and monitoring system
- identifying potential IRR and related issues arising from the potential use of new products
- developing IRR management policies, procedures and limits, and authorizing exceptions to policies and limits

Individuals and committees responsible for making decisions about interest-rate risk management should be clearly identified. Many medium-sized and large banks and banks with concentrations in complex instruments delegate responsibility for IRR management to a committee of senior managers, sometimes called an asset/liability committee (ALCO). In such institutions, policies should clearly identify ALCO membership, the committee's duties and responsibilities, the extent of its decision-making authority, and the form and frequency of its periodic reports to senior management and the board of directors. An ALCO should have sufficiently broad participation across major banking functions (for example, lending, investment, deposit, funding) to ensure that its decisions can be executed effectively throughout the institution. In many large institutions, the ALCO delegates day-to-day responsibilities for IRR management to an independent risk-management department or function.

Regardless of the level of organization and formality used to manage IRR, individuals involved in the risk-management process (including separate risk-management units, if present) should be sufficiently independent of the business lines to ensure adequate separation of duties and avoid potential conflicts of interest. Also, personnel charged with measuring and monitoring IRR should have a well-founded understanding of all aspects of the institution's IRR profile. Compensation policies for these individuals should be adequate enough to attract and retain personnel who are well qualified to assess the risks of the institution's activities.

Authorized Activities

Institutions should clearly identify the types of financial instruments that are permissible for managing IRR, either specifically or by their characteristics. As appropriate to its size and complexity, the institution should delineate procedures for acquiring specific instruments, managing individual portfolios, and controlling the institution's aggregate IRR exposure. Major hedging or risk-management initiatives should be approved by the board or its appropriate delegated committee before being implemented.

Before introducing new products, hedging, or position-taking initiatives, management should also ensure that adequate operational procedures and risk-control systems are in place. Proposals to undertake such new instruments or activities should contain these features:

- a description of the relevant product or activity
- an identification of the resources required to establish sound and effective IRR management of the product or activity
- an analysis of the risk of loss from the proposed activities in relation to the institution's overall financial condition and capital levels
- the procedures to be used to measure, monitor, and control the risks of the proposed product or activity

Limits

The goal of IRR management is to maintain an institution's interest-rate risk exposure within self-imposed parameters over a range of possible changes in interest rates. A system of IRR limits and risk-taking guidelines provides the means for achieving that goal. Such a system should set boundaries for the institution's level of IRR and, where appropriate, provide the capability to allocate these limits to individual portfolios or activities. Limit systems should also ensure that limit violations receive prompt management attention.

Aggregate IRR limits clearly articulating the amount of IRR acceptable to the firm should be approved by the board of directors and reevaluated periodically. Limits should be appropriate to the size, complexity, and financial condition of the organization. Depending on the nature of an institution's holdings and its general sophistication, limits can also be identified for individual business units, portfolios, instrument types, or specific instruments.[4] The level of detail of risk limits should reflect the characteristics of the institution's holdings, including the various sources of IRR to which the institution is exposed. Limits applied to portfolio categories and individual instruments should be consistent with and complementary to consolidated limits.

IRR limits should be consistent with the institution's overall approach to measuring and managing IRR and should address the potential impact of changes in market interest rates on both reported earnings and the institution's economic value of equity (EVE). From an earnings perspective, institutions should explore limits on net income as well as net interest income to fully assess the contribution of non-interest income to the IRR exposure of the institution. Limits addressing the effect of changing interest rates on economic value may range from those focusing on the potential volatility of the value of the institution's major holdings to a comprehensive estimate of the exposure of the institution's EVE.

The limits for addressing the effect of rates on an institution's profitability and EVE should be appropriate for the size and complexity of its underlying positions. Relatively simple limits identifying maximum maturity/repricing gaps, acceptable maturity profiles, or the extent of volatile holdings may be adequate for institutions engaged in traditional banking activities and with few holdings of long-term instruments, options, instruments with embedded options, or other instruments whose value may be substantially affected by changes in market rates. For more complex institutions, quantitative limits on acceptable changes in its estimated earnings and EVE under specified scenarios may be more appropriate. Banks that have significant intermediate- and long-term mismatches or complex option positions should, at a minimum, have economic value–oriented limits that quantify and constrain the potential changes in economic value or bank capital that could arise from those positions.

Limits on the IRR exposure of earnings should be broadly consistent with those used to control the exposure of a bank's economic value. IRR limits on earnings variability primarily address the near-term recognition of the effects of changing interest rates on the institution's financial condition. IRR limits on economic value reflect efforts to control the effect of changes in market rates on the present value of the entire future earnings stream arising from the institution's current holdings.

IRR limits and risk tolerances may be keyed to specific scenarios of market-interest-rate movements, such as an increase or decrease of a particular magnitude. The rate movements used in developing these limits should represent meaningful stress situations, taking into account historic rate volatility and the time required for management to address exposures. Moreover, stress scenarios should take account of the range of the institution's IRR characteristics, including mismatch, basis, and option risks. Simple scenarios using parallel shifts in interest rates may be insufficient to identify these risks.

Increasingly, large, complex institutions are using advanced statistical techniques to measure IRR across a probability distribution of potential interest-rate movements and express limits in terms of statistical confidence intervals. If properly used, these techniques can be particularly useful in measuring and managing options positions.

Risk-Measurement and -Monitoring Systems

An effective process of measuring, monitoring, and reporting exposures is essential for adequately managing IRR. The sophistication and complexity of this process should be appropriate to the size, complexity, nature, and mix of an institution's business lines and its IRR characteristics.

IRR Measurement

Well-managed banks have IRR measurement systems that measure the effect of rate changes on both earnings and economic value. The latter is particularly important for institutions with significant holdings of intermediate and long-term instruments or instruments with embedded options because their market values can be particularly sensitive to changes in market interest rates. Institutions with significant non-interest income that is sensitive to changes in

4. Section 2020, "Acquisition and Management of Nontrading Securities and Derivative Products," discusses issues in setting price volatility limits in the acquisition of securities and derivatives.

interest rates should focus special attention on net income as well as net interest income. Since the value of instruments with intermediate and long maturities and embedded options is especially sensitive to interest-rate changes, banks with significant holdings of these instruments should be able to assess the potential longer-term impact of changes in interest rates on the value of these positions—the overall potential performance of the bank.

IRR measurement systems should (1) assess all material IRR associated with an institution's assets, liabilities, and OBS positions; (2) use generally accepted financial concepts and risk-measurement techniques; and (3) have well-documented assumptions and parameters. Material sources of IRR include the mismatch, basis, and option risk exposures of the institution. In many cases, the interest-rate characteristics of a bank's largest holdings will dominate its aggregate risk profile. While all of a bank's holdings should receive appropriate treatment, measurement systems should rigorously evaluate the major holdings and instruments whose values are especially sensitive to rate changes. Instruments with significant embedded or explicit option characteristics should receive special attention.

IRR measurement systems should use generally accepted financial measurement techniques and conventions to estimate the bank's exposure. Examiners should evaluate these systems in the context of the level of sophistication and complexity of the institution's holdings and activities. A number of accepted techniques are available for measuring the IRR exposure of both earnings and economic value. Their complexity ranges from simple calculations and static simulations using current holdings to highly sophisticated dynamic modeling techniques that reflect potential future business and business decisions. Basic IRR measurement techniques begin with a maturity/repricing schedule, which distributes assets, liabilities, and OBS holdings into time bands according to their final maturity (if fixed-rate) or time remaining to their next repricing (if floating). The choice of time bands may vary from bank to bank. Those assets and liabilities lacking contractual repricing intervals or maturities are assigned to repricing time bands according to the judgment and analysis of the institution.

Simple maturity/repricing schedules can be used to generate rough indicators of the IRR sensitivity of both earnings and economic values to changing interest rates. To evaluate earnings exposures, liabilities arrayed in each time band can be subtracted from the assets arrayed in the same time band to yield a dollar amount of maturity/repricing mismatch or gap in each time band. The sign and magnitude of the gaps in various time bands can be used to assess potential earnings volatility arising from changes in market interest rates.

A maturity/repricing schedule can also be used to evaluate the effects of changing rates on an institution's economic value. At the most basic level, mismatches or gaps in long-dated time bands can provide insights into the potential vulnerability of the economic value of relatively noncomplex institutions. Such long-term gap calculations along with simple maturity distributions of holdings may be sufficient for relatively noncomplex institutions. On a slightly more advanced, yet still simplistic, level, estimates of the change in an institution's economic value can be calculated by applying economic-value sensitivity weights to the asset and liability positions slotted in the time bands of a maturity/repricing schedule. The weights can be constructed to represent estimates of the change in value of the instruments maturing or repricing in that time band given a specified interest-rate scenario. When these weights are applied to the institution's assets, liabilities, and OBS positions and subsequently netted, the result can provide a rough approximation of the change in the institution's EVE under the assumed scenario. These measurement techniques can prove especially useful for institutions with small holdings of complex instruments.[5] Further refinements to simple risk weighting techniques can be achieved by incorporating the risk of options, the potential for basis risk, and non-parallel shifts in the yield curve using customized risk weights applied to the specific instruments or instrument types arrayed in the maturity repricing schedule.

Larger institutions and those with complex risk profiles that entail meaningful basis or option risks may find it difficult to monitor IRR adequately using simple maturity/repricing analyses. Generally, they will need to employ more

5. James V. Houpt and James A. Embersit, "A Method for Evaluating Interest Rate Risk in Commercial Banks," *Federal Reserve Bulletin*, vol. 77 (August 1991), 625–37 and David M. Wright and James V. Houpt, "An Analysis of Commercial Bank Exposure to Interest Rate Risk," *Federal Reserve Bulletin*, vol. 82 (February 1996), 115–128.

sophisticated simulation techniques. For assessing the exposure of earnings, simulations estimating cash flows and resulting earnings streams over a specific period are conducted based on existing holdings and assumed interest-rate scenarios. When these cash flows are simulated over the entire expected lives of the institution's holdings and discounted back to their present values, an estimate of the change in EVE can be calculated.

Static cash-flow simulations of current holdings can be made more dynamic by incorporating more detailed assumptions about the future course of interest rates and the expected changes in a bank's business activity over a specified time horizon. Combining assumptions on future activities and reinvestment strategies with information about current holdings, these simulations can project expected cash flows and estimate dynamic earnings and EVE outcomes. These more sophisticated techniques, such as option-adjusted pricing analysis and Monte Carlo simulation, allow for dynamic interaction of payment streams and interest rates to better capture the effect of embedded or explicit options.

The IRR measurement techniques and associated models should be sufficiently robust to adequately measure the risk profile of the institution's holdings. Depending on the size and sophistication of the institution and its activities, as well as the nature of its holdings, the IRR measurement system should have the capability to adequately reflect (1) uncertain principal amortization and prepayments; (2) caps and floors on loans and securities, where material; (3) the characteristics of both basic and complex OBS instruments held by the institution; and (4) changing spread relationships necessary to capture basis risk. Moreover, IRR models should provide clear reports that identify major assumptions and allow management to evaluate the reasonableness of and internal consistency among key assumptions.

Data Integrity and Assumptions

The usefulness of IRR measures depends on the integrity of the data on current holdings, validity of the underlying assumptions, and IRR scenarios used to model IRR exposures. Techniques involving sophisticated simulations should be used carefully so that they do not become "black boxes," producing numbers that appear to be precise, but that may be less accurate when their specific assumptions and parameters are revealed.

The integrity of data on current positions is an important component of the risk-measurement process. Institutions should ensure that current positions are delineated at an appropriate level of aggregation (for example, by instrument type, coupon rate, or repricing characteristic) to ensure that risk measures capture all meaningful types and sources of IRR, including those arising from explicit or embedded options. Management should also ensure that all material positions are represented in IRR measures, that the data used are accurate and meaningful, and that the data adequately reflect all relevant repricing and maturity characteristics. When applicable, data should include information on the contractual coupon rates and cash flows of associated instruments and contracts. Manual adjustments to underlying data should be well documented.

Senior management and risk managers should recognize the key assumptions used in IRR measurement, as well as reevaluate and approve them periodically. Assumptions should also be documented clearly and, ideally, the effect of alternative assumptions should be presented so that their significance can be fully understood. Assumptions used in assessing the interest-rate sensitivity of complex instruments, such as those with embedded options, and instruments with uncertain maturities, such as core deposits, should be subject to rigorous documentation and review, as appropriate to the size and sophistication of the institution. Assumptions about customer behavior and new business should take proper account of historical patterns and be consistent with the interest-rate scenarios used.

Nonmaturity Deposits

An institution's IRR measurement system should consider the sensitivity of nonmaturity deposits, including demand deposits, NOW accounts, savings deposits, and money market deposit accounts. Nonmaturity deposits represent a large portion of the industry's funding base, and a variety of techniques are used to analyze their IRR characteristics. The use of these techniques should be appropriate to the size, sophistication, and complexity of the institution.

In general, treatment of nonmaturity deposits should consider the historical behavior of the institution's deposits; general conditions in the institution's markets, including the degree of competition it faces; and anticipated pricing behavior under the scenario investigated. Assumptions should be supported to the fullest extent practicable. Treatment of nonmaturity deposits within the measurement system may, of course, change from time to time based on market and economic conditions. Such changes should be well founded and documented. Treatments used in constructing earnings simulation assessments should be conceptually and empirically consistent with those used in developing EVE assessments of IRR.

IRR Scenarios

IRR exposure estimates, whether linked to earnings or economic value, use some form of forecasts or scenarios of possible changes in market interest rates. Bank management should ensure that IRR is measured over a probable range of potential interest-rate changes, including meaningful stress situations. The scenarios used should be large enough to expose all of the meaningful sources of IRR associated with an institution's holdings. In developing appropriate scenarios, bank management should consider the current level and term structure of rates and possible changes to that environment, given the historical and expected future volatility of market rates. At a minimum, scenarios should include an instantaneous plus or minus 200 basis point parallel shift in market rates.[6] Institutions should also consider the use of multiple scenarios, including the potential effects of changes in the relationships among interest rates (option risk and basis risk) as well as changes in the general level of interest rates and changes in the shape of the yield curve.

The risk-measurement system should support a meaningful evaluation of the effect of stressful market conditions on the institution. Stress-testing should be designed to provide information on the kinds of conditions under which the institution's strategies or positions would be most vulnerable; thus, testing may be tailored to the risk characteristics of the institution. Possible stress scenarios might include abrupt changes in the term structure of interest rates, relationships among key market rates (basis risk), liquidity of key financial markets, or volatility of market rates. In addition, stress scenarios should include conditions under which key business assumptions and parameters break down. The stress-testing of assumptions used for illiquid instruments and instruments with uncertain contractual maturities, such as core deposits, is particularly critical to achieving an understanding of the institution's risk profile. Therefore, stress scenarios may not only include extremes of observed market conditions but also plausible worst-case scenarios.

Management and the board of directors should periodically review the results of stress tests and the appropriateness of key underlying assumptions. Stress-testing should be supported by appropriate contingency plans.

IRR Monitoring and Reporting

An accurate, informative, and timely management information system is essential for managing IRR exposure, both to inform management and support compliance with board policy. Reporting of risk measures should be regular and clearly compare current exposure with policy limits. In addition, past forecasts or risk estimates should be compared with actual results as one tool to identify any potential shortcomings in modeling techniques.

A bank's senior management and its board or a board committee should receive reports on the bank's IRR profile at least quarterly. More frequent reporting may be appropriate depending on the bank's level of risk and its potential for significant change. While the types of reports prepared for the board and for various levels of

6. Analysis of quarterly and annual data on changes of the Constant Maturities Treasury Securities (CMT) over the period of January 1, 1974, to December 31, 1994, suggests that a 200 basis point parallel shift in the yield curve represents a plausible stress scenario for assessing IRR. The following data illustrate that over the past 17 years, quarterly changes in yields on CMTs exceeded 193 bp for the three-month CMT and 137 bp for the 30-year CMT 1 percent of the time. Data on annual yield changes illustrate that yield changes on CMTs exceeded 194 bp 5 percent of the time and exceeded 151 bp 10 percent of the time.

Changes in Yields of Constant Maturities Treasury Securities

	Quarterly changes	*Annual changes*	
	99% confidence level	*95% confidence level*	*90% confidence level*
		Basis Point Change	
3-mo. CMT	193 bp	274 bp	212 bp
1-yr. CMT	191 bp	271 bp	210 bp
2-yr. CMT	180 bp	255 bp	198 bp
3-yr. CMT	175 bp	248 bp	192 bp
5-yr. CMT	166 bp	235 bp	182 bp
7-yr. CMT	161 bp	228 bp	177 bp
10-yr. CMT	152 bp	216 bp	167 bp
30-yr. CMT	137 bp	194 bp	151 bp

management will vary based on the institution's IRR profile, they should, at a minimum, allow senior management and the board or committee to—

- evaluate the level of and trends in the bank's aggregate IRR exposure;
- demonstrate and verify compliance with all policies and limits;
- evaluate the sensitivity and reasonableness of key assumptions;
- assess the results and future implications of major hedging or position-taking initiatives that have been taken or are being actively considered;
- understand the implications of various stress scenarios, including those involving breakdowns of key assumptions and parameters;
- review IRR policies, procedures, and the adequacy of the IRR measurement systems; and
- determine whether the bank holds sufficient capital for the level of risk being taken.

Comprehensive Internal Controls

An institution's IRR management process should be an extension of its overall structure of internal controls. Properly structured, a system of internal controls should promote effective and efficient operations; reliable financial and regulatory reporting; and compliance with relevant laws, regulations, and institutional policies. In determining whether internal controls meet these objectives, examiners should consider the general control environment of the organization; the process for identifying, analyzing, and managing IRR; the adequacy of management information systems; and adherence to control activities such as approvals, confirmations, and reconciliations.

An important element of an institution's internal controls for IRR is management's comprehensive evaluation and review of the various components of the IRR management process. Although procedures for establishing limits and adhering to them may vary among institutions, periodic reviews should be conducted to determine whether the organization enforces its IRR policies and procedures. Positions that exceed established limits should receive the prompt attention of appropriate management and should be resolved according to the process described in approved policies. Periodic reviews of the IRR management process should also be conducted in light of significant changes in the nature of instruments acquired, risk-measurement methodologies, limits, and internal controls that have occurred since the last review.

Reviews of the accuracy and performance of the IRR measurement system should also be conducted and include assessments of the assumptions, parameters, and methodologies used in the institution's IRR measurement system. During a review, examiners should seek to understand, test, and document the current measurement process; evaluate the system's accuracy; and recommend solutions to any identified weaknesses. The results of this review, along with any recommendations for improvement, should be reported to the board and acted upon in a timely manner. Institutions with complex risk exposure are encouraged to have their measurement systems reviewed by external auditors or other knowledgeable outside parties to ensure their adequacy and integrity. Since measurement systems may incorporate one or more subsidiary systems or processes, institutions should ensure that multiple component systems are well integrated and consistent in all critical respects.

The frequency and extent to which an institution should reevaluate its risk-measurement methodologies and models depends, in part, on the specific IRR exposures created by their holdings and activities, the pace and nature of changes in market interest rates, and the extent to which there are new developments in measuring and managing IRR. At a minimum, institutions should review their underlying IRR measurement methodologies and IRR management process annually, and more frequently as market conditions dictate. In many cases, internal evaluations may be supplemented by reviews of external auditors or other qualified outside parties, such as consultants with expertise in IRR management.

Rating the Adequacy of IRR Management

Examiners should incorporate their assessment of the adequacy of IRR management into their overall rating of risk management, which is subsequently factored into the management component of an institution's CAMELS rating. Ratings of IRR management can follow the general framework used to rate overall risk management:

- A rating of 1 or strong would indicate that management effectively identifies and controls the IRR posed by the institution's activities, including those from new products.
- A rating of 2 or satisfactory would indicate that the institution's management of IRR is largely effective, but lacking in some modest degree. It reflects a responsiveness and ability to cope successfully with existing and foreseeable exposures that may arise in carrying out the institution's business plan. While the institution may have some minor risk-management weaknesses, these problems have been recognized and are being addressed. Generally, risks are being controlled in a manner that does not require additional or more than normal supervisory attention.
- A rating of 3 or fair signifies IRR management practices that are lacking in some important ways and, therefore, are a cause for more than normal supervisory attention. One or more of the four elements of sound IRR management are considered fair and have precluded the institution from fully addressing a significant risk to its operations. Certain risk-management practices are in need of improvement to ensure that management and the board are able to identify, monitor, and control adequately all significant risks to the institution.
- A rating of 4 or marginal represents marginal IRR management practices that generally fail to identify, monitor, and control significant risk exposures in many material respects. Generally, such a situation reflects a lack of adequate guidance and supervision by management and the board. One or more of the four elements of sound risk management are considered marginal and require immediate and concerted corrective action by the board and management.
- A rating of 5 or unsatisfactory indicates a critical absence of effective risk-management practices to identify, monitor, or control significant risk exposures. One or more of the four elements of sound risk management is considered wholly deficient, and management and the board have not demonstrated the capability to address deficiencies. Deficiencies in the institution's risk-management procedures and internal controls require immediate and close supervisory attention.

QUANTITATIVE LEVEL OF IRR EXPOSURE

Evaluating the quantitative level of IRR involves assessing the effects of both past and potential future changes in interest rates on an institution's financial condition, including the effects on its earnings, capital adequacy, liquidity, and, in some cases, asset quality. This assessment involves a broad analysis of an institution's business mix, balance-sheet composition, OBS holdings, and holdings of interest rate–sensitive instruments. Characteristics of the institution's material holdings should also be investigated to determine (and quantify) how changes in interest rates might affect its performance. The rigor of this evaluation process should reflect the size, sophistication, and nature of the institution's holdings.

Assessment of the Composition of Holdings

An overall evaluation of an institution's holdings and its business mix is an important first step in evaluating the quantitative level of IRR exposure. The evaluation should focus on identifying (1) major on- and off-balance-sheet positions, (2) concentrations in interest-sensitive instruments, (3) the existence of highly volatile instruments, and (4) significant sources of non-interest income that may be sensitive to changes in interest rates. Identifying major holdings of particular types or classes of assets, liabilities, or off-balance-sheet instruments is particularly pertinent since the interest rate–sensitivity characteristics of an institution's largest positions or activities will tend to dominate its IRR profile. The composition of assets should be assessed to determine the types of instruments held and the relative proportion of holdings they represent, both with respect to total assets and within appropriate instrument portfolios. Examiners should note any specialization or concentration in particular types of investment securities or lending activities and identify the interest-rate characteristics of the instruments or activities. The assessment should also incorporate an evaluation of funding strategies and the composition of deposits, including core deposits. Trends and changes in the composition of assets, liabilities, and off-balance-sheet holdings should be fully assessed—especially when the institution is experiencing significant growth.

Examiners should identify the interest sensitivity of an institution's major holdings. For many instruments, the stated final maturity, coupon interest payment, and repricing frequency are the primary determinants of their interest-rate sensitivity. In general, the shorter the repricing frequency, or maturity for fixed-rate instruments, the greater the impact of a change in rates on the *earnings* of the asset, liability, or OBS instrument employed will be because the cash flows derived, either through repricing or reinvestment, will more quickly reflect market rates. Conversely, the longer the repricing frequency, or maturity for fixed-rate instruments, the more sensitive the *value* of the instrument will be to changes in market interest rates. Accordingly, basic maturity/repricing distributions and gap schedules are important first screens in identifying the interest sensitivity of major holdings from both an earnings and value standpoint.

Efforts should also be made to identify instruments whose value is highly sensitive to rate changes. Even if they do not represent a major position, the rate sensitivity of these holdings may be large enough to have a material effect on the institution's aggregate exposure. Highly interest rate–sensitive instruments generally have fixed-rate coupons with long maturities, significant embedded options, or some elements of both. Identifying explicit options and instruments with embedded options is particularly important. Because of their asymmetrical cash flows under varying scenarios, these holdings may exhibit significantly volatile price and earnings behavior in changing-rate environments. The interest-rate sensitivity of exchange-traded options is usually readily identified due to the standardization of exchange contracts. On the other hand, the interest-rate sensitivity of over-the-counter derivative instruments and the option provisions embedded in other financial instruments, such as the right to prepay a loan without penalty, may be less readily identifiable. Instruments tied to residential mortgages, such as mortgage pass-through securities, collateralized mortgage obligations (CMOs), real estate mortgage investment conduits (REMICs), and various mortgage-derivative products, generally entail some form of embedded optionality. Certain types of CMOs and REMICs constitute high-risk mortgage-derivative products and should be clearly identified. U.S. agency and municipal securities, as well as traditional forms of lending and borrowing arrangements, can often incorporate options into their structures. U.S. agency structured notes and municipal securities with long-dated call provisions are just two examples. Many commercial loans also make use of caps or floors. Over-the-counter OBS instruments, such as swaps, caps, floors, and collars, can involve highly complex structures and, thus, can be quite volatile in the face of changing interest rates.

An evaluation of an institution's funding sources relative to the profile of its assets is fundamental to the assessment of IRR. Reliance on volatile or complex funding structures can significantly increase IRR when asset structures are fixed-rate or long-term in nature. Conversely, long-term liabilities financing shorter-term assets can also increase IRR. The role of nonmaturity or core deposits in an institution's funding base is particularly pertinent to any assessment of IRR. Depending on their composition and the underlying client base, core deposits can provide significant opportunities for institutions to administer and manage the interest rates paid on this funding source. Thus, high levels of stable core deposit funding may provide an institution with significant control over its IRR profile. Examiners should assess the characteristics of an institution's nonmaturity deposit base, including the types of accounts offered, the underlying customer base, and important trends that may influence the rate sensitivity of this funding source.

In general, examiners should evaluate trends and attempt to identify any structural changes in the interest-rate risk profile of an institution's holdings, such as shifts of asset holdings into longer-term instruments or instruments that may have embedded options, changes in funding strategies and core deposit balances, and the use of off-balance-sheet instruments. Significant changes in the composition of an institution's holdings may reduce the usefulness of historical performance as an indicator of future performance.

Examiners should also identify and assess material sources of interest-sensitive fee income. Loan-servicing income, especially when related to residential mortgages, can be an important and highly volatile element in an institution's earnings profile. Servicing income is linked to the size of the servicing portfolio and, thus, can be greatly affected by the rate of prepayment on mortgages in the servicing portfolio. Revenues arising from securitization of other types of loans, including credit card receivables, can also be very sensitive to changes in interest rates.

An analysis of both on- and off-balance-sheet holdings should also consider potential basis risk, that is, whether instruments with adjustable-rate characteristics that reprice in a similar time period will reprice differently than assumed. Consideration of basis risk is particularly pertinent when offsetting positions reprice in the same time period. Typical examples include assets that reprice with three-month Treasury bills paired against liabilities repricing with three-month LIBOR or prime-based assets paired against other short-term funding sources. Analyzing the repricing characteristics of major adjustable-rate positions should help to identify such situations.

Exposure of Earnings to IRR

When evaluating the potential effects of changing rates on an institution's earnings, examiners should assess the key determinants of the net interest margin, the effect that fluctuations in net interest margins can have on overall net income, and the rate sensitivity of non-interest income and expense. Analyzing the historical behavior of the net interest margin, including the yields on major assets, liabilities, and off-balance-sheet positions that make up that margin, can provide useful insights into the relative stability of an institution's earnings. For example, a review of the historical composition of assets and the yields earned on those assets clearly identifies an institution's business mix and revenue-generating strategies and reveals important insights into the potential vulnerabilities of these revenues to changes in rates. Similarly, an assessment of the rates paid on various types of deposits over time can help identify the institution's funding strategies, how the institution competes for deposits, and the potential vulnerability of its funding base to rate changes.

Understanding the effect of potential fluctuations in net interest income on overall operating performance is also important. High overhead structures at some banks may require high net interest margins to generate even moderate levels of income. Accordingly, relatively high net interest margins may not necessarily imply a higher tolerance to changes in interest rates. Examiners should fully consider the potential effects of fluctuating net interest margins when analyzing the exposure of net income to changes in interest rates.

Additionally, examiners should assess the contribution of non-interest income to net income, including its interest-rate sensitivity and how it affects the IRR of the institution. Significant sources of rate-insensitive non-interest income provide stability to net income and can mitigate the effect of fluctuations in net interest margins.

A historical review of changes in an institution's earnings—both net income and net interest income—in relation to changes in market rates is an important step in assessing the rate sensitivity of its earnings. When appropriate, this review should assess the institution's performance during prior periods of volatile rates.

Important tools used to gauge the potential volatility in future earnings include basic maturity and repricing gap calculations and income simulations. Short-term repricing gaps between assets and liabilities in intervals of one year or less can provide useful insights on the exposure of earnings. These can be used to develop rough approximations of the effect of changes in market rates on an institution's profitability. Examiners can develop rough gap estimates using available call report information, as well as the bank's own internally generated gap or other earnings exposure calculations if risk-management and -measurement systems are deemed adequate. When available, a bank's own earnings-simulation model provides a particularly valuable source of information: a formal estimate of future earnings (a "baseline") and an evaluation of how earnings would change under different rate scenarios. Together with historical earnings patterns, an institution's estimate of the IRR sensitivity of its earnings derived from simulation models is an important indication of the exposure of its near-term earnings stability.

As detailed in the preceding subsection, sound risk-management practices require IRR to be measured over a probable range of potential interest-rate changes. At a minimum, an instantaneous shift in the yield curve of plus or minus 200 basis points should be used to assess the potential impact of rate changes on an institution's earnings.

Examiners should evaluate the exposure of earnings to changes in interest rates relative to the institution's overall level of earnings and the potential length of time such exposure might persist. For example, simulation estimates of a small, temporary decline in earnings, while likely an issue for shareholders and directors, may be less of a supervisory concern if the institution has a sound earnings and capital base. On the other hand, exposures that could offset earnings for a significant period (as some thrifts experienced during the 1980s) and even deplete capital would be a great concern to both management and supervisors. Exposures measured by gap or simulation analysis under the minimum 200 basis point scenario that would result in a significant decline in net interest margins or net income should prompt further investigation of the adequacy and stability of earnings and the adequacy of the institution's risk-management process. Specifically, in institutions exhibiting significant earnings exposures, examiners should emphasize the results of the institution's stress tests to determine the extent to which more significant and stressful rate moves might magnify the erosion in earnings identified in the more modest rate scenario. In addition, examiners should emphasize the need for management to understand the magnitude and nature of the institution's IRR and the adequacy of its limits.

While an erosion in net interest margins or net income of more than 25 percent under a 200 basis point scenario should warrant considerable examiner attention, examiners should take into account the absolute level of an institution's earnings both before and after the estimated IRR shock. For example, a 33 percent decline in earnings for a bank with a strong return on assets (ROA) of 1.50 percent would still leave the bank with an ROA of 1.00 percent. In contrast, the same percentage decline in earnings for a bank with a fair ROA of 0.75 percent results in a marginal ROA of 0.50 percent.

Examiners should ensure that their evaluation of the IRR exposure of earnings is incorporated into the rating of earnings under the CAMELS rating system. Institutions receiving an earnings rating of 1 or 2 would typically have minimal exposure to changing interest rates. Conversely, significant exposure of earnings to changes in rates may, in itself, provide a sufficient basis for a lower rating.

Exposure of Capital and Economic Value

As set forth in the capital adequacy guidelines for state member banks, the risk-based capital ratio focuses principally on broad categories of credit risk and does not incorporate other factors, including overall interest-rate exposure and management's ability to monitor and control financial and operating risks. Therefore, the guidelines point out that in addition to evaluating capital ratios, an overall assessment of capital adequacy must take account of " . . . a bank's exposure to declines in economic value of its capital due to changes in interest rates. For this reason, the final supervisory judgement on a bank's capital adequacy may differ significantly from conclusions that might be drawn solely from the level of its risk-based capital ratio."

Banking organizations with low proportions of assets maturing or repricing beyond five years, relatively few assets with volatile market values (such as high-risk CMOs and structured notes or certain off-balance-sheet derivatives), and large and stable sources of nonmaturity deposits are unlikely to face significant economic value exposure. Consequently, an evaluation of their economic value exposure may be limited to reviewing available internal reports showing the asset/liability composition of the institution or the results of internal-gap, earnings-simulation, or economic-value simulation models to confirm that conclusion.

Institutions with fairly significant holdings of longer maturing or repricing assets, concentrations in value-sensitive on- and off-balance-sheet instruments, or a weak base of nonmaturity deposits warrant more formal and quantitative evaluations of economic-value exposures. This includes reviewing the results of the bank's own internal reports for measuring changes in economic value, which should address the adequacy of the institution's risk-management process, reliability of risk-measurement assumptions, integrity of the data, and comprehensiveness of any modeling procedures.

For institutions that appear to have a potentially significant level of IRR and that lack a reliable internal economic-value model, examiners should consider alternative means for quantifying economic-value exposure, such as internal-gap measures or off-site monitoring or surveillance screens that rely on call report data to estimate economic-value exposure. For example, the institution's gap schedules might be used to derive a duration gap by applying duration-based risk weights to the bank's aggregate positions. In estimating changes in economic value using alternative means, the relative crudeness of these techniques and lack of detailed data (such as the absence of coupon or off-balance-sheet data) should be taken into account when drawing conclusions about the institution's exposure and capital adequacy.

An evaluation of an institution's capital adequacy should also consider the extent to which past interest-rate moves may have reduced the economic value of capital through the accumulation of net unrealized losses on financial instruments. To the extent that past rate moves have reduced the economic or market value of a bank's claims more than they have reduced the value of its obligations, the institution's economic value of capital is less than its stated book value.

To evaluate the embedded net loss or gain in an institution's financial structure, fair-value data on the securities portfolio can be used as the starting point; this information should be readily available from the call report or bank internal reports. Other major asset categories that might contain material embedded gains or losses include any assets maturing or repricing in more than five years, such as residential, multifamily, or commercial mortgage loans. By comparing a portfolio's weighted average coupon with current market yields, examiners may get an indication of the magnitude of any potential unrealized gains or losses. For companies with hedging strategies that use derivatives, the current positive or negative market value of these positions should be obtained, if available. For banks with material holdings of originated or purchased mortgage-servicing rights, capitalized amounts should be evaluated to ascertain that they are recorded at the lower of cost or fair value and that management has appropriately written down any values that are impaired pursuant to generally accepted accounting rules.

The presence of significant depreciation in securities, loans, or other assets does not necessarily indicate significant embedded net losses; depreciation may be offset by a decline in the market value of a bank's liabilities. For example, stable, low-cost nonmaturity deposits typically become more profitable to banks as rates rise, and they can add significantly to the bank's financial strength. Similarly, below-market-rate deposits, other borrowings, and subordinated debt may also offset unrealized asset losses caused by past rate hikes.

For banks with substantial depreciation in their securities portfolios, low levels of nonmaturity deposits and retail time deposits, or high levels of IRR exposure, unrealized losses can have important implications for the supervisory assessment of capital adequacy. If stressful conditions require the liquidation or restructuring of the securities portfolio, economic losses could be realized and, thereby, reduce the institution's regulatory capitalization. Therefore, for higher-risk institutions, an evaluation of capital adequacy should consider the potential after-tax effect of the liquidation of available-for-sale and held-to-maturity accounts. Estimates of the effect of securities losses on regulatory capital ratio may be obtained from surveillance screens that use call report data or the bank's internal reports.

Examiners should also consider the potential effect of declines and fluctuations in earnings on an institution's capital adequacy. Using the results of internal model simulations or gap reports, examiners should determine whether capital-impairing losses might result from changes in market interest rates. In cases where potential rate changes are estimated to cause declines in margins that actually result in losses, examiners should assess the effect on capital over a two- or three-year earnings horizon.

When rating capital adequacy in the context of IRR exposure, examiners should consider the effect of changes in market interest rates on the economic value of equity, level of embedded losses in the bank's financial structure, and impact of potential rate changes on the institution's earnings. The IRR of institutions that show material declines in earnings or economic value of capital from a 200 basis point shift should be evaluated fully, especially if that decline would lower an institution's pro forma prompt-corrective-action category. For example, a well-capitalized institution with a 5.5 percent leverage ratio and an estimated change in economic value arising from an appropriate stress scenario amounting to 2.0 percent of assets would have an adjusted leverage ratio of 3.5 percent, causing a pro forma two-tier decline in its prompt-corrective-action category to the undercapitalized category. After considering the level of embedded losses in the balance sheet, the stability of the institution's funding base, its exposure to near-term losses, and the quality of its risk-management process, the examiner may need to give the institution's capital adequacy a relatively low rating. In general, sufficiently adverse effects of market-rate shocks or weak management and control procedures can provide a basis for lowering a bank's rating of capital adequacy. Moreover, even less severe exposures could contribute to a lower rating if combined with exposures from asset concentrations, weak operating controls, or other areas of concern.

Examination Process for Evaluating IRR

As the primary market risk most banks face, IRR should usually receive consideration in full-scope exams. It may also be the topic of targeted examinations. To meet examination objectives efficiently and effectively while remaining sensitive to potential burdens imposed on institutions, the examination of IRR should follow a structured, *risk-focused approach*. Key elements of a risk-focused approach to the examination process for IRR include (1) off-site monitoring and risk assessment of an institution's IRR profile and (2) appropriate planning and scoping of the on-site examination to ensure that it is as efficient and productive as possible. A fundamental tenet of this approach is that supervisory resources are targeted at functions, activities, and holdings that pose the most risk to the safety and soundness of an institution. Accordingly, institutions with low levels of IRR would be expected to receive relatively less supervisory attention than those with more severe IRR exposures.

Many banks have become especially skilled in managing and limiting the exposure of their earnings to changes in interest rates. Accordingly, for most banks and especially for smaller institutions with less complex holdings, the IRR element of the examination may be relatively simple and straightforward. On the other hand, some banks consider IRR an intended consequence of their business strategies and choose to take and manage that risk explicitly—often with complex financial instruments. These banks, along with banks that have a wide array of activities or complex holdings, generally should receive greater supervisory attention.

Off-Site Risk Assessment

Off-site monitoring and analysis involves developing a preliminary view or ''risk assessment'' before initiating an on-site examination. Both the level of IRR exposure and quality of IRR management should be assessed to the fullest extent possible during the off-site phase of the examination process. The following information can be helpful in this assessment:

- organizational charts and policies identifying authorities and responsibilities for managing IRR
- IRR policies, procedures, and limits
- ALCO committee minutes and reports (from six to twelve months before the examination)
- board of director reports on IRR exposures
- audit reports (both internal and external)
- position reports, including those for investment securities and off-balance-sheet instruments
- other available bank-internal-risk reports, including those detailing key assumptions
- reports outlining key characteristics of concentrations and material holdings of interest-sensitive instruments
- documentation for inputs, assumptions, and methodologies used in measuring risk
- Federal Reserve surveillance reports and supervisory screens

Quantitative IRR exposure can be assessed off-site by conducting as much of the analysis summarized in this subsection as is practicable. This includes assessments of the bank's overall balance-sheet composition and holdings of interest-sensitive instruments. An assessment of the exposure of earnings can be accomplished using supervisory screens, examiner-constructed measures, and internal bank measures obtained from management reports received before the on-site engagement. Similar assessments can be made on the exposure of capital or economic value.

An off-site review of the quality of the risk-management process can significantly improve the efficiency of the on-site engagement. The key to assessing the quality of management is an organized discovery process aimed at determining whether appropriate policies, procedures, limits, reporting systems, and internal controls are in place. This discovery process should, in particular, ascertain whether all the elements of a sound IRR management policy are applied consistently to material concentrations of interest-sensitive instruments. The results and reports of prior examinations provide important information about the adequacy of risk management.

Examination Scope

The off-site risk assessment is an informed hypothesis of both the adequacy of IRR management and the magnitude of the institution's exposure. The scope of the on-site examination of IRR should be designed to confirm or reject that hypothesis and should target specific areas of interest or concern. In this way, examination procedures are tailored to the activities and risk profile of the institution and use flexible and targeted work-documentation programs for the on-site examination. Confirmation of hypotheses on the adequacy of the IRR management process is especially important. In general, if IRR management is identified as adequate, examiners can rely more heavily on the bank's internal IRR measures for assessing quantitative exposures.

The examination scope for assessing IRR should be commensurate with the complexity of the institution and consistent with the off-site risk assessment. For example, only baseline examination procedures would be used for institutions whose off-site risk assessment indicates that they have adequate IRR management processes and low levels of quantitative exposure. Such institutions would include those with noncomplex balance-sheet structures that meet the following criteria:

- Asset structures are principally short-term. Long-term assets constitute less than 25 percent of total assets and the combination of long-term assets and 30 percent of intermediate-term assets constitute less than 30 percent of assets. Long-term assets are considered those that have maturity or repricing intervals greater than five years, and intermediate-term assets are defined as those that have maturity or repricing intervals between one and five years.
- High-risk mortgage securities are less than 5 percent of total assets.
- Structured notes are less than 5 percent of total assets.
- There are no off-balance-sheet positions.
- The capital base is strong, and the institution has a history of stable earnings.

For these and other institutions identified as potentially low risk, the scope of the on-site examination would consist of only those examination procedures necessary to confirm the risk-assessment hypothesis. The adequacy of IRR management could be confirmed through a basic review of the appropriateness of policies, internal reports, and controls and the institution's adherence to them. The integrity and reliability of the information used to assess the quantitative level of risk could be confirmed through limited sampling and testing. In general, if the risk assessment is confirmed by basic examination procedures, the examiner may conclude the IRR examination process.

Institutions assessed to have high levels of IRR exposure and strong IRR management may require more extensive examination scopes to confirm the risk assessment. These procedures may entail more analysis of the institution's IRR measurement system and the IRR characteristics of major holdings. Where high quantitative levels of exposure are found, examiners should focus special attention on the sources of this risk and on significant concentrations of interest-sensitive instruments. Institutions assessed to have high exposure and weak risk-management systems would require an extensive work-documentation program. Internal measures should be used cautiously, if at all.

Regardless of the size or complexity of an institution, care must be taken during the on-site phase of the examination to ensure confirmation of the risk assessment and identification of issues that may have escaped off-site analysis. Accordingly, the examination scope should be adjusted as on-site findings dictate.

Assessing CAMELS Ratings

For most institutions, interest-rate risk is their primary market-risk exposure. Accordingly, the CAMELS market-risk sensitivity or "S" rating for these institutions should be based on assessments of the adequacy of IRR management practices and the quantitative level of IRR exposure.[7] In particular, CAMELS "S" ratings dealing primarily with IRR should be based on, but not limited to, an assessment of the following evaluation factors:

- the sensitivity of the financial institution's earnings or the economic value of its capital to adverse changes in interest rates

7. Section A.5020.1, "Overall Conclusions Regarding Condition of the Bank: Uniform Financial Institutions Rating System," provides guidance on the market-risk sensitivity component of the CAMELS rating system.

- the ability of management to identify, measure, monitor, and control exposure to interest-rate risk given the institution's size, complexity, and risk profile
- the nature and complexity of interest-rate risk exposure arising from nontrading positions
- where appropriate, the nature and complexity of market-risk exposure arising from trading and foreign operations

"S" ratings based primarily on IRR should conform with the following framework:

1 A rating of 1 indicates that interest-rate risk sensitivity is well controlled and that there is minimal potential that the earnings performance or capital position will be adversely affected. Risk-management practices are strong for the size, sophistication, and market risk accepted by the institution. The level of earnings and capital provide substantial support for the degree of interest-rate risk taken by the institution.

2 A rating of 2 indicates that interest-rate risk sensitivity is adequately controlled and that there is only moderate potential that the earnings performance or capital position will be adversely affected. Risk-management practices are satisfactory for the size, sophistication, and interest-rate risk accepted by the institution. The level of earnings and capital provide adequate support for the degree of interest-rate risk taken by the institution.

3 A rating of 3 indicates that control of interest-rate risk sensitivity needs improvement or that there is significant potential that the earnings performance or capital position will be adversely affected. Risk-management practices need to be improved given the size, sophistication, and level of risk accepted by the institution. The level of earnings and capital may not adequately support the degree of interest-rate risk taken by the institution.

4 A rating of 4 indicates that control of interest-rate risk sensitivity is unacceptable or that there is high potential that the earnings performance or capital position will be adversely affected. Risk-management practices are deficient for the size, sophistication, and level of risk accepted by the institution. The level of earnings and capital provide inadequate support for the degree of interest-rate risk taken by the institution.

5 A rating of 5 indicates that control of interest-rate risk sensitivity is unacceptable or that the level of risk taken by the institution is an imminent threat to its viability. Risk-management practices are wholly inadequate for the size, sophistication, and level of interest-rate risk accepted by the institution.

The adequacy of an institution's IRR management is a leading indicator of its potential IRR exposure. Therefore, assessment of IRR management practices should be the basis for the overall assessment of an institution's IRR. Unsafe exposures and management weaknesses should be fully reflected in "S" ratings. Unsafe exposures and unsound management practices that are not resolved during the on-site examination should be addressed through subsequent follow-up actions by the examiner and other supervisory personnel.

1. To evaluate the policies regarding interest-rate risk established by the board of directors and/or senior management, including the limits established for the bank's interest-rate risk profile.
2. To determine if the bank's interest-rate risk profile is within those limits.
3. To evaluate the management of the bank's interest-rate risk, including the adequacy of the methods and assumptions used to measure interest-rate risk.
4. To determine if internal management reporting systems provide the information necessary for informed interest-rate management decisions and for monitoring the results of those decisions.
5. To initiate corrective action when interest-rate management policies, practices, and/or procedures are deficient in controlling and monitoring interest-rate risk.

1. Determine if interest-rate risk is managed at the bank level or on a holding company basis.
2. Review the bank's written policies for reasonableness. At a minimum, they should cover—
   a. definition and measurement of acceptable risks, including acceptable levels of interest-rate exposure;
   b. net interest margin goals;
   c. sources and uses of funds;
   d. off-balance-sheet activities that affect interest-rate exposure;
   e. responsibilities within the bank for interest-rate-risk management decisions; and
   f. reporting mechanisms.
3. Evaluate the internal controls or the internal audit function. Determine whether internal mechanisms are adequate to ensure compliance with established limits on interest-rate risk. If they are determined to be inadequate, complete or update the Internal Control Questionnaire. The examiner should prepare a brief description of the bank's interest-rate-risk policies and practices as well as identify areas in need of improvement.
4. Review the UBPR, interim financial reports, and internal management reports, paying particular attention to—
   a. on- and off-balance-sheet mix and trends;
   b. the methodology used by the bank to measure interest-rate risk; and
   c. the stability of interest margins under varying economic conditions or simulations (causes of significant fluctuations should be identified).
5. Evaluate the bank's exposure to interest-rate risk by:
   a. Obtaining and reviewing any reports regularly prepared by management for controlling and monitoring interest-rate risk.
   b. Requesting the appropriate information for determining the level of interest-rate risk present in the bank's assets, liabilities, and off-balance-sheet activities, if management does not, at a minimum, regularly prepare rate-sensitivity reports (the circumstances facing the bank and the existing interest-rate environment should govern the degree of analysis).
   c. Estimating the effect of an adverse interest-rate change on future earnings or economic value by using the bank's gap reports, duration measures, or simulation models (the latter measure is especially useful if the bank's exposure seems large).
   d. Determining the bank's ability to adjust its interest-rate position.
6. Evaluate the quality of interest-rate-risk management. The bank's procedures and controls should be in compliance with the minimum guidelines set forth in SR-96-13. See Section 4090.1 and SR-99-18. The evaluation should include, but is not limited to, the following:
   a. Assess whether the methods and assumptions used to measure interest-rate risk are adequate relative to the size of the bank and the complexity of its balance sheet.
   b. Assess management's knowledge of interest-rate risk in relation to the size and complexity of the bank's balance sheet. In particular, assess their understanding of the methods used by the bank to measure the risk.
   c. Determine whether the level of risk is within the limits set.
   d. Assess the bank's ability to adjust its interest-rate position.
   e. Determine if the reporting process provides clear and reliable information on a timely basis (at least quarterly).
   f. Determine if new products or hedging instruments are adequately analyzed before purchase.
7. Determine the adequacy of the net interest margin based on an analysis of the components of the margin (i.e., interest expense and interest income). If the margin or any component is unusually high or low, determine—
   a. if goals have been established for net interest earnings;
   b. management's success in meeting established goals;
   c. the effect of the bank's interest-rate-risk position on meeting established goals;

   d. the effect of the bank's pricing policies on meeting established goals; and
   e. the effect of the bank's credit-risk appetite on the margin.
8. Review the interest-rate-risk management section of the last report of examination. Determine if there were concerns in this area and if corrective action was required.
9. Write in appropriate report format and discuss with management general remarks on—
   a. the quality of the bank's planning to control and manage interest-rate risk;
   b. the level of the bank's interest-rate exposure and an assessment of the associated degree of risk;
   c. the quality of the related administrative controls and internal management reporting systems; and
   d. the effect of interest-rate-risk management decisions on earnings and capital.
10. Update the workpapers with any information that will facilitate future examinations.

Discuss with senior management the bank's policies and practices with regard to the following:

1. Has the board of directors, consistent with its duties and responsibilities, adopted an interest rate risk management policy that includes:
   a. A formal mechanism to coordinate interest rate sensitivity decisions?
   b. Clear lines of responsibility and authority for decisions affecting interest rate sensitivity?
   c. Guidelines for the level of interest rate risk, including that associated with off-balance-sheet products, if any?
   d. Outside limits for the imbalance between balance-sheet and off-balance-sheet positions and for the potential exposure of earnings or equity to changes in interest rates?
2. Have internal management reports been prepared that provide an adequate basis for making interest rate management decisions and for monitoring the results of those decisions? Specifically:
   a. Are reports prepared on the bank's rate sensitivity using an appropriate measurement method?
   b. Is historical information on asset yields, cost of funds, and net interest margins readily available?
   c. Are interest margin variations, both from the prior reporting period and from the budget, regularly monitored?
   d. Is sufficient information available to permit an analysis of the cause of interest margin variations?
3. Does the foregoing information provide an adequate basis for evaluating internal controls in that deficiencies in areas not covered by this questionnaire do not significantly impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.

LITIGATION AND OTHER LEGAL MATTERS

Events or conditions arising from litigation,[1] claims, and assessments are matters within the direct knowledge and, often, control of bank management. Accordingly, management is the primary source of information about these matters.[2] Examiners ordinarily do not possess legal skills and therefore cannot make legal judgments on such information. The examiner should request that bank management send a letter of inquiry to those attorneys with whom it has consulted on litigation, claims, and assessments. The letter of inquiry is the examiner's primary means of corroborating information furnished by management.

When requesting these inquiries, the examiner should consider the scope of counsel's involvement with the bank. Banks frequently engage a number of law firms, so the examiner should have the bank direct requests to both general counsel and counsel whose service is limited to particular matters. Ordinarily, inquiries should be made of all outside counsel.

In certain instances, however, the examiner may be reasonably certain that some of the bank's counsels are handling only routine matters that ultimately won't have a significant effect on the bank's financial condition. In these cases, the examiner-in-charge may decide not to send letters of inquiry to those counsels.

Requests for corroboration from legal counsel should ask for information about litigation, impending litigation, claims, and contingent liabilities. For the purposes of these requests, the terms impending litigation and contingent liabilities have the following meanings:

- *Impending litigation.* Litigation threatened against the bank by a third party but not formally commenced.
- *Contingent liabilities.* Matters other than litigation or claims, which available information indicates have at least a reasonable possibility of impairing assets or increasing liabilities. Contingent liabilities should include unasserted claims or assessments.

A letter of inquiry should ask for a response both as of the examination date and as of the date of counsel's response. That date of response should be as close to the completion of the examination as practicable, yet should allow sufficient time for evaluation of responses and follow-up of nonreplies. In some cases, the examiner may wish to obtain an interim response (in addition to a final response) so that a timely preliminary evaluation of material legal matters may be made. Letters of inquiry should be mailed early enough to allow them to circulate within the law firm because several attorneys may be considering legal matters for the bank. Before completing the examination, the examiner should request that appropriate bank officials contact counsel who have not responded to the initial letter of inquiry.

The examiner should not assume that bank management or counsel will keep him or her informed of developments subsequent to the date of counsel's response. Accordingly, if there is reason to believe that there may be subsequent developments, the examiner should contact bank management again before submitting the report of examination. If bank management is uncooperative or regarded as incapable of supervising matters concerning litigation, or if other sensitivities mandate circumvention of bank management, then the examiner should bring the matter to the attention of Federal Reserve Bank management for further communications with the bank's management and counsel, which could include direct contact with bank counsel.

EXAMINATION-RELATED SUBSEQUENT EVENTS

As a practical matter, the examination, and therefore the report of examination, is as of a

1. Legal or litigation risk is the risk that contracts are not legally enforceable or documented properly. Legal risks should be limited and managed through policies developed by the institution's legal counsel. At a minimum, guidelines and processes should be in place to ensure the enforceability of counterparty agreements.

2. In limited circumstances, a bank director who is not an officer of the bank may have direct knowledge and control of legal information, usually when the director's primary occupation is as an attorney. Management in these rare instances may have limited knowledge and control of legal information.

stated date. However, events or transactions sometimes occur, subsequent to the date of examination, but before the date the report of examination is submitted to the Reserve Bank, that may have a significant effect on the soundness of a bank. Such events and transactions are referred to as ‘‘subsequent events’’ and may be of two types.

One type includes those events or transactions that provide additional evidence about conditions that existed at the examination date. Examples of this type are the bankruptcy of a significant borrower or the resolution of outstanding litigation.

The second type includes those events that provide evidence about conditions that did not exist at the date of examination, but that arose subsequently. An example of that type of event would be new litigation arising subsequent to the examination date but before submission of the examination report or a merger agreement signed subsequent to the examination date.

All information that becomes available before the submission of the report of examination should be used by the examiner in his or her evaluations of the bank. Accordingly, all events or transactions that either significantly affect or have the potential to significantly affect the soundness of the bank should be reflected in the report of examination, regardless of whether they occurred before or subsequent to the examination date.

Litigation and Other Legal Matters; Examination-Related Subsequent Events

Examination Objectives

Effective date May 1996

Section 4100.2

1. To determine whether any events or transactions have occurred subsequent to the examination date that have had or may have a significant impact on the present or future soundness of the bank or on the conclusions expressed in the report of examination.
2. To determine the effect of legal counsel's evaluation of litigation, impending litigation, claims, and contingent liabilities on the examiner's overall conclusion regarding the soundness of the bank.

1. Obtain from the bank officer responsible for legal matters a listing of impending or threatened litigation. For each item, the following information should be included:
   a. nature of the litigation
   b. progress of case to date
   c. how management is responding or intends to respond to the litigation
   d. an evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss
2. Obtain from the bank officer responsible for legal matters a listing of unasserted claims or assessments management considers will probably be asserted and which, if asserted, would have at least a reasonable possibility of an unfavorable outcome. For each item, the following information should be included:
   a. nature of the matter
   b. how management intends to respond if the claim is asserted
   c. possible exposure if the claim is asserted
3. Obtain from management a listing of attorneys and legal firms to whom litigation and related matters have been referred. Also, obtain a listing of any litigation noted in the newest review done by internal or external auditors from the examiner assigned internal control, and determine that corrections have been accomplished.
4. Review bills supporting major charges to the general ledger expenses account(s) for legal services as a test of the completeness of the list supplied by the bank.
5. Request that management incorporate information obtained in above steps in a letter to the bank's legal counsel for corroboration.
6. Evaluate management's listing of litigation, unasserted claims and assessments, and counsel's replies for the effect on the financial condition of the bank, giving appropriate consideration to any insurance coverage.
7. Obtain and review copies of any subsequent interim financial statements. Examples of such statements are—
   a. published reports sent to shareholders or others
   b. reports submitted to the board of directors by internal auditors, external auditors, or management
   c. statements of condition
   d. income statements
      - Inquire as to whether interim statements obtained were prepared on the same basis as that used for the statements as of the examination date. If not, request proper adjustments to the interim statements.
      - Compare the interim financial statements, especially income statements, with similar statements for the corresponding period in the prior year and to budgets, profit plans, etc., for the current period, if such are available.
      - Obtain from management satisfactory explanations for any unusual items or significant fluctuations noted.
8. Make inquiries of and hold discussions with officers and other executives who have responsibility for the following matters:
   a. changes in credit lines or transactions with officers, directors, controlling shareholders, affiliated bank holding companies, affiliates of an affiliated holding company, or their interests
   b. changes in significant accounting policies
   c. changes in senior officers
   d. any event or combination of events which have had or could have a material adverse effect on the bank's financial condition, including liquidity, or results of operation, such as the default of a bond issue in which the bank has substantial holdings or the filing of bankruptcy by a major borrower
   e. commencement or discontinuance of services not requiring prior approval
   f. execution of significant contracts, such as for employment, leases, pension, or other fringe benefit programs
   g. significant new contingent liabilities or commitments other than those referred to above
   h. significant changes in assets which may not be evident from the review of subsequent interim financial statements, such as a shift in the amount of loans or

investments in special categories, or unusal adjustments made in or after the subsequent interim financial statements reviewed in connection with step 7 above

9. Distribute information obtained in step 8 to the appropriate examiners.
10. Read minutes of all meetings of stockholders, directors, and appropriate committees (investment, loans, etc.).
    a. Ascertain from officials of the bank whether minutes of all such meetings subsequent to the examination date are set forth in the minute book.
    b. As to meetings for which minutes have not been prepared at the date of the review, inquire directly of persons present at the meetings and, preferably, of the person charged with the responsibility of preparing the minutes, concerning matters dealt with at such meetings.
11. If specific violations of law or areas of weakness have been reported to management earlier in the examination, determine the extent to which management has proceeded toward corrective action.
12. Make additional inquiries or perform such procedures as considered necessary and appropriate to dispose of questions that arose in the course of the preceding procedures, inquiries, and discussions.
13. If, as a result of performing the above procedures, information is obtained that has a significant impact on the evaluation of the soundness of the bank, extend the appropriate examination procedures so that sufficient evidence is reviewed and documented in the workpapers to support the conclusions reached.
14. Prepare comments for the examination report on any events or transaction noted which may have a material effect on the soundness of the bank.
15. Update the workpapers with any information that will facilitate future examinations.

INTRODUCTION

Off-balance-sheet credit activities have been one of the fastest growing areas of banking activity. Although these activities may not be reflected on the balance sheet, they must be thoroughly reviewed because they can expose the bank to contingent liabilities. Contingent liabilities are financial obligations of a bank that are dependent on future events or actions of another party.

The purpose of this section is to provide a concise reference for contingent liabilities that arise from off-balance-sheet credit activities (for example, loan commitments and letters of credit). This section will also include some discussion of other contingent liabilities, which arise from asset sales and other off-balance-sheet activities. Activities such as trusts, securities clearance, securities brokerage, and corporate management advisory services involve significant operational and fiduciary risks and require specialized examination procedures. Consult section 6010, ''Other Types of Examinations,'' in this manual for further information about these activities.

Derivatives are also not covered in this section. The acquisition and management of derivatives for the bank's own account are covered in detail in sections 2020 and 4090, ''Acquisition and Management of Nontrading Securities and Derivative Instruments'' and ''Interest-Rate Risk Management'' of this manual. The *Trading Activities Manual* provides more specific guidance for the examination of banks that are involved in derivatives trading and customer accommodation activities.

Risks associated with contingent liabilities may ultimately result in charges against capital. As a result, full-scope examinations will include an analysis of these risks. Each of the major components of the examination—capital, asset quality, management, liquidity, and earnings—incorporates an assessment of the risks associated with off-balance-sheet credit activities. While it is impossible to enumerate all of the types and characteristics of contingent liabilities here, some of the more common ones are discussed in this section. In all cases, the examiner's overall objectives are to assess the potential impact of these contingent liabilities on the financial condition of the bank, to ascertain the likelihood that such contingencies may ultimately result in losses to the bank, to ensure that management has appropriate systems to identify and control contingent liabilities, and to ensure compliance with all applicable laws, regulations, and statements of regulatory policy.

OFF-BALANCE-SHEET LENDING ACTIVITIES

In reviewing individual credit lines, all of a customer's borrowing arrangements with the bank (for example, direct loans, letters of credit, and loan commitments) should be considered. The factors analyzed in evaluating a direct loan (financial performance, ability and willingness to pay, collateral protection, and future prospects) are applicable to the review of off-balance-sheet lending arrangements. When analyzing these activities, however, examiners should evaluate the probability of draws under the bank's off-balance-sheet lending arrangements with its customers and should evaluate whether the allowance for loan and lease losses adequately reflects the associated risks. Consideration should also be given to compliance with laws and regulations. Refer to section 2040, ''Loan Portfolio Management,'' of this manual for further details.

Loan Commitments

A formal loan commitment is a written agreement signed by the borrower and the lender that details the terms and conditions under which a loan, up to a specified amount, will be made. Unlike a standby letter of credit, which commits the bank to satisfying its customer's obligation to a third party, a loan commitment involves only the bank and its customer. The commitment will have an expiration date and, in exchange for agreeing to make the accommodation, the bank often requires the customer to pay a fee and/or maintain a stipulated compensating balance.

Some commitments, such as a working capital line, revolving credit facility, or a term loan facility, are expected to be used. Other commitments, such as back-up lines of credit for commercial paper issuance, involve usage that is not anticipated unless the customer is unable to retire or roll over the issue at maturity.

Lines of Credit

A line of credit expresses to the customer, usually by letter, a bank's willingness to lend up to a certain amount over a specified timeframe. These lines of credit are disclosed to the customer and are referred to as ''advised'' or ''confirmed'' lines. In contrast, ''guidance'' lines (also referred to as internal guidance lines) are not disclosed to the customer. ''Guidance'' lines of credit are formally approved like any other loans or commitments and are established to aid the loan officer who is servicing an account act quickly to an unexpected request for funds. Many lines of credit may be cancelled if the customer's financial condition deteriorates; others are simply subject to cancellation at the option of the issuer, such as ''guidance'' lines and other nonbinding agreements. Lines of credit usually require periodic or annual borrowing cleanups. Not adhering to cleanup provisions is a well-defined weakness.

Disagreements may arise as to what constitutes a legally binding commitment. A bank's own descriptive terminology alone may not always be the best guideline. For example, a credit arrangement could be referred to as a revocable line of credit but, at the same time, it may be a legally binding commitment to lend—especially if consideration has been given by the customer for the bank's promise to lend and if the terms of the agreement between the parties result in a contract. Therefore, management of the bank should properly distinguish its legally binding loan commitments from its revocable loan commitments. Proper documentation will help ensure that the bank's position is defensible if legal action becomes necessary to cancel a loan commitment.

Some lending agreements contain a ''material adverse change'' (MAC) clause, which is intended to allow the bank to terminate the commitment or line of credit if the customer's financial condition deteriorates. This clause may apply to the continuing financial condition of guarantors. The extent to which MAC clauses are enforceable depends on several factors, including whether a legally binding relationship remains despite specific financial covenants that are violated. Some documents make only a vague reference to a borrower's responsibility for maintaining a satisfactory financial condition. Although the enforceability of MAC clauses may be subject to some uncertainty, such clauses may provide the bank with leverage in negotiations with the customer over such issues as requests for additional collateral and/or personal guarantees.

A bank cannot always routinely determine whether funding of a commitment or line of credit will be required; therefore, the examiner must always subject the line of credit to careful analysis. A MAC clause could allow the bank to refuse funding to a financially troubled borrower; a default in other contract covenants could cause the termination of the commitment or line of credit. Some banks might strictly enforce the terms of a credit arrangement and refuse funding if any of the covenants are broken. Other banks take a more accommodating approach and will continue to make advances unless the customer files for bankruptcy. In the final analysis, the procedures normally followed by the bank in honoring or terminating a contingent lending agreement are important in the examiner's overall evaluation of the credit risk.

Risk Management for Loan Commitments and Lines of Credit

The primary risk inherent in any future extension of credit is that the condition of the borrower may change between the issuing of the commitment and its funding. However, commitments may also entail liquidity and interest-rate risk.

Examiners should evaluate anticipated drawdowns of an issuing bank's loan commitments and lines of credit relative to the bank's anticipated funding sources. A draw under lines of credit may be in the form of a letter of credit issued on the borrower's behalf. Such letters of credit share the same collateral as the line of credit, and the issuance of the letter of credit uses availability under the line. At each examination, the draws that are anticipated for unused commitments and advised lines of credit should be estimated. If the amount of unfunded commitments is large relative to the bank's liquidity position, further analysis is suggested to determine whether borrowed funds will have to be used and, if so, the amount and sources of such funds. Concerns and comments should be noted on the Liquidity/Funds Management page in the report of examination. Also, loan commitments are to be reported on the commitments and contingencies schedule in the report of examination. For further information, refer to sections 4020, 4090, and 6000, ‘‘Asset/Liability Management,’’ ‘‘Interest-Rate Risk Management,’’ and ‘‘Instructions for the Report of Examination,’’ in this manual.

LETTERS OF CREDIT

A letter of credit substitutes the credit capacity of a financial institution for that of an individual or a corporation. The concept of substituting one obligor’s financial standing for another party’s financial standing has been used in financing the international shipment of merchandise for centuries (imports and exports). Today, letters of credit are also used in a wide variety of other commercial financing transactions, such as guaranteeing obligations involving the private placement of securities and ensuring payment in the event of nonperformance of an obligated party. In addition, letters of credit are used to secure the guarantees of principals in real estate development loans. For additional information on letters of credit, see section 7080, ‘‘International—Letters of Credit,’’ in this manual.

Elements of a Letter of Credit

A letter of credit should contain the following elements:

- a conspicuous statement that the document is a letter of credit
- a specified expiration date or a definite term and an amount
- an obligation of the issuer to pay that is solely dependent on the presentation of conforming documents as specified in the letter of credit and not on the factual performance or nonperformance by the parties to the underlying transaction
- an unqualified obligation of the account party to reimburse the issuer for payments made under the letter of credit

A letter of credit involves at least three parties and is three separate and distinct contracts:

- a contract between the account party and the beneficiary under which the account party has an obligation of payment or performance
- a contract between the account party and the issuer of the letter of credit (The issuer is the party obligated to pay when the terms of the letter of credit are satisfied. The account party agrees to reimburse the issuer for any payments made.)
- a contract between the issuer and the beneficiary, whereby the issuer agrees to pay the beneficiary in compliance with the terms and conditions of the letter

Policies and Procedures

Maintaining adequate written policies and procedures and monitoring letters of credit activities are part of the fiduciary and oversight responsibilities of the board of directors. Generally, policies and procedures governing the institution’s issuance of letters of credit are contained in a section of the loan policy manual.

The letter of credit policy should thoroughly explain the institution’s procedures in issuing both commercial letters of credit and standby letters of credit. The policy should outline desirable and undesirable issuances, designate persons authorized to issue letters of credit and their corresponding loan authority, and define the recordkeeping and documentation requirements including the need to establish separate files for each issuance.

If several lending departments issue letters of credit, the policy should explicitly assign responsibility for file maintenance and recordkeeping. A separate file containing an exact copy of each outstanding letter of credit and all the supporting documentation that the underwriter used in deciding to issue the letter should be included in the file. This documentation should be the same as the financial documentation used for originating any other form of credit, which includes current financial statements, current income statements, purpose of the letter of credit, collateral-security documentation, proof-of-lien position, borrowing authorization, all correspondence, and officers’ memoranda.

Documentation

In addition, the file must contain the documentation associated with any disbursements or payments made. For a commercial letter of credit, these documents may include—

- the draft (sometimes called the bill of exchange), which is the demand for payment;
- the commercial invoice, a document describing the goods being shipped (prepared by the seller and signed by the buyer);
- the bill of lading, which documents that shipment of the goods has taken place and gives the issuer an interest in the goods in the event the account party defaults;
- customs documentation that verifies that all required duties have been paid;
- the insurance certificate, which provides evidence that the seller has procured insurance;
- the consular documents, which state that the shipment of goods satisfies the import/export regulations; and
- the certificates of origin and inspection, which state that the goods originated in a specified country to guard against the substitution of second-quality merchandise.

The documents associated with standby letters of credit are far less complicated than those for commercial letters of credit. Often no document is necessary to support the beneficiary's draw upon a standby letter of credit. This is what is referred to as a clean standby letter of credit and should be discouraged due to the possible legal expense of defending any action taken in honoring or dishonoring a draw without specific documentary requirements. At a minimum, standby letters of credit should require a beneficiary's certificate asserting that the account party has not performed according to the contract or has defaulted on the obligation, as well as a copy of the contract between the account party and beneficiary.

Accounting Issues

Since letters of credit represent a contingent liability to the issuing institution, they must be disclosed in the financial statements in accordance with generally accepted accounting principles (GAAP). The Financial Accounting Standards Board has stipulated in its Statement of Financial Accounting Standard No. 5 that the nature and the amount of a standby letter of credit must be disclosed in the institution's financial statement. Commercial letters of credit and standby letters of credit should be accounted for on the balance sheet as liabilities if it is probable that the bank will disburse funds, and if the amount of the funding is determinable. Most standby letters of credit will not be recorded as a liability. However, their existence will be disclosed in the footnotes to the financial statements.

Benefits of Letters of Credit

Both the customer and the financial institution can benefit from letters of credit. Through the use of a letter of credit, a customer can often obtain a less expensive source of funds than would be possible through direct financing from the institution. For example, the customer may be able to take advantage of a seller's credit terms with the backing of a letter of credit to substantiate the customer's credit capacity. The institution receives a fee for providing the service. In addition, the institution hopes to build a better working relationship with its customers, who may generate or refer other profitable business.

Revocable or Irrevocable

Letters of credit can be issued as either revocable or irrevocable. The revocable letter of credit is rarely used because it may be amended or canceled by the issuer without the consent of the other parties. Most letters of credit are issued as irrevocable with a stipulation that no changes may be made to the original terms without the full consent of all parties.

Risks in Issuing Letters of Credit

A financial institution must be aware of the credit risks that are associated with letters of credit and must issue letters of credit only when its resources are adequate. Although letters of credit are not originally made as loans, they may lead to loans if the account party cannot meet its obligations. Therefore, the institution must implement the same prudent underwriting guidelines for letters of credit as for other extensions of commercial credit. Refer to section 2080, "Commercial Loans," in this manual for further details.

The importance of adequate documentation cannot be overemphasized. Commercial letters of credit are part of a continuous flow of transactions evolving from letters of credit to sight drafts to acceptances. Repayment may depend on the eventual sale of the goods involved; however, the goods may not provide any collateral protection. Thus, proper handling and accuracy of the required documents are of primary concern. Letters of credit are frequently issued via tested telex, which verifies the authenticity of the sender (usually another bank). No institution should honor a letter of credit presented by a beneficiary without first confirming its authenticity.

Commercial letters of credit involving imports must be considered unsecured until the goods have passed customs, the security documents specified in the letter of credit have been presented, and the goods have been verified and controlled.

Letters of credit are subject to the risk of fraud perpetrated by customers, beneficiaries, or insiders of the issuing institution. Moreover, standby letters of credit can be used by officers or directors as a vehicle for obtaining credit at another institution. It is important to note that Regulation O requirements apply to standby letters of credit.

Consequently, letters of credit should be issued under the same strict internal controls as any other extension of credit. Such controls include a requirement of dual or multilevel authorizations and the segregation of the issuing, recordkeeping, acceptance, and payment functions.

Risks in Honoring Letters of Credit

The honoring of another institution's letter of credit or acceptance requires strict verification procedures as well as dual authorization by the honoring financial institution. Reasons for strict procedures and authorizations are numerous. The issuer may be unable or unwilling to honor a letter of credit or standby letter of credit, claiming that the document is fraudulent or a forgery or that the signer was unauthorized. Before honoring any other institution's letter of credit, a bank should confirm in writing that the letter of credit is valid and will be honored under specified conditions. Agreements with issuers for accepting letters of credit issued by tested telex should provide specific conditions under which they will be honored.

To minimize risks of loss, compliance with the conditions outlined within the letter of credit must be strict—not merely substantial. Testing of LOCs should involve two or more persons through dual authorization or segregation of duties to prevent fraud by employees in this process.

Uniform Commercial Code

Both the issuer and the beneficiary of letters of credit are obligated to conform to a uniform set of rules governed by article 5 of the Uniform Commercial Code (UCC). These rules are referenced in the Uniform Customs and Practice for Documentary Credits (UCP). The UCC is a set of articles governing commercial transactions adopted by various states, whereas the UCP encompasses all of the international guidelines for trading goods and services. Local laws and customs vary and must be followed under advice of counsel.

TYPES OF LETTERS OF CREDIT

There are two major types of letters of credit: the commercial letter of credit, also referred to as a trade letter of credit, and the standby letter of credit. Banks have significantly increased their issuances of letters of credit, particularly standby letters. A contributing factor to this significant increase is that by issuing letters of credit, an institution can increase its earnings without disbursing funds and increasing total assets. The institution charges a fee for the risk of default or nonperformance by the customer, thereby increasing the bank's return on average assets. It is important for examiners to be concerned with the elements of risk that are present in the institution's practices regarding the issuance of letters of credit. Examiners should then assess the institution's system of controls that can mitigate the risks (including staff experience, proper documentation, and the quality of underwriting). The standards for issuing letters of credit should be no less stringent than the standards for making a loan. Likewise, the letter-of-credit portfolio requires a review as thorough as the lending review. A default or nonperformance by the account party of a letter of credit will have the same impact as a default on a loan.

Commercial Letters of Credit

The commercial letter of credit (LOC) is commonly used as a means of financing the sale of goods between a buyer and seller. Generally, a seller will contract with a buyer on an open-account basis, whereby the seller ships the goods to the buyer and submits an invoice. To avoid the risk of nonpayment, the seller may require the buyer to provide a commercial letter of credit. To satisfy the requirement, the buyer applies for a letter of credit at a financial institution. If approved, the letter of credit would contain specified terms and conditions in favor of the seller (beneficiary), and the buyer (account party) would agree to reimburse the financial institution for payments drawn against the letter. The commercial letter of credit can be used to finance one shipment or multiple shipments of goods. Once documents that provide evidence that the goods have been shipped in accordance with the terms of the letter of credit are received, the seller can draw against the issued letter of credit through a documentary draft or a documentary demand for payment. The institution honors the draft, and the buyer incurs an obligation to reimburse the institution.

Letters of credit can be secured by cash deposits, a lien on the shipped goods or other inventory, accounts receivable, or other forms of collateral. Commercial letters of credit ''sold for cash'' (that is, secured by cash deposits) pose very little risk to a bank as long as the bank, before making payment on the draft, ensures that the beneficiary provides the proper documents. If credit is extended to pay for the goods, the subsequent loan presents the same credit risks associated with any other similar loan.

Standby Letters of Credit

The standby letter of credit (SBLOC) is an irrevocable commitment on the part of the issuing institution to make payment to a designated beneficiary if the institution's customer, the account party, defaults on an obligation. The SBLOC differs from the commercial letter of credit because it is not dependent on the movement of goods. While the commercial letter of credit eliminates the beneficiary's risk of nonpayment under the contract of sale, the SBLOC eliminates the financial risks resulting from nonperformance under a contract. The SBLOC, in effect, enhances the credit standing of the bank's customer.

SBLOCs may be financially oriented (financial SBLOCs), whereby an account party agrees to make payment to the beneficiary, or SBLOCs may be service-oriented (performance SBLOCs), whereby the financial institution guarantees to make payment if its customer fails to perform a nonfinancial contractual obligation.

Financial SBLOCs

Financial SBLOCs are often used to back direct financial obligations such as commercial paper, tax-exempt securities, or the margin requirements of exchanges. For example, if the bank's customer issues commercial paper supported by an SBLOC, and the bank's customer is unable to repay the commercial paper at maturity, the holder of the commercial paper may request the bank to make payment. Upon receipt of the request, the bank would repay the holders of the commercial paper and account for the payment as a loan to the customer under the letter of credit. Because of this irrevocable commitment, the bank has, in effect, directly substituted its credit for that of its customer upon the issuance of the SBLOC; consequently, the SBLOC has become a credit enhancement for the customer.

Performance SBLOCs

Performance SBLOCs are generally transaction-specific commitments that the issuer will make payment if the bank's customer fails to perform a nonfinancial contractual obligation, such as to ship a product or provide a service. Performance SBLOCs are often used to guarantee bid or performance bonds. Through a performance SBLOC, the bank provides a guaranty of funds to complete a project if the account party does not perform under the contract. In contrast to the financial SBLOC, the bank's irrevocable commitment provides liquidity to the obligor and not directly to a third-party beneficiary.

Unlike a commercial letter of credit, a demand for payment against an SBLOC is generally an indication that something is wrong. The nonperformance or default that triggers payment under the SBLOC often signals the financial weakness of the customer, whereas payment under a commercial letter of credit suggests that the account party is conducting its business as usual. Standby letters of credit can be either unsecured or secured by a deposit or other form of collateral.

Uses

The uses of standby letters of credit are practically unlimited. The more common areas of use include the following.

Financing Real Estate Development. A mortgagee will condition its loan commitment upon a cash contribution to a project by the developers. Although the lender insists that the developers have some equity in the project, the developer may not have funds available as they are tied up in other projects. The parties often use the letter of credit to satisfy the requirement for equity without the need for a cash deposit.

Fulfilling Municipal Regulations. Most municipalities require some form of a performance bond to ensure that infrastructure improvements, such as buildings, roads, and utility services, are completed. Because the bonding companies generally required a letter of credit as collateral for their bond, developers began offering the SBLOC to the municipality as a substitute. The SBLOC is probably more common than the performance bond. The SBLOC provides the municipality the guaranty of funds to complete necessary improvements if the developer does not perform as required.

Securing Notes. A lender will sometimes ask its obligor to secure the balance of a promissory note with an SBLOC issued by another bank.

Ensuring Performance. The standby letter of credit is similar to a performance bond. Often the seller of goods will have the borrower obtain a commercial letter of credit to ensure payment; simultaneously, the buyer will have the seller obtain a standby letter of credit to ensure that the goods are delivered when agreed and in acceptable condition.

Guaranteeing Securities. The standby letter of credit guarantees obligations involving the private placement of securities, such as revenue and development bonds. If an SBLOC secures against default, such paper will generally have a higher rating and bear a lower rate of interest. An SBLOC could also be used as a credit enhancer for packaging retail loans for public sale. The use of an SBLOC in this situation typically carries minimal overall risk because the packaging institution normally sets aside a contingent reserve for losses. However, if the reserve is inadequate, the SBLOC should be reviewed for possible classification.

SBLOCs Issued as Surety for Revenue Bonds

SBLOCs may be issued in conjunction with the development of a property that is financed with tax-free or general revenue bonds. In these transactions, a municipal agency—typically, a local housing authority or regional development authority—sells bonds to investors in order to finance the development of a specific project. Once the bonds are issued, the proceeds are placed with a trustee and then loaned at less than market rates to the developer of the project. The below-market-rate loan that is granted to the developer enables the municipal agency to encourage development without expending tax dollars. The municipal agency has no liability; the bond investors only have recourse against the specific project. If the bonds are exempt from federal taxation, they will generally carry a below-market interest rate. If the bonds are not tax free—and some municipal bonds are not tax free—they will carry a market rate of interest.

Because the bonds are secured only by the project, an SBLOC is typically obtained by the beneficiary (in this example, the municipal agency) from a financial institution to provide additional security to the bondholders. The SBLOC is usually for an amount greater than the face amount of the bonds, so the bondholders' accrued interest between interest payment dates is usually secured. The bank generally secures its SBLOC with a lien that is subordinate to the authority's or trustees' lien against the property and the personal guarantees of the principal. Underwriting standards and credit analysis for SBLOCs should mirror those employed for direct loans.

The trustee receives periodic payments from the developer and then pays the bondholders their periodic interest payments and also pays the financial institution its letter-of-credit fee. In the event of a default by the developer, the trustee will draw upon the SBLOC to repay the bondholders. If such a default occurs, the issuing financial institution assumes the role of the lender for the project.

The structure of the transaction requires the bank issuing the SBLOC to assume virtually all of the risk. Because the purpose of these bonds is to encourage development, financially marginal projects, which would not be feasible under conventional financing, are often financed in this manner. The primary underwriting consideration is the ability of the securing property to service the debt. The debt-service-coverage calculations should include both the tax-free rate, if applicable, obtained through the revenue bonds and market interest rates. The operations of the securing property should also be monitored on an ongoing basis. If new construction is involved, the progress should be monitored and any cost overruns should be identified and addressed.

Renewal of SBLOCs

Although most SBLOCs contain periodic renewal features, the examiner must be aware that the bank cannot relieve itself from liability simply by choosing not to renew the SBLOC. Virtually all of the bond issues require a notice of nonrenewal before the expiration of the SBLOC. If such notice is received by the trustee, the trustee normally considers the notice an event of default and draws against the existing SBLOC. The bank should protect itself, therefore, by continuously monitoring both the project and the status of the bonds. Documentation should be maintained in the bank's file to substantiate the property's occupancy, its cashflow position, and the status of the bonds. In addition to the current status of interest payments, any requirements for a sinking fund that are contained in the bond indenture should also be monitored.

Some letters of credit are automatically renewable unless the issuing bank gives the beneficiary prior notice (usually 30 days). These letters of credit represent some additional risk because of the notification requirement placed on the bank. As noted above, proper monitoring and timely follow-up are imperative to minimize risk.

Without the benefit of a substantial guarantor or equity in the collateral, these SBLOCs present more than normal risk of loss. If the SBLOC is converted into an extension of credit, the loan will likely be classified substandard or worse. Protection against loss may be provided by a long-term lease from a major tenant of an industrial property or a lease from a housing authority with a governmental funding commitment or guaranty.

Classification of SBLOCs

It may be appropriate to adversely classify an SBLOC if draws under the SBLOC are probable and a well-defined credit weakness exists. For example, deterioration of the financial standing of the account party could jeopardize performance under the letter of credit and result in the requirement of payment to the beneficiary. Such a payment would result in a loan to the account party and could result in a collection problem, especially if the SBLOC was unsecured. If payment is probable and the account party does not have the ability to repay the institution, an adverse classification is warranted. FASB 5 requires that if a loss contingency is probable and can be reasonably estimated, a charge to income must be accrued. Refer to section 2060, ''Classification of Credits,'' in this manual for procedures on SBLOC classification.

BANKER'S ACCEPTANCES

When the beneficiary presents a draft to the issuer in compliance with the terms of a commercial letter of credit, the method of honoring the draft is acceptance. The issuer will stamp the word ''accepted'' across the face of the draft, which makes the instrument negotiable. Thus, the institution upon which the draft is drawn converts what was originally an order to pay into an unconditional promise to pay. Depending on the terms specified in the letter of credit, payment of the draft can vary from sight to 180 days. There is a ready market for these instruments, because payment must be made at maturity by the accepting institution, whether or not it is reimbursed by its customer. These acceptances are readily negotiable, and a beneficiary may sell accepted time drafts to other financial institutions at a discount. Acceptances are governed by article 3 of the UCC, and any rights the parties have under acceptance are subject to the rules of that article. For further discussion of banker's acceptances, see section 7060, ''International—Banker's Acceptances,'' and the Instructions for the Preparation of the Report of Condition and Income.

Participations in Banker's Acceptances

The following discussion refers to the roles of accepting and endorsing banks in banker's acceptances. It does not apply to banks purchasing other banks' acceptances for investment purposes. Banker's acceptances may represent either a direct or contingent liability of the bank. If the acceptance is created by the bank, it constitutes a direct liability that must be paid on a specified future date. The acceptance is also an on-balance-sheet, recognized liability. If a bank participates in the funding risk of an acceptance created by another bank, the liability is contingent and the item is carried off-balance-sheet. The financial strength and repayment ability of the accepting bank should be considered in analyzing the amount of risk associated with these contingent liabilities.

Participations in acceptances conveyed to others by the accepting bank include transactions that provide for the other party to the participation to pay the amount of its participated share to the accepting bank at the maturity of the acceptance, whether or not the account party defaults. Participations in acceptances acquired by the nonaccepting bank include transactions that provide for the nonaccepting bank to pay the amount of its participated share to the accepting bank at the maturity of the acceptance, whether or not the account party defaults.

Call Report Treatment

For regulatory reporting purposes, the existence of such participations is not to be recorded on the balance sheet. Rather, both the accepting bank conveying the participation to others and the bank acquiring the participation from the accepting bank must report the amounts of such participations in the appropriate item in Schedule RC-L, Commitments and Contingencies. (The amount of participations in acceptances reported in Schedule RC-L by a member bank may differ from the amount of such participations that enter into the calculation of the bank's acceptances to be counted toward its acceptance limit imposed by section 13 of the Federal Reserve Act (12 USC 372). These differences are mainly attributable to participations in ineligible acceptances, to participations with ''uncovered'' institutions, and to participations that do not conform to the minimum requirements set forth in 12 CFR 250.163.)

NOTE-ISSUANCE AND REVOLVING UNDERWRITING CREDIT FACILITIES

The first note-issuance facility (NIF) was introduced in 1981. A NIF is a medium-term (five- to seven-year) arrangement under which a borrower can issue short-term paper. The paper is issued on a revolving basis, with maturities ranging from as low as seven days to up to one year. Underwriters are committed either to purchasing any unsold notes or to providing standby credit. Bank borrowing usually involves commercial paper consisting of short-term certificates of deposit and, for nonbank borrowers, generally promissory notes (Euronotes). Although NIF is the most common term used for this type of arrangement, other terms include the revolving underwriting facility (RUF) and the standby note-issuance facility (SNIF).

Another type of facility, a RUF, was introduced in 1982. A RUF is a medium-term revolving commitment to guarantee the overseas sale of short-term negotiable promissory notes (usually a fixed-spread over LIBOR) issued by the borrower at or below a predetermined interest rate. RUFs separate the roles of the medium-term risk-taker from the funding institutions (the short-term investors). RUFs and NIFs allow access to capital sources at interest rates considerably below conventional financing rates. The savings in interest cost are derived because the borrower obtains the lower interest costs prevailing in the short-term markets, while still retaining the security of longer term financing commitments. The notes issued under RUFs are attractive for institutional investors since they permit greater diversification of risk than the certificates of deposit of only one bank. Underwriters favor them because their commitments do not appear on the statement of financial condition. RUFs are usually structured for periods of four to seven years.

A RUF differs from a NIF in that it separates the functions of underwriting and distribution. With a RUF, the lead bank (manager or arranger) acts as the only placing agent. The arranger retains total control over the placing of the notes.

NIFs and RUFs are discussed further in the *Bank Holding Company Supervision Manual.*

GUARANTEES ISSUED

State member banks and foreign branches of U.S. banks are allowed to issue guarantees or sureties under certain circumstances. Such guarantees are to be reported as contingent liabilities in Schedule RC-L. Refer to section 7090, ''International—Guarantees Issued,'' of this manual and to the call report instructions for further information.

ASSET SALES

The term ''asset sales,'' in the following context, encompasses the range of activities from the sale of whole loans to the sale of securities representing interests in pools of loans. Asset-sales programs entail establishing both a portfolio of assets that are structured to be easily salable and a distribution network to sell the assets. Most large banks have expended great effort in developing structures and standard procedures to streamline asset-sale transactions and continue to do so.

Asset sales, if done properly, can have a legitimate role in a bank's overall asset and liability management, and can contribute to the efficient functioning of the financial system. In addition, these activities can assist a bank in diversifying its risks and improving its liquidity.

The benefits of a qualifying sale transaction are numerous. In particular, the sale of a loan reduces capital requirements. The treatment also enhances net income, assuming that the loan was sold for a profit.

Banks' involvement in commercial loan sales and in public issuance of mortgage and asset-backed securities has grown tremendously over the last decade. Banks are important both as buyers and sellers of whole loans, loan participations, and asset-backed securities. Banks also play important roles in servicing consumer receivables and mortgages backing securities and in providing credit enhancement to originators of primarily asset-backed securities.

Both whole loans and portions of loans are sold. Banks sell portions of loans through participation arrangements and syndication agreements.

Participations

A loan participation is a sharing or selling of ownership interests in a loan between two or more financial institutions. Normally, a lead bank originates the loan and sells ownership interests to one or more participating banks at the time the loan is closed. The lead bank (originating bank) normally retains a partial interest in the loan, holds all loan documentation in its own name, services the loan, and deals directly with the customer for the benefit of all participants. Properly structured, loan participations allow selling banks to accommodate large loan requests that would otherwise exceed lending limits, to diversify risk, and to improve liquidity by obtaining additional loanable funds. Participating banks are able to compensate for low local demand for loans or invest in large loans without their servicing burdens and origination costs. If not appropriately structured and documented, however, a loan participation can present unwarranted risks to both the seller and purchaser of the loan. Examiners should determine the nature and adequacy of the participation arrangement and should analyze the credit quality of the loan. For further information on participations, refer to section 2040, ''Loan Portfolio Management,'' in this manual.

Syndication

A syndication is an arrangement in which two or more banks lend directly to the same borrower pursuant to one loan agreement. Each bank in the syndicate is a party to the loan agreement and receives a note from the borrower evidencing the borrower's debt to that bank. Each participant in the syndicate, including the lead bank, records its own share of the participated loan. Consequently, the recourse issues and contingent liabilities encountered in a loan participation involving syndication are not normally an issue. However, many banks involved in syndicated transactions will sell some of their allotment of the facility through subparticipations. These subparticipations should be reviewed in the same manner as any other participation arrangement.

Asset Securitization

Banks have long been involved with asset-backed securities, both as investors in these securities and as sellers of assets within the context of the securitization process. In recent years, banks have increased their participation in the long-established market for those securities that are backed by residential mortgage loans. They have also expanded their securitizing activities to other types of assets, including credit card receivables, automobile loans, boat loans, commercial real estate loans, student loans, nonperforming loans, and lease receivables. See section 4030, ‘‘Asset Securitization,’’ for a detailed discussion of the securitization process.

Risks

Assets sold without recourse are generally not a contingent liability, and the bank should reflect on its books only that portion of the assets it has retained. In some instances, however, participations must be repurchased to facilitate ultimate collection. For example, a bank may sell the portion of a loan that is guaranteed by the Small Business Administration (SBA) and retain the unguaranteed portion and the responsibility for servicing the loan. In the event of a default, the holder of the guaranteed portion has the option to request the originating bank to repurchase its portion before presenting the loan to the SBA for ultimate disposition and collection. In addition, some banks may repurchase assets and absorb any loss even when no legal responsibility exists. It is necessary to determine management’s practice in order to evaluate the degree of risk involved. If management routinely repurchases assets that were sold without recourse, a contingency liability should be recognized. The amount of the liability should be based on historical data.

Contingent liabilities may also result if the bank, as the seller of a loan without recourse, does not comply with provisions of the agreement. Noncompliance may result from a number of factors, including failure on the part of the selling institution to receive collateral and/or security agreements, obtain required guarantees, or notify the purchasing party of default or adverse financial performance by the borrower. The purchaser of a loan may also assert claims that the financial information, which the purchaser relied on when acquiring the loan, was inaccurate, misleading, or fraudulent and that the selling bank was aware of the deficiencies. Therefore, a certain degree of risk may in fact be evident in assets allegedly sold without recourse. Examiners need to be mindful of this possibility and its possible financial consequences on the bank under examination.

Banks also face credit, liquidity, and interest-rate risk in the period in which they accumulate the assets for sale. Especially in mortgage banking activities, the need to carefully monitor interest-rate risk in the ‘‘pipeline’’ represents one of the significant risks of the business. Sellers of participations also face counterparty risk similar to that of a funding desk, because the loan-sales operation depends on the ongoing willingness of purchasers to roll over existing participations and to buy new ones. In addition, many banks sell loans in the secondary market but retain the responsibility for servicing the loans.

Accounting Issues

For regulatory reporting purposes, some transactions involving the ‘‘sale’’ of assets must be reported as financing transactions (that is, as borrowings secured by the assets ‘‘sold’’), and others must be reported as sales of the assets involved. The treatment required for any particular transfer of assets depends on whether the ‘‘seller’’ retains risk in connection with the transfer of the assets. In general, to report the transfer of assets as a sale, the selling institution must retain no risk of loss or obligation for payment of principal or interest.

All recourse arrangements should be documented in writing. If a loan is sold with recourse back to the seller, the selling bank has, in effect, retained the full credit risk of the loan, and its lending limit to the borrower is not reduced by the amount sold. Loans sold with recourse are to be treated as borrowings of the selling bank from the purchasing bank. Examiners should consider asset sales subject to formal or informal repurchase agreements (or understandings) to be sales ‘‘with recourse’’ regardless of other wording in the agreement to the contrary.

In determining the true recourse nature of an asset sale, examiners must determine the extent to which the credit risk has been transferred from the seller to the purchaser. In general, if the risk of loss or obligation for payments of principal or interest is retained by, or may ultimately fall back upon, the seller or lead bank, the transaction must be reported by the seller as a borrowing from the purchaser and by the purchaser as a loan to the seller. Complete details on the treatment of asset sales for purposes of the report of condition and income are found in the glossary of the Instructions for the Preparation of the Report of Condition and Income under the entry ‘‘sales of assets.’’

OTHER OFF-BALANCE-SHEET ACTIVITIES AND CONTINGENT LIABILITIES

Banks often provide a large number of customer services, which normally do not result in transactions subject to entry on the general ledger. These customer services include safekeeping, the rental of safe deposit boxes, the purchase and sale of investments for customers, the sale of traveler’s checks, the sale of U.S. Savings Bonds, collection services, federal funds sold as agent, operating leases, and correspondent bank services. It is the bank’s responsibility to ensure that collateral and other nonledger items are properly recorded and protected by effective custodial controls. Proper insurance must also be obtained to protect against claims arising from mishandling, negligence, mysterious disappearance, or other unforeseen occurrences. Failure to take these protective steps may lead to contingent liabilities. In addition, pending litigation in which the bank is a defendant could expose the bank to substantial risk of loss. Refer to section 4000, ‘‘Other Examination Areas,’’ in this manual for further information.

Banks often enter into operating leases as lessees of buildings and equipment. The arrangements should be governed by a written lease. For a material lease, the examiner must determine whether the lease is truly an operating lease or if it is a capitalized lease pursuant to FASB 13. Capitalized leases and associated obligations must be recorded on the books of the bank in accordance with FASB 13 and the instructions for the preparation of the Report of Condition and Income. Refer to the instructions for the call report and to section 2190, ‘‘Bank Premises and Equipment,’’ in this manual for further information about capitalized leases.

While operating leases do not affect the bank’s capital ratios, the costs of an operating lease may have a material effect upon the earnings of the bank. Moreover, operating leases may involve other responsibilities for the bank, and the bank’s failure to perform these responsibilities may ultimately result in litigation and loss to the bank. The examiner must be cognizant of the requirements imposed on the bank by its leasing arrangements.

Some banks purchase federal funds from smaller correspondent banks as agent. This off-balance-sheet activity is more fully discussed in section 2030, ‘‘Bank Dealer Activities,’’ in this manual.

1. To determine if policies, practices, procedures, and internal controls regarding contingent claims from off-balance-sheet credit activities are adequate.
2. To determine if bank officers are operating in conformance with the established guidelines.
3. To evaluate the off-balance-sheet credit activities for credit quality and collectibility.
4. To determine the scope and adequacy of the audit function.
5. To determine compliance with applicable laws and
6. To initiate corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws or regulations have been noted.

INTRODUCTION

To meet competitive pressures, banks provide a large number of customer services that normally do not result in assets and liabilities subject to entry on the general ledger, but that may involve significant risk. These customer services include fiduciary accounts, investment management, customer safekeeping, rental of safe deposit box facilities, purchase and sale of investments for customers, sale of traveler's checks, and collection department services. The bank is responsible for properly maintaining and safeguarding all consigned items. Banks accomplish the necessary control and review of consigned and collection items through non-ledger control or memorandum accounts. Automated systems, such as a Securities Movements Accounting and Control system (SMAC), can provide proper control for fiduciary, customer safekeeping, custodial, and investment management accounts.

CUSTOMER SAFEKEEPING

Custodial and Investment Management Accounts

Banks may act as custodians for customers' investments such as stocks, bonds, or gold. Custodial responsibilities may involve simple physical storage of the investments, as well as recording sales, purchases, dividends, and interest.[1] On the other hand, responsibilities may be expanded to include actually managing the account. This type of account management includes advising customers when to sell or buy certain investments, as well as meeting their recording requirements. In addition, the bank may lend securities from custodial accounts if authorized by the customer. This transaction allows the bank, as custodian, to charge a fee for lending the securities, thereby reducing its net custody costs. Also, both the bank and the custodial account benefit from interest earned on the transaction. This type of transaction should be governed by a policy that clearly specifies quality and maturity parameters. Additionally, to prevent defaults, borrowers should be subject to minimum credit standards, ongoing financial monitoring, and aggregate borrowing limits. Banks may also indemnify customer accounts against losses from a borrower or collateral default. Such indemnification creates a contingent financial risk to the institution.

Before providing such management and/or lending services, the bank should seek the advice of legal counsel about applicable state and federal laws concerning that type of bank-customer relationship. In addition, the use of signed agreements or contracts that clearly define the services to be performed by the bank is a vitally important first step in limiting the bank's potential liability and risk. The bank must also ensure that a proper control environment, including joint custody and access procedures, is established and maintained in support of custodial and management activities. Clearly, the largest and most active companies take on an increased level of risk. For companies that are aggressively pursuing custodial services or other nontraditional lines of business, the examiner should consider an expanded scope of review for these activities.

Safe Deposit Boxes

When banks maintain safe deposit box facilities, the bank and the customer enter into a contract whereby the bank receives a fee for renting safe deposit boxes. The bank assumes the responsibility of exercising reasonable care and precaution against loss of the box's contents. When a loss does occur, unless the bank can demonstrate it has maintained the required standard of care, it could be held liable for the loss. The required standard of care is defined as that which would be taken by a reasonably prudent and careful person engaged in the same business. Two different keys are required to open the box, and the customer and the bank each have one. Careful verification of a customer's identification is critical to meeting an appropriate standard of care. The customer is not required to disclose the contents of the box to the bank and

1. Collection of interest and dividend income cannot be facilitated by the bank where the securities held are still in the customer's name, unless the paying agent is advised to change the dividend/interest address. Typically, when securities remain in the registered name of the holder, the holder continues to receive the dividend/interest payments. If the securities are re-registered into the name of the bank (or its nominee), then dividends and interest are received by the bank for the credit of the custodial customer.

upon court order the bank may gain access to the box without the presence of the customer.

Safekeeping

In addition to items held as collateral for loans, banks occasionally hold customers' valuables for short periods of time. The bank may or may not charge a fee for the service. Although it is a convenience for bank customers, many banks attempt to discourage the practice by emphasizing the benefits of a safe deposit box. When it is not possible or practical to discourage a customer, the same procedures that are employed in handling collateral must be followed. Items to be stored should be inventoried by two persons and maintained under dual control in the bank's vault. A multicopy, prenumbered, safekeeping receipt should be prepared with a detailed description of the items accepted and it should be signed by the customer. Sealed packages with contents unknown to the bank should never be accepted for safekeeping.

COLLECTION ITEMS

The collection department is one of the most diversified areas in the bank. It engages in receiving, collecting, and liquidating items which generally require special handling and for which credit normally is given only after final payment is received. The bank acts as agent for its customers or correspondents and receives a fee for that service. Even though general ledger accounts rarely are used in the collection process, the importance and value of customer assets under bank control demand the use of accounting procedures adequate to provide a step-by-step historical summary of each item processed. An audit trail must be developed to substantiate the proper handling of all items and to reduce the bank's potential liability.

CONSIGNED ITEMS

The most common items held on consignment by banks are unissued traveler's checks and gold. Traveler's checks have gained widespread popularity because of the possibility that customers can obtain a refund if the checks are lost or stolen. Traveler's checks are issued for a fee or commission shared by the consignor and the issuing bank. Generally, a working supply of the checks is maintained at the teller line or selling station and a reserve supply is maintained under dual control in the bank's vault.

Under paragraph 7 of section 5136 of the Revised Statutes, national banks may exercise their powers "by buying and selling exchange, coin and bullion." This statute is applied to state member banks under section 9, paragraph 20, of the Federal Reserve Act. Consequently, banks may deal only in gold or silver that qualifies as coin or bullion. The term "coin" means coins minted by a government or exact restrikes, minted at a later date by, or under the authority of, the issuing government. The restrictions contained in the Glass-Steagall Act, which prohibit investment in or underwriting of securities, also are applicable to securities of companies involved with gold.

Rarely does a bank receive sufficient revenues from the above transactions to cover the cost of handling them. However, banks must offer a full range of services to be competitive and attract customers. The bank assumes the responsibility and related contingent liability to properly maintain the assets of others and to properly record all transactions involved with the consigned items.

INTERNAL CONTROL CONSIDERATIONS

It is essential that bank policy provides for proper internal controls, operating procedures, and safeguards. In all cases, control totals must be generated and the function balanced periodically by someone not associated with the function. Proper insurance protection must also be obtained to protect against claims arising from mishandling, negligence, mysterious disappearance, or other unforeseen occurrences. If an employee should, by fraud or negligence, permit unauthorized removal of items held for safekeeping or issue traveler's checks improperly, the bank may be held liable for losses. Therefore, banks should maintain adequate bonding for contingent liabilities and the examiner should review applicable insurance policies.

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

1. If selected for implementation, complete or update the Consigned Items and Other Non-Ledger Control Accounts section of the Internal Control Questionnaire.
2. Based on the evaluation of internal controls and the work performed by internal/external auditors, determine the scope of the examination.
3. Test for compliance with policies, practices, procedures and internal controls in conjunction with performing the remaining examination procedures. Obtain a listing of any deficiencies noted in the latest review done by internal/external auditors from the examiner assigned ''Internal Control'' and determine if appropriate corrections have been made.
4. Obtain a listing of consigned items and other non-ledger control accounts from the bank.
5. Scan any existing control accounts for any significant fluctuations and determine the cause of fluctuations.
6. Compare bank control records to remittance records for unissued U.S. savings bonds and food stamps.
7. Determine compliance with laws and regulations pertaining to non-ledger control accounts by determining, through observation and discussion with management, that there exist no violation of the prohibition against a bank participating in lotteries (section 9A of the Federal Reserve Act (12 USC 25A)).
8. Prepare in appropriate report form, and discuss with appropriate officer(s):
   a. Violations of laws and regulations.
   b. Recommended corrective action when policies, practices or procedures are deficient.
9. Update the workpapers with any information that will facilitate future examinations.

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

SAFE DEPOSIT BOXES

1. Has counsel reviewed and approved the lease contract in use which covers the rental, use and termination of safe deposit boxes?
*2. Is a signed lease contract on file for each safe deposit box in use?
3. Are receipts for keys to the safe deposit box obtained?
4. Are officers or employees of the bank prohibited from acting as a deputy or having the right of access to safe deposit boxes except their own or one rented in the name of a member of their family?
5. Is the guard key to safe deposit boxes maintained under absolute bank control?
6. Does the bank refuse to hold, for renters, any safe deposit box keys?
7. Is each admittance slip signed in the presence of the safe deposit clerk and the time and date of entry noted?
8. Are admittance slips filed numerically?
9. Are vault records noted for joint tenancies and co-rental contracts requiring the presence of two or more persons at each access?
10. Are the safe deposit boxes locked closed when permitting access and the renter's key removed and returned to the customer?
11. Is the safe deposit clerk prohibited from assisting the customer in looking through the contents of a box?
12. Does the safe deposit clerk witness the relocking of the box?
13. Are all coupon booths examined by an attendant after being used but before being assigned to another renter, to be sure the previous person did not leave behind anything of value?
14. Has a standard fee schedule for this service been adopted?
15. Are all collections of rental income recorded when received?
16. Are all safe deposit boxes where lessee is delinquent in rent, flagged or otherwise marked so that access will be withheld until rent is paid?
17. Is there a file maintained of all attachments, notices of bankruptcy, letters of guardianship and letters testamentary served on the bank?
18. Is an acknowledgment of receipt of all property, and a release of liability signed upon termination of occupancy?
19. Are locks changed when boxes are surrendered, whether or not keys are lost?
20. Is drilling of boxes witnessed by two individuals?
21. Are the contents of drilled boxes inventoried, packaged, and placed under dual control?
*22. Are all extra locks and keys maintained under dual control?

Conclusion

23. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
24. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

ITEMS IN SAFEKEEPING

*25. Are such items segregated from bank-owned assets and maintained under dual control?
26. Is there a set charge or schedule of charges for this service?

27. Do bank policies prohibit holding items in safekeeping free of charge?
28. Are duplicate receipts issued to customers for items deposited in safekeeping?
29. Are the receipts prenumbered?
*30. Is a safekeeping register maintained to show details of all items for each customer?
*31. Is a record maintained of all entries to custodial boxes or vaults?
32. Does the bank refuse to accept sealed packages when the contents are unknown?
33. If the bank has accepted sealed packages for safekeeping, the contents of which are not described, has the approval of the bank's counsel been obtained?
34. When safekeeping items are released, are receipts obtained from the customer?

Conclusion

35. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
36. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

CUSTODIAN ACCOUNTS

(Omit this section if the bank's trust department handles such accounts).

*37. Does the bank have written contracts on hand for each account that clearly define the functions to be performed by the bank?
38. Has bank counsel reviewed and approved the type and content of the contracts being used?
39. Does the bank give customers duplicate receipts with detailed descriptions, including dates of coupons attached, if applicable, for all items accepted?
40. Are those receipts prenumbered?
41. Do bank procedures prohibit its holding any investments not covered by a sale or purchase order in this department?
42. Are all orders for the purchase and sale of investments properly authorized in the account contract or signed by customers?
43. For coupon securities held by the bank:
    a. Is a tickler file or other similar system used to ensure prompt coupon redemption on accounts where the bank has been authorized to perform that service?
    b. Are procedures in effect to prevent clipping of coupons where bank is not so authorized?
    c. Have procedures been adopted to insure prompt customer credit when coupon proceeds or other payments are received?
*44. Are all investment items handled in this area maintained under dual control?
45. Have procedures been established for withdrawal and transmittal of items to customers?
*46. Does an officer review and approve all withdrawals prior to the transaction?
47. Has a standard fee schedule for this service been adopted?

Conclusion

48. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
49. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

COLLECTION ITEMS

50. Is access to the collection area controlled (if so, indicate how)?
*51. Are permanent registers kept for incoming and outgoing collection items?
52. Are all collections indexed in the collection register?
53. Do such registers furnish a complete history of the origin and final disposition of each collection item?

54. Are receipts issued to customers for all items received for collection?
55. Are serial numbers or prenumbered forms assigned to each collection item and all related papers?
*56. Are all incoming tracers and inquiries handled by an officer or employee not connected with the processing of collection items?
57. Is a record kept to show the various collection items which have been paid and credited as a part of the day's business?
58. Is an itemized daily summary made of all collection fees, showing collection numbers and amounts?
59. Are employees handling collection items periodically rotated, without advance notification, to other banking duties?
*60. Is the employee handling collection items required to make settlement with the customer on the same business day that payment of the item is received?
61. Does the bank have an established policy of not allowing the customer credit until final payment is received?
*62. Have procedures been established, including supervision by an officer, for sending tracers and inquiries on unpaid collection items in the hands of correspondents?
63. In the event of nonpayment of a collection item, is the customer notified and the item promptly returned?
*64. Are the files of notes entered for collection clearly and distinctly segregated from bank-owned loans and discounts?
*65. Are collection notes above maintained under memorandum control and is the control balanced regularly?
66. Are collection files locked when the employee handling such items is absent?
67. Are vault storage facilities provided for collection items carried over to the next day's business?
*68. Does the collection teller turn over all cash to the paying teller at the close of business each day and start each day with a standard change fund?
69. Has a standard fee schedule for this service been adopted?
70. Is the fee schedule always followed?
71. Is a permanent record maintained for registered mailed?

Conclusion

72. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
73. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

CONSIGNED ITEMS

*74. Is the reserve stock of consigned items maintained under dual control?
75. Are working supplies kept to a reasonable minimum, i.e., two or three days' supply, and adequately protected during banking hours?
*76. Is a memorandum control maintained of consigned items?
77. Are separate accounts with the consignor maintained at each issuing location (branch), if applicable?
*78. Is the working supply put in the vault at night and over weekends or holidays or is it otherwise protected?
79. Are remittances for sales made on a regularly scheduled basis, if not daily?

Conclusion

80. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
81. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

Modern economies require an efficient system for transferring funds between financial institutions and between financial institutions and their customers. Banks and other depository institutions use payment systems both to transfer funds related to their own operations—for example, when engaging in federal-funds transactions—and to transfer funds on behalf of their customers. Depository institutions and the Federal Reserve together provide the basic infrastructure for the nation's payment system.

Commercial banks maintain accounts with each other and with the Federal Reserve Banks; through these accounts, the payments of the general public are recorded and ultimately settled. The demand for electronic funds transfer (EFT) services has increased with improved data communication and computer technology. Community banks that previously executed EFT transactions through a correspondent can now initiate their own same-day settlement transactions nationwide. The need for same-day settlement transactions has precipitated financial institutions' increased reliance on EFT systems. Financial institutions commonly use their EFT operations to make and receive payments, buy and sell securities, and transmit payment instructions to correspondent banks worldwide. In the United States, most of the dollar value of all funds transfers is concentrated in two electronic payment systems: Fedwire, which is a Federal Reserve service, and the Clearing House Interbank Payments System (CHIPS), which is a private-sector multilateral settlement system owned and operated by CHIPCo LLC, a subsidiary of the New York Clearing House Association.

Final settlement occurs when payment obligations between payment-system participants are extinguished with unconditional and irrevocable funds. For transactions settled in physical currency, payment and settlement finality occur simultaneously. On occasion, settlement finality may not occur on the same day a payment is made. Without immediate settlement finality, the recipient of a payment faces the uncertainty of not receiving the value of funds that has been promised. The exposure to this uncertainty is generally referred to as *payment system risk* (PSR).

Payment system risk refers to the risk of financial loss to the participants in and operators of payment systems due to a variety of exposures, such as counterparty or customer default, operational problems, fraud, or legal uncertainty about the finality of settled payments. A major source of payment system risk arises when participants in or the operator of a payment system extends unsecured, intraday credit to facilitate the smooth and efficient flow of payments. For example, the aggregate value of intraday credit extended by the Federal Reserve, in the form of daylight overdrafts in institutions' Federal Reserve accounts, is substantial and creates significant credit exposure for the Federal Reserve Banks.

A daylight overdraft occurs whenever an institution has a negative account balance during the business day. Such a credit exposure can occur in an account that an institution maintains with a Federal Reserve Bank or with a private-sector financial institution. At a Reserve Bank, a daylight overdraft occurs when an institution has insufficient funds in its Federal Reserve account to cover Fedwire funds transfers, incoming book-entry securities transfers, or other payment activity processed by the Reserve Bank, such as automated clearinghouse or check-clearing transactions. Similarly, banks are exposed to credit risk when they permit their customers to incur daylight overdrafts in their accounts. More specific information about the types of risks involved under the rubric of payment systems risk is discussed later in this section.

When developing an institution's overview, performing annual and quarterly risk assessments, and conducting the institution's examination, examiners should review an instsitution's payment system risk and EFT practices. Supervisory and examination guidance and procedures should be followed to determine the risk assessment, matrix, supervisory plan, and scope of an examination. This guidance should also be used when conducting the examination. An overall initial analysis of an institution's payment system risk practices can provide examiners with quick insight on the adequacy of its current internal controls and risk-management practices, and on whether the institution's payment activity creates intraday exposures that may pose significant risk if not managed properly.

In general, examiners should review the frequency, magnitude, and trend of daylight overdrafts in an institution's Federal Reserve account, as well as any breaches of its net debit cap.

Examiners should analyze the reasons for the daylight overdrafts and cap breaches; the nature of the transactions causing the overdrafts (for example, correspondent check clearings or funds transfers); whether the number of customers, correspondents, and respondents is concentrated among only a few entities; whether there is a clear pattern of transactions; and the types of activities involved. In addition, examiners should review and determine the adequacy of the board-of-directors resolution authorizing the institution's net debit cap and use of Federal Reserve intraday credit (as required by the PSR policy). The examiners' most important goal is to ensure that banks have and use appropriate risk-management policies and procedures that effectively monitor and control their exposure to payment system risk.

TYPES OF PAYMENT SYSTEMS

An understanding of the mechanics of the various payment systems is necessary to evaluate the operational procedures depository institutions use to control payment-processing risks for their own or their customers' accounts.

EFT Systems

Fedwire

The Fedwire funds-transfer system is a real-time gross settlement system in which depository institutions initiate funds transfers that are immediate, final, and irrevocable when processed. Depository institutions that maintain a reserve or clearing account with a Federal Reserve Bank may use Fedwire to send payments to or receive payments from other account holders directly. Depository institutions use Fedwire to handle large-value, time-critical payments, such as payments for the settlement of interbank purchases and sales of federal funds; the purchase, sale, and financing of securities transactions; the disbursement or repayment of loans; and the settlement of real estate transactions.

In the Fedwire funds-transfer system, only the originating financial institution can remove funds from its Federal Reserve account. Originators provide payment instructions to the Federal Reserve either online or offline. Online participants send instructions through a mainframe or PC connection to Fedwire, and no manual processing by the Federal Reserve Banks is necessary. Offline participants give instructions to the Reserve Banks by telephone. Once the telephone request is authenticated, the Reserve Bank enters the transfer instruction into the Fedwire system for execution. The manual processing required for offline requests makes them more costly; thus, they are suitable only for institutions that have small, infrequent transfers. (For further information, see www.federalreserve.gov/paymentsystems/fedwire/.)

CHIPS

The Clearing House Interbank Payments System (CHIPS) is a large-value funds-transfer system for U.S. dollar payments between domestic or foreign banks that have offices located in the United States. CHIPS is a real-time final settlement system that continuously matches, nets, and settles queued payment orders.

All CHIPS payment orders are settled against positive balances, simultaneously offset by incoming payment orders, or some combination of both. To facilitate this process, CHIPCo maintains an account on the books of the Federal Reserve Bank of New York. Each CHIPS participant has a pre-established opening-position requirement, which, once funded by a Fedwire funds transfer, is used to settle payment orders throughout the day.

During the operating day, participants submit payment orders to a centralized queue maintained by CHIPS. Payment orders that do not pass certain settlement conditions are held in the central queue until an opportunity for settlement occurs or until the end-of-day settlement process. The sending and receiving participants are not obligated to settle these queued payment orders.

Each afternoon, each participant with a closing-position requirement must transfer, through Fedwire, its requirement to the CHIPS account at the Federal Reserve Bank of New York.[1] These requirements, when delivered, are credited to participants' balances. After completion of this process, CHIPS will transfer to those participants who have any balances remaining,

1. Although CHIPS no longer makes distinctions between settling and nonsettling participants, CHIPS participants can use nostro banks to make transfers on their behalf.

that is, participants in an overall net positive position for the day, the full amount of those positions. (For further information, see the CHIPS rules at www.chips.org.)

Manual Systems

Not all financial institutions employ an EFT system. Some banks execute such a small number of EFT transactions that the cost of a computer-based system such as Fedwire is prohibitive. Instead, these banks will continue to execute EFTs by a telephone call to a correspondent bank. Executing EFT transactions in this way is an acceptable practice as long as the bank has adequate internal control procedures.

Message Systems

The message systems employed by financial institutions, corporations, or other organizations to originate payment orders—either for their own benefit or for payment to a third party—are indispensable components of funds-transfer activities. Unlike payment systems, which transmit actual debit and credit entries, message systems process administrative messages and instructions to move funds. The actual movement of the funds is then accomplished by initiating the actual entries to debit the originating customer's account and to credit the beneficiary's account at one or more financial institutions. If the beneficiary's account or the beneficiary bank's account is also with the originator's bank, the transaction is normally handled internally through *book entry.* If the beneficiary-related accounts are outside the originating customer's bank, the transfer may be completed by use of a payment system such as Fedwire or CHIPS. The means of arranging payment orders ranges from manual methods (for example, memos, letters, telephone calls, fax messages, or standing instructions) to electronic methods using telecommunications networks. These networks may include those operated by the private sector, such as SWIFT or Telex, or other networks operated internally by particular financial institutions.

Even though the transfers initiated through systems such as SWIFT and Telex do not result in the immediate transfer of funds from the issuing bank, they do result in the issuing bank's having an immediate liability, which is payable to the disbursing bank. Therefore, the internal operating controls of these systems should be as stringent as the ones implemented for systems such as Fedwire and CHIPS.

SWIFT

Society for Worldwide Interbank Financial Telecommunications (SWIFT) is a nonprofit cooperative of member banks that serves as a worldwide interbank telecommunications network. Based in Brussels, Belgium, SWIFT is the primary system employed by financial institutions worldwide to transmit either domestic or international payment instructions. (For further information, see www.swift.com.)

TELEX

Several private telecommunications companies offer worldwide or interconnected services that provide a printed permanent record of each message transmitted. Telex is the primary message system for institutions that do not have access to SWIFT. The Telex systems do not include built-in security features. Telex users exchange security codes, and senders sequentially number messages sent to another institution.

Automated Clearinghouse and Check Transactions

The automated clearinghouse (ACH) is an electronic payment delivery system most often used to process low-dollar repetitive retail payments. The system is used primarily for preauthorized recurring payments such as payroll, corporate payments to vendors, Social Security payments, insurance premium payments, and utility payments. First introduced in the early 1970s as a more efficient alternative to checks, ACH has evolved into a nationwide mechanism that processes electronically originated credit and debit transfers for any participating institution nationwide. An alternative to paper checks, the ACH handles billions of payments annually.

Financial institutions are encouraged to obtain a copy of the ACH rules of the National Automated Clearing House Association (NACHA): *A*

Complete Guide to Rules and Regulations Governing the ACH Network. The ACH rules provide detailed information on the rule changes, their operational impact, and whether any software changes are required. The rulebook is designed to help financial institutions comply with the current NACHA rules, which are applicable to all ACH participants and include a system of national fines. (For further information, see www.nacha.org.)

The Federal Reserve ACH is governed by Operating Circular #4, "Automated Clearing House Items." Other important federal legislation concerning the ACH can be found in Regulation E (primarily regarding consumer rights in electronic funds transfers) and Regulation CC (regulations concerning the availability of funds). (For further information, see www.frbservices.org.)

There are two types of ACH transactions: ACH credits and ACH debits. A file containing mortgage payments or insurance premiums could be an example of an ACH debit file. In this transaction, funds flow from the receiver to the originator of the transaction. ACH debit transactions are very similar to check transactions. Both receivers of ACH debit files and payers of checks have the right to return transactions for various reasons, such as insufficient funds in the account or a closed account. The major risk facing institutions that originate ACH debit transactions and collect checks for customers is return-item risk. Return-item risk extends from the day funds are made available to the customer until the individual return items are received.

ACH credit transactions are similar to Fedwire funds transfers in that funds flow from the originator of the transaction to the receiver. A company payroll would be an example of an ACH credit transaction: the bank originating payments on behalf of a customer (the employer in this instance) has a binding commitment to make the payments to the ACH processor when the bank deposits its files with the ACH processor. Since the ACH is a value-dated mechanism, that is, transactions may be originated one or two days before the specified settlement day, the bank is exposed to temporal credit risk that may extend from one to three business days, depending on when the customer (the employer) funds the payments it originates. If the customer fails to fund the payments on the settlement day, the potential loss faced by the originating bank is equal to the total value of payments deposited with the processor from the time the payments are deposited until the customer funds these payments.

BOOK-ENTRY SYSTEMS

Fedwire Book-Entry Securities Transfers

The Fedwire book-entry securities system is known as the National Book-Entry System (NBES). It consists of a safekeeping function and a transfer and settlement function. The safekeeping function involves the electronic storage of securities records in custody accounts. The transfer and settlement function involves the transfer of securities between parties.

Transfers of Fedwire book-entry securities are initiated in the same manner as Fedwire funds transfers. Depository institutions that maintain a reserve account with a Federal Reserve Bank can use the NBES to hold and transfer U.S. Treasury and U.S. government agency securities (including mortgage-backed securities), as well as securities issued by certain international organizations such as the World Bank. These securities are held and transferred in electronic (book-entry) form; the U.S. Treasury and international organizations no longer issue physical securities, nor do most federal agencies.

Securities transfers can be made free of payment or against a designated payment. Nonetheless, most securities transfers involve the delivery of securities and the simultaneous exchange of payment for the securities, a transaction called delivery-versus-payment. The transfer of securities ownership and related funds (if any) is final at the time of transfer. Access to the securities service is limited to depository institutions and a few other organizations, such as federal agencies, state government treasurers' offices (which are designated by the Department of the Treasury to hold securities accounts), and limited-purpose trust companies that are members of the Federal Reserve System. Nonbank brokers and dealers typically hold and transfer their securities through depository institutions that are Fedwire participants and that provide specialized government securities clearing services. (For more information, see www.federalreserve.gov/paymentsystems/fedwire/.)

Transfer-Size Limit on Book-Entry Securities

Secondary-market book-entry securities transfers on Fedwire are limited to a transfer size of $50 million par value. This limit is intended to encourage partial deliveries of large trades in order to reduce position building by dealers, a major cause of book-entry securities overdrafts before the introduction of the transfer-size limit and daylight-overdraft fees. This limitation does not apply to—

- original-issue deliveries of book-entry securities from a Reserve Bank to an institution, or
- transactions sent to or by a Reserve Bank in its capacity as fiscal agent of the United States, government agencies, or international organizations.

Thus, requests to strip or reconstitute Treasury securities or to convert bearer or registered securities to or from book-entry form are exempt from this limitation. Also exempt are pledges of securities to a Reserve Bank as principal (for example, discount window collateral) or as agent (for example, Treasury Tax and Loan collateral).

Private Book-Entry Systems

In addition to U.S. Treasury and government-agency securities, major categories of financial instruments commonly traded in the United States include corporate equities and bonds, municipal (state and local) government securities, money market instruments, and derivatives such as swaps and exchange-traded options and futures. These instruments are generally traded through recognized exchanges or over-the-counter dealer markets. The mechanisms for clearance and settlement vary by type of instrument and generally involve specialized financial intermediaries, such as clearing corporations and depositories. Clearing corporations provide trade comparison and multilateral netting of trade obligations. Depositories, in contrast, hold physical securities and provide book-entry transfer and settlement services for their members.

The vast majority of corporate equity and bond trades are cleared through the National Securities Clearing Corporation (NSCC). Most corporate securities, as well as municipal government bonds, are held at the Depository Trust Company (DTC) in New York. Settlement of securities cleared through the NSCC is effected by book-entry transfers at the DTC. The DTC and the NSCC are owned by the Depository Trust and Clearing Corporation, an industry-owned holding company. (For more information, see www.dtcc.com.)

U.S. Treasury, federal-agency, and mortgage-backed securities are generally traded in over-the-counter markets. The Fixed Income Clearing Corporation (FICC) compares and nets its members' trades in most U.S. Treasury and federal-agency securities. The FICC relies on the Fedwire book-entry securities-transfer system, discussed above, to effect final delivery of securities to its participants. The FICC is owned by the DTCC. (For more information see www.ficc.com.)

The FICC also provides automated post-trade comparison, netting, risk-management, and pool-notification services to the mortgage-backed securities market. The FICC provides its specialized services to major market participants active in various Government National Mortgage Association (GNMA), Federal Home Loan Mortgage Corporation (Freddie Mac or FHLMC), and Federal National Mortgage Association (Fannie Mae or FNMA) mortgage-backed securities programs. The net settlement obligations of FICC participants are settled through the Fedwire book-entry securities system.

PAYMENT SYSTEMS RISK POLICY OVERVIEW

The Federal Reserve's Policy on Payments System Risk (the PSR policy) addresses risks that payment systems present to the Federal Reserve Banks, the banking system, and other sectors of the economy. Section II of the PSR policy focuses on institutions'[2] use of Federal Reserve intraday credit.[3] An integral component of the PSR policy is a program to control the use of Federal Reserve intraday credit, commonly

2. The PSR policy uses the term *institutions*, which refers to depository institutions, U.S. branches and agencies of foreign banking organizations, Edge and agreement corporations, bankers' banks, limited-purpose trust companies, government-sponsored enterprises, and international organizations, unless the context indicates a different meaning.

3. Section I of the PSR policy addresses private-sector systems and other policies. The full text of the PSR policy is available at www.federalreserve.gov/paymentsystems/psr/.

referred to as *daylight credit* or *daylight overdrafts.* Individual Reserve Banks are responsible for administering the Board's PSR policy and ensuring compliance by institutions. A primary objective of examiners when evaluating payment system risk is to ensure that banks using Federal Reserve payment services comply with the Board's PSR policy.

PSR Policy Objectives

Like institutions that offer payment services to customers, Federal Reserve Banks may be exposed to risk of loss when they process payments for institutions that hold accounts with them. The Federal Reserve guarantees payment on Fedwire funds and book-entry securities transfers, net settlement service (NSS) entries,[4] and ACH credit originations made by account holders. If an institution was to fail after sending a transaction that placed its account in an overdraft position, the Federal Reserve would be obligated to cover the payment and bear any resulting losses. Risk is present even when an institution overdraws its account at a Reserve Bank for only a few minutes during the day.

Similar types of risk are generated when customers of private financial institutions and participants in some private-sector payment arrangements incur daylight overdrafts. In addition, daylight credit may be a source of systemic risk in the payment system. *Systemic risk* refers to the potential that the failure of one participant in a payment system, or in the financial markets generally, to meet its required obligations will cause other participants or financial institutions to be unable to meet their settlement obligations when due.

The PSR policy establishes limits on the maximum amount of Federal Reserve daylight credit exposure that an institution may use during a single day or over a two-week period. These limits are sufficiently flexible to reflect the overall financial condition and operational capacity of each institution using Federal Reserve payment services. The policy also permits Reserve Banks to protect themselves from the risk of loss by unilaterally reducing net debit caps; imposing collateralization or clearing-balance requirements; rejecting or delaying certain transactions during the day until the institution has collected balances in its Federal Reserve account; or, in extreme cases, taking the institution offline or prohibiting it from using Fedwire.

4. The Federal Reserve's NSS provides settlement services to various clearinghouses.

Daylight-Overdraft Capacity

Under the Federal Reserve's PSR policy, each institution that maintains an account at a Federal Reserve Bank is assigned or may establish a net debit cap, as outlined below. The net debit cap limits the amount of intraday Federal Reserve credit that the institution may use during a given interval. The policy allows financially healthy institutions that have regular access to the discount window to incur daylight overdrafts in their Federal Reserve accounts up to their individual net debit caps. In addition, the policy allows certain institutions to pledge collateral to the Federal Reserve in order to access additional daylight-overdraft capacity above their net debit caps. In these instances, the institution can incur daylight overdrafts up to the value of its net debit cap plus any Reserve Bank–approved collateralized credit.

NET DEBIT CAPS

An institution's net debit cap refers to the maximum dollar amount of uncollateralized daylight overdrafts that the institution may incur in its Federal Reserve account. An institution's cap category and its capital measure determine the dollar amount of its net debit cap.[5] An institution's net debit cap is calculated as its cap multiple, as listed in table 1, times its capital measure:

$$\text{net debit cap} = \text{cap multiple} \times \text{capital measure}$$

Because a net debit cap is a function of an institution's capital measure, the dollar amount

5. The capital measure used in calculating an institution's net debit cap depends on its home-country supervisor and chartering authority. For institutions chartered in the United States, net debit caps are multiples of ''qualifying'' or similar capital measures, that is, those capital instruments that can be used to satisfy risk-based capital standards, as set forth in the capital adequacy guidelines of the federal financial institution regulatory agencies.

Table 1—Net debit cap multiples

	Net debit cap multiples	
Cap categories	*Single-day*	*Two-week average*
High	2.25	1.50
Above average	1.875	1.125
Average	1.125	0.75
De minimis	0.40	0.40
Exempt-from-filing*	$10 million or 0.20	$10 million or 0.20
Zero	0	0

* The net debit cap for the exempt-from-filing category is equal to the lesser of $10 million or 0.20 multiplied by the institution's capital measure.

of the cap will vary over time as the institution's capital measure changes. An institution's cap category, however, is normally fixed over a one-year period. Cap categories and their associated cap levels, set as multiples of capital, are listed in table 1.

An institution is expected to avoid incurring daylight overdrafts whose daily maximum level, averaged over a two-week period, would exceed its two-week average cap, and, on any day, would exceed its single-day cap. The two-week average cap provides flexibility, recognizing that fluctuations in payments can occur from day to day. The purpose of the single-day cap is to limit excessive daylight overdrafts on any day and to ensure that institutions develop internal controls that focus on the exposures each day, as well as over time. Institutions in the zero, exempt-from-filing, and de minimis cap categories have one cap that applies to both the single-day peak overdraft and the average overdraft for a two-week period.

The Board's policy on net debit caps is based on a specific set of guidelines and some degree of examiner oversight. Under the Board's policy, a Reserve Bank may limit or prohibit an institution's use of Federal Reserve intraday credit if (1) the institution's use of daylight credit is deemed by the institution's supervisor to be unsafe or unsound, (2) the institution does not qualify for a positive net debit cap (see section II.C.2., "Cap Categories," of the PSR policy), or (3) the institution poses excessive risk to a Reserve Bank by incurring chronic overdrafts in excess of what the Reserve Bank determines is prudent.

Cap Categories

The PSR policy defines six cap categories: high, above average, average, de minimis, exempt-from-filing, and zero. The high, above-average, and average cap categories are referred to as "self-assessed" caps.

Self-Assessed

To establish a net debit cap category of high, above average, or average, an institution must perform a self-assessment of its creditworthiness, intraday funds management and control, customer credit policies and controls, and operating controls and contingency procedures. The assessment of creditworthiness is based on the institution's supervisory rating and prompt-corrective-action designation. An institution may perform a full assessment of its creditworthiness in certain limited circumstances, for example, if its condition has changed significantly since the last examination, or if it possesses additional substantive information on its financial condition. An institution performing a self-assessment must also evaluate its intraday funds-management procedures and its procedures for evaluating the financial condition of and establishing intraday credit limits for its customers. Finally, the institution must evaluate its operating controls and contingency procedures to determine if they are sufficient to prevent losses due to fraud or system failures.

An examiner's review of an institution's assessment is an important part of determining the institution's compliance with the PSR policy. An examiner is responsible for ensuring that the institution has applied the guidelines appropriately and diligently, that the underlying analysis and methodology were reasonable, and that the resulting self-assessment was generally consistent with examination findings. The following discussion is a simplified explanation of the self-assessment factors. A more detailed explanation of the self-assessment process is provided in the *Guide to the Federal Reserve's Payments System Risk Policy.* (The guide is available on the Internet at www.federalreserve.gov/paymentsystems/psr/.)

Creditworthiness. Of the four self-assessment factors, creditworthiness is the most influential in determining an overall net debit cap for a given institution. The creditworthiness factor is principally determined by a combination of the institution's capital adequacy and most recent supervisory rating. In the self-assessment, an institution's creditworthiness is assigned one of the following ratings: excellent, very good, adequate, or below standard. An excellent or a very good rating indicates that an institution demonstrates a sustained level of financial performance above its peer-group norm. As a general matter, fundamentally sound institutions that experience only modest weaknesses receive a rating of very good.

Most institutions will use the creditworthiness matrix to determine this component's rating. If an institution's creditworthiness rating is adequate or better, it then proceeds to rate the other three factors in the self-assessment process. The institution's assessment of the other three factors determines whether its composite rating will be lower than or equal to that determined by the creditworthiness factor. If the overall creditworthiness is either adequate or below standard, then the institution does not qualify for a positive daylight-overdraft cap. In certain limited circumstances, an institution may conduct a full analysis of this component. The matrix and information regarding the full analysis are available in the *Guide to the Federal Reserve's Payment System Risk Policy.*

Intraday funds management and control. The purpose of analyzing intraday funds management and control is to assess an institution's ability to fund its daily settlement obligations across all payment systems in which it participates. The analysis requires a review of funds management, credit, operations personnel, and payment activity over a period of time.

To obtain an accurate understanding of funds movements, an institution must fully understand its daily use of intraday credit as well as its use of intraday credit on average over two-week periods. The analysis covers a sufficient period of time so that an institution can determine its peak demand for intraday credit and establish its average use of such credit. The more volatile an institution's payments activity, the longer the interval that is selected for analysis. The analysis incorporates all operational areas with access to payment systems. In addition to large-dollar funds and book-entry securities-transfer activity, the review should address check clearing, ACH, currency operations, and other payment activity that results in relatively large-value settlement obligations. Thus, the analysis should not be limited to online payment systems or to payment systems to which the institution has online access. Additionally, institutions with direct access to Fedwire or to other payment systems in more than one Federal Reserve District must combine all of these access points into a single integrated analysis.

In performing the analysis, the institution considers both liquidity demands and the potential credit risks associated with participation in each payment system. The institution's capacity to settle its obligations in both routine and nonroutine circumstances must be carefully assessed. In many cases, a complete assessment of an institution's ability to control its intraday obligations extends beyond its ability to control its use of Federal Reserve intraday credit within the constraints of its net debit cap. Rather, the assessment extends to the institution's ability to control its position across all payment systems to a level that permits it to fund its obligations regularly. This type of assurance requires an institution to fully understand the nature of its obligations and to establish systems that permit it to monitor daily activity and respond to unusual circumstances.

Customer credit policies and controls. The assessment of an institution's customer credit policies and controls requires two distinct analyses:

- an analysis of the institution's policies and procedures for assessing the creditworthiness of its customers, counterparties, and correspondents

- an analysis of the institution's ability to monitor the positions of individual customers and to control the amount of intraday and interday credit extended to each customer

The analyses require the involvement of both credit and operations personnel, and both analyses should focus on the creditworthiness of all customers, including corporate and other institutions that are active users of payment services. In addition, the creditworthiness of correspondents and all counterparties on privately operated clearing and settlement systems must be assessed.

Operating controls and contingency procedures. The purpose of the analysis of operating controls and contingency procedures is to assess the integrity and the reliability of an institution's payment operations to ensure that they are not a source of operating risk. The integrity of operations is of particular concern because operational errors and fraud can increase the cost of payment services and undermine public confidence in the payments mechanism. Similar results can occur if payment systems are unreliable and if parties making and receiving payments do not have confidence that timely payments will be made.

Overall assessment rating. Once the four self-assessment components are analyzed and an overall rating is determined, the institution's self-assessment and recommended cap category must be reviewed and approved by the institution's board of directors at least once each 12-month period. A cap determination may be reviewed and approved by the board of directors of a holding company parent of an institution, provided that (1) the self-assessment is performed by each entity incurring daylight overdrafts, (2) the entity's cap is based on the measure of the entity's own capital, and (3) each entity maintains for its primary supervisor's review its own file with supporting documents for its self-assessment and a record of the parent's board-of-directors review. The directors' approval must be communicated to the Reserve Bank by submission of a board-of-directors resolution. The Reserve Bank then reviews the cap resolution for appropriateness, in conjunction with the institution's primary regulator. If the Reserve Bank determines that the cap resolution is not appropriate, the institution is informed that it must re-evaluate its self-assessment and submit another resolution. A resolution to establish a different cap category may be submitted by the institution, or it may be required by the Reserve Bank before the annual renewal date, if circumstances warrant such a change.

De Minimis

Institutions that qualify for a de minimis net debit cap incur relatively small daylight overdrafts and thus pose little risk to the Federal Reserve. To ease the burden of performing a self-assessment for these institutions, the PSR policy allows institutions that meet reasonable safety-and-soundness standards to incur daylight overdrafts of up to 40 percent of their capital measure if the institution submits a board-of-directors resolution.

An institution with a de minimis cap must submit to its Reserve Bank at least once in each 12-month period a copy of its board-of-directors resolution (or a resolution by its holding company's board) approving the institution's use of daylight credit up to the de minimis level. If an institution with a de minimis cap exceeds its cap during a two-week reserve-maintenance period, its Reserve Bank will decide whether the de minimis cap should be maintained or whether the institution will be required to perform a self-assessment for a higher cap.

Exempt-from-Filing

The majority of institutions that hold Federal Reserve accounts have an exempt-from-filing net debit cap. Granted at the discretion of the Reserve Bank, the exempt-from-filing cap category permits institutions that only rarely incur daylight overdrafts in their Federal Reserve accounts to incur daylight overdrafts that exceed the lesser of $10 million or 20 percent of their capital measure. If a Reserve Bank determines that an institution is eligible for exempt-from-filing status, it will assign this cap category without requiring any additional documentation. The Reserve Banks will review the status of an exempt institution that incurs overdrafts in its Federal Reserve account in excess of $10 million or 20 percent of its capital measure on more than two days in any two consecutive two-week reserve-maintenance periods. The Reserve Bank will decide if the exemption should be maintained or if the institution will be required to file for a higher cap.

Zero

Some financially healthy institutions that could obtain positive net debit caps choose to have zero caps. Often these institutions have very conservative internal policies regarding the use of Federal Reserve daylight credit, or they simply do not want to incur daylight overdrafts and any associated daylight-overdraft fees. If an institution that has adopted a zero cap incurs a daylight overdraft, the Reserve Bank counsels the institution and may monitor the institution's activity in real time and reject or delay certain transactions that would cause an overdraft. If the institution qualifies for a positive cap, the Reserve Bank may suggest that the institution adopt an exempt-from-filing cap or file for a higher cap, if the institution believes that it will continue to incur daylight overdrafts. In addition, a Reserve Bank may assign an institution a zero net debit cap. Institutions that may pose special risks to the Reserve Banks, such as those institutions without regular access to the discount window, those incurring daylight overdrafts in violation of this policy, or those in weak financial condition, are generally assigned a zero cap. Chartered institutions may also be assigned a zero net debit cap.

Collateralized Capacity

While net debit caps provide sufficient liquidity to most institutions, some institutions experience liquidity pressures. Consequently, certain institutions with self-assessed net debit caps may pledge collateral to their administrative Reserve Bank (ARB) to secure daylight-overdraft capacity in excess of their net debit caps, subject to Reserve Bank approval. This policy is intended to provide extra liquidity through the pledge of collateral to the few institutions that might otherwise be constrained from participating in risk-reducing payment system initiatives. Institutions that request daylight-overdraft capacity beyond the net debit cap must have already explored other alternatives to address their increased liquidity needs.[6] An institution that wishes to expand its daylight-overdraft capacity by pledging collateral should consult with its ARB.[7] The ARB will work with an institution that requests additional daylight-overdraft capacity to decide on the appropriate maximum daylight-overdraft capacity level. In considering the institution's request, the Reserve Bank will evaluate the institution's rationale for requesting additional daylight-overdraft capacity as well as its financial and supervisory information. The financial and supervisory information considered may include, but is not limited to, capital and liquidity ratios, the composition of balance-sheet assets, CAMELS or other supervisory ratings and assessments, and SOSA rankings (for U.S. branches and agencies of foreign banks). Institutions are also expected to submit the following information when requesting collateralized capacity:

- the amount of maximum daylight-overdraft capacity requested
- written justification for requesting additional daylight-overdraft capacity
- written approval from the institution's board of directors or, in the case of U.S. branches and agencies of foreign banks, written approval from the bank's most senior officer responsible for formulating policy at the foreign bank's U.S. head office
- a principal contact at the institution

When deciding whether an institution is eligible for collateralized capacity, the ARB will consider the institution's reasons for applying for additional collateralized capacity; the information related to the institution's condition; and other information, as applicable. If the ARB approves the request for a maximum daylight-overdraft capacity level, the institution must submit a board-of-directors resolution for the maximum daylight-overdraft capacity level at least once in each 12-month period, indicating its board-of-directors approval of that level. An institution's maximum daylight-overdraft capacity is defined as follows:

maximum daylight-overdraft capacity =
single-day net debit cap +
collateralized capacity[8]

6. Some potential alternatives available to a depository institution to address increased intraday credit needs include (1) shifting funding patterns, (2) delaying the origination of funds transfers, or (3) transferring some payments-processing business to a correspondent bank.

7. The ARB is responsible for the administration of Federal Reserve credit, reserves, and risk-management policies for a given institution or other legal entity.

8. Collateralized capacity, on any given day, equals the amount of collateral pledged to the Reserve Bank, not to exceed the difference between the institution's maximum

Institutions with exempt-from-filing and de minimis net debit caps may not obtain additional daylight-overdraft capacity by pledging collateral. These institutions must first obtain a self-assessed net debit cap. Institutions with zero net debit caps also may not obtain additional daylight-overdraft capacity by pledging collateral. If an institution has adopted a zero cap voluntarily, but qualifies for a positive cap, it may not obtain additional daylight-overdraft capacity by pledging collateral without first obtaining a self-assessed net debit cap to obtain additional daylight-overdraft capacity. Institutions that have been assigned a zero net debit cap by their ARB are not eligible to apply for additional daylight-overdraft capacity.

ROLE OF DIRECTORS

The directors of an institution establish and implement policies to ensure that its management follows safe and sound operating practices, complies with applicable banking laws, and prudently manages financial risks. Given these responsibilities, the directors play a vital role in the Federal Reserve's efforts to reduce risks within the payment system. As part of the PSR policy, the Federal Reserve requests that directors, at a minimum, undertake the following responsibilities:

- Understand the institution's practices and controls for the risks it assumes when processing large-dollar transactions for both its own account and the accounts of its customers or respondents.
- Establish prudent limits on the daylight overdrafts that the institution incurs in its Federal Reserve account and on its privately operated clearing and settlement systems.
- Periodically review the frequency and dollar levels of daylight overdrafts to ensure that the institution operates within the guidelines established by its board of directors. Directors should be aware that, under the Federal Reserve's PSR policy, repeated policy violations could lead to reductions in the institution's daylight-overdraft capacity, or to the imposition of restrictions on its Federal Reserve account activity, either of which could affect the institution's operations.

daylight-overdraft capacity level and its single-day net debit cap.

Each institution that performs a self-assessment for a net debit cap should establish daylight-overdraft policies and controls after considering its creditworthiness, intraday funds management and control, customer credit policies and controls, and operating controls and contingency procedures.

The directors may appoint a committee of directors to focus on the institution's participation in payment systems and its use of daylight credit. Furthermore, a higher-level board of the same corporate family may conduct a self-assessment review, if necessary, and approve a resolution. The board of directors should be aware that delegating the review process to a committee or higher-level board does not absolve the directors from the responsibilities stated in the Federal Reserve's PSR policy. The directors cannot delegate this responsibility to an outside consultant or third-party service provider.

For resolutions on collateralized capacity, the board of directors must understand the use and purposes of the pledged collateral under the PSR policy. The directors must understand the reasons that the institution is applying for additional daylight-overdraft capacity, the amount of the collateralized capacity, and the total amount of the net debit cap plus Reserve Bank–approved collateralized credit.

The Federal Reserve recognizes that directors of foreign banks do not necessarily serve in the same capacity as directors of banks in the United States. Therefore, individuals who are responsible for formulating policy at the foreign bank's head office may substitute for directors in performing the responsibilities specified in the PSR policy.

Resolutions

A board-of-directors resolution is required to establish a cap in the de minimis or self-assessed cap categories (high, above average, or average). In addition, a separate resolution is required for self-assessed institutions that wish to obtain collateralized capacity above their net debit caps. These resolutions must follow a prescribed format. Specifically, resolutions must include (1) the official name of the institution, (2) the city and state in which the institution is located, (3) the date the board acted, (4) the cap category adopted, (5) the appropriate official signature, (6) the ABA routing number of the institution, and (7) the corporate seal. For a board resolution approving the results of a self-assessment, the resolution must identify the ratings assigned to each of the four components of the assessment as well as the overall rating used to determine the actual net debit cap. In addition, the institution should indicate if it did not use the creditworthiness-matrix approach in determining its creditworthiness rating.

An institution's primary supervisor may review resolutions, and any information and materials the institution's directors used to fulfill their responsibilities under the PSR policy must be made available to the bank supervisor's examiners. Supporting documentation used in determining an appropriate cap category must be maintained at the institution. At a minimum, the following items must be maintained in the institution's ''cap resolution file'':

- an executed copy of the resolution adopting the net debit cap and/or collateralized capacity
- worksheets and supporting analysis used in its self-assessment of its own cap category
- for institutions with self-assessed caps, copies of management's self-assessment of creditworthiness, intraday funds management and control, customer credit policies and controls, and operating controls and contingency procedures
- minutes and other documentation that serve as a formal record of any directors' discussions on the self-assessment and/or request for collateralized capacity
- status reports the board of directors received on the institution's compliance with both the resolutions adopted by the directors and the PSR policy
- other materials that provide insight into the directors' involvement in carrying out their responsibilities under the PSR policy, including special studies or presentations made to the directors
- for the collateralized-capacity resolution, the amount and type of collateral pledged and the amount of maximum daylight-overdraft capacity
- for the supplemental securities-in-transit collateralized-capacity resolution, the amount of pledged securities in transit and the amount of other collateral pledged, if applicable[9]

The board-of-directors resolution for de minimis and self-assessed institutions and for collateralized-capacity resolutions is valid for one year after the Reserve Bank approves the net debit cap or the amount of maximum daylight-overdraft capacity. An institution with a de minimis cap must renew its cap resolution annually by submitting a new resolution to its Reserve Bank. An institution with a self-assessed cap must perform a new self-assessment annually and submit an updated cap resolution to its Reserve Bank. An institution that has a self-assessed cap and has obtained additional collateralized capacity above its net debit cap must submit a board-of-directors resolution to its Reserve Bank annually. Procedures for submitting these resolutions are the same as those for establishing the initial cap; however, an institution may submit a resolution for a different cap category or a different amount of collateralized capacity, if appropriate. The Reserve Bank, in conjunction with an institution's primary supervisor, will review the appropriateness of each resolution.

Because the self-assessment process may, in some cases, require considerable time to complete and approve, institutions should be aware of the expiration date of their cap resolutions well in advance. If a new cap resolution is not received by the expiration date, an institution may be assigned a zero cap, which would generally preclude the institution from using any Federal Reserve daylight credit.

Confidentiality

The Federal Reserve considers institutions' daylight-overdraft caps; cap categories; and collateralized capacity, if applicable, to be confidential information and will only share this information with an institution's primary supervisor. Institutions are also expected to treat cap and collateralized-capacity information as confidential. Cap and collateralized-capacity information should not be shared with outside parties or mentioned in any public documents.

9. Institutions with self-assessed net debit caps that receive Reserve Bank approval to support a limit on maximum daylight-overdraft capacity with securities in transit must submit a board-of-directors resolution at least once in each 12-month period. The resolution requires the institution's board of directors to acknowledge that (1) securities in transit will be used to collateralize daylight-overdraft capacity in a manner consistent with the reasons and purposes submitted to the institution's administrative Reserve Bank and (2) the value of the securities in transit pledged to the Reserve Bank will fluctuate during the day and over time.

DAYLIGHT-OVERDRAFT MONITORING AND CONTROL

All institutions that maintain Federal Reserve accounts are expected to monitor their account balances on an intraday basis. Institutions should be fully aware of payments they are making from their accounts each day and how those payments are funded. Institutions are encouraged to use their own systems and procedures, as well as the Federal Reserve's systems, to monitor their Federal Reserve account balance and payment activity.

Daylight-Overdraft Measurement

To determine whether a daylight overdraft has occurred in an institution's account, the Federal Reserve uses a set of transaction-posting rules that define explicitly the time of day that debits and credits for transactions processed by a Reserve Bank will post to the account. All Fedwire funds transfers, book-entry securities transfers, and NSS transactions are posted to an institution's account as they occur throughout the day. Other transactions, including ACH and check transactions, are posted to institutions' accounts according to a defined schedule.[10] These posting rules should help institutions control their use of intraday credit because they allow institutions to monitor the time that each transaction is credited or debited to their account. Note that these posting times affect the calculation of the account balance for daylight-overdraft-monitoring and pricing purposes but do not affect the finality or revocability of the entry to the account. An important feature of the posting rules is a choice of posting times for check credits.

10. On September 22, 2004, the Board revised its PSR policy (effective July 20, 2006) concerning interest and redemption payments on securities issued by government-sponsored enterprises (GSEs) and certain international organizations. Currently, Reserve Banks process and post these payments to institutions' Federal Reserve accounts by 9:15 a.m. eastern time, the same posting time as for U.S. Treasury securities' interest and redemption payments, even if the issuer has not fully funded its payments. The revised policy requires Reserve Banks to release these interest and redemption payments as directed by the issuer, provided the issuer's Federal Reserve account contains sufficient funds to cover them. Each issuer will be required to fund its interest and redemption payments by 4 p.m. eastern time for the payments to be processed that day.

Monitoring Daylight Overdrafts

To monitor an institution's overdraft activity and its compliance with the PSR policy and to calculate daylight-overdraft charges, the Federal Reserve uses the Daylight-Overdraft Reporting and Pricing System (DORPS). DORPS captures all debits and credits resulting from an institution's payment activity and calculates end-of-minute account balances using the daylight-overdraft posting rules. As measured by DORPS, an institution's account balance is calculated at the end of each minute, based on its opening balance and all payment transactions posted to the institution's account up until that moment. The daylight-overdraft measurement period begins with the current official opening time of Fedwire and continues until the official closing time. Although DORPS records positive as well as negative account balances, positive balances do not offset negative balances for purposes of determining compliance with net debit caps or for calculating daylight-overdraft fees. In cases of unscheduled extensions of Fedwire hours, the final closing account balance is recorded as if it was the balance at the standard closing time, and balances between the scheduled and actual closing times are not recorded. DORPS generates various reports at the end of each two-week reserve-maintenance period. These reports provide useful information for monitoring daylight overdrafts, such as peak daily overdrafts for the period; overdrafts in excess of net debit cap; end-of-minute account balances for a particular day; and related ratios, such as the peak daily overdraft relative to net debit cap.

Monitoring PSR Policy Compliance

Reserve Banks generally monitor institutions' compliance with the PSR policy over each two-week reserve-maintenance period. In most cases, a policy violation occurs when an institution's account balance for a particular day shows one or more negative end-of-minute account balances in excess of its single-day net debit cap or when an institution's average peak daily overdraft over a reserve-maintenance period exceeds its two-week average cap.[11] The

11. An institution's average peak daily overdraft is calculated by adding the largest overdraft incurred for each day during a reserve-maintenance period and dividing that sum by the number of business days in the period.

exceptions to this general rule are discussed below.

Institutions in the exempt-from-filing cap category are normally allowed two cap breaches in two consecutive two-week reserve-maintenance periods without violating the PSR policy. For institutions in the de minimis or self-assessed cap categories or for institutions that have been approved for maximum daylight-overdraft capacity, each cap breach is considered a policy violation. A Reserve Bank may waive a violation if it determines that the overdraft resulted from circumstances beyond the institution's control.

An institution with a self-assessed cap that has been approved for maximum daylight-overdraft capacity should avoid incurring daylight overdrafts that, on average over a two-week period, exceed its two-week-average limit, and that, on any day, exceed its single-day limit. The two-week-average limit is equal to the two-week average cap plus the amount of applicable Reserve Bank–approved collateral, averaged over a two-week reserve-maintenance period. The single-day limit is equal to an institution's net debit cap plus the amount of applicable Reserve Bank–approved collateral.

For daylight-overdraft purposes, accounts of U.S. branches and agencies of foreign banks and accounts involved in merger-transitions are monitored on a consolidated basis; that is, a single account balance is derived by adding together the end-of-minute balances of each account. The accounts of affiliated institutions are monitored separately if they are separate legal entities. In addition, for institutions with accounts in more than one Federal Reserve District, an ARB is designated. The ARB coordinates the Federal Reserve's daylight-overdraft monitoring for the consolidated accounts or institutions.

Consequences of Violations

A PSR policy violation may initiate a series of Reserve Bank actions aimed at deterring an institution's excessive use of Federal Reserve intraday credit. These actions depend on the institution's history of daylight overdrafts and its financial condition. Initially, the Reserve Bank may assess the causes of the overdrafts and review account-management practices. In addition, the Reserve Bank may require an institution to submit documentation specifying the actions it will take to address the overdraft problems. If policy violations continue, the Reserve Bank may take additional actions. For example, if a financially healthy institution in the zero, exempt-from-filing, or de minimis cap category continues to breach its cap, the Reserve Bank may recommend that the institution file a cap resolution or perform a self-assessment to obtain a higher net debit cap.

If an institution continues to violate the PSR policy, and if counseling and other Reserve Bank actions have been ineffective, the Reserve Bank may assign the institution a zero cap. In addition, the Reserve Bank may impose other account controls that it deems prudent, such as requiring increased clearing balances; rejecting Fedwire funds transfers, ACH credit originations, or NSS activity in excess of the account balance; or requiring the institution to fund certain transactions in advance. Reserve Banks also keep institutions' primary regulators apprised of any recurring overdraft problems.

Real-Time Monitoring

The Account Balance Monitoring System (ABMS) is the system Reserve Banks use to monitor in real time the payment activity of institutions that potentially expose the Federal Reserve and other payment-system participants to excessive risk exposure. ABMS is both an information source and an account-monitoring and control tool. It allows institutions to obtain intraday balance information for purposes of managing their use of daylight credit and avoiding overnight overdrafts. All institutions that have an electronic connection to the Federal Reserve's Fedwire funds-transfer service, such as a FedLine® terminal or a computer interface connection, are able to review their intraday Federal Reserve account position in ABMS. While ABMS is not a substitute for an institution's own internal tracking and monitoring systems, it does provide real-time account information based on Fedwire funds and securities transfers and NSS transactions. Additionally, ABMS captures debits and credits resulting from other payment activity as those transactions are processed in the Reserve Bank's accounting system. ABMS also provides authorized Federal Reserve Bank personnel with a mechanism to monitor and control account activity for selected institutions.

ABMS has the capability to reject or intercept funds transfers from an institution's account. This capability is called *real-time monitoring.* The Federal Reserve Banks use real-time monitoring to prevent selected institutions from transferring funds from their accounts if there are insufficient funds to cover the payments. Institutions are generally notified before a Reserve Bank begins monitoring their account in real time.

If an institution's account is monitored in the ''reject'' mode in ABMS, any outgoing Fedwire funds transfer, NSS transaction, or ACH credit origination that would cause an overdraft above a specified threshold, such as the institution's net debit cap plus any Reserve Bank–approved collateral pledged, would be immediately rejected back to the sending institution. The institution could then initiate the transfer again when sufficient funds became available in its account. If an institution's account is monitored in the ''intercept'' mode, sometimes referred to as the ''pend'' mode, outgoing funds transfers, NSS transactions, or ACH credit originations that would cause an overdraft in excess of the threshold will not be processed but will be held. These intercepted transactions will either be released by the Reserve Bank once funds are available in the institution's account or rejected back to the institution. Reserve Banks will normally be in direct contact with an institution in the event any of its funds transfers are intercepted.

Institutions can view Federal Reserve accounting information on the web through FedLine. The Account Management Information (AMI) application provides real-time access to intraday account-balance and daylight-overdraft balance information, detailed transaction information, and a variety of reports and inquiry services. Institutions can obtain information on accessing ABMS and AMI from any Federal Reserve Bank.

SPECIAL TYPES OF INSTITUTIONS

U.S. Branches and Agencies of Foreign Banks

Under the PSR policy, U.S. branches and agencies of foreign banks are typically treated the same as domestic institutions. However, several unique considerations affect the way in which the policy is applied to U.S. branches and agencies of foreign banks. In general, net debit caps for foreign banking organizations (FBOs) are calculated in the same manner as they are for domestic banks, that is, by applying cap multiples for one of the six cap categories to a capital measure. For U.S. branches and agencies of foreign banks, net debit caps on daylight overdrafts in Federal Reserve accounts are calculated by applying the cap multiples for each cap category to the FBO's U.S. capital equivalency measure. U.S. capital equivalency is equal to the following:

- 35 percent of capital for FBOs that are financial holding companies (FHCs)
- 25 percent of capital for FBOs that are not FHCs and have a strength-of-support assessment (SOSA) ranking of 1[12]
- 10 percent of capital for FBOs that are not FHCs and are ranked a SOSA 2
- 5 percent of ''net due to related institutions'' for FBOs that are not FHCs and are ranked a SOSA 3

U.S. branches and agencies of foreign banks that (1) wish to establish a non-zero net debit cap, (2) are an FHC, or (3) are ranked a SOSA 1 or 2 are required to file the Annual Daylight Overdraft Capital Report for U.S. Branches and Agencies of Foreign Banks (FR 2225). Granting a net debit cap or any extension of intraday credit to an institution is at the discretion of the Reserve Bank. If a Reserve Bank grants a net debit cap or extends intraday credit to a financially healthy FBO ranked a SOSA 3, the Reserve Bank may require such credit to be fully collateralized, given the heightened supervisory concerns associated with these FBOs.

As it does with U.S. institutions, the ARB must have the ability to assess regularly the financial condition of a foreign bank in order to

12. The SOSA ranking is composed of four factors: the FBO's financial condition and prospects, the system of supervision in the FBO's home country, the record of the home country's government in support of the banking system or other sources of support for the FBO, and transfer-risk concerns. Transfer risk relates to the FBO's ability to access and transmit U.S. dollars, which is an essential factor in determining whether an FBO can support its U.S. operations. The SOSA ranking is based on a scale of 1 through 3, with 1 representing the lowest level of supervisory concern.

grant the institution a daylight-overdraft cap other than zero. The ARB will generally require information regarding tier 1 and total risk-based capital ratios for the consolidated foreign bank. Accordingly, U.S. branches and agencies of foreign banks seeking a positive daylight-overdraft cap (exempt, de minimis, or self-assessment cap categories) should provide the ARB with capital ratios at the time the cap is established and annually thereafter. U.S. branches and agencies of foreign banks that are based in countries that do not adhere to the Basel Capital Accord should provide information comparable to the accord format. Workpapers for capital ratios need to be maintained at a designated U.S. branch or agency and are subject to review by the institution's primary supervisor. The Federal Reserve considers capital information provided to the ARB in connection with an institution's daylight-overdraft cap to be confidential.

Allocation of Caps

The Federal Reserve monitors the daylight overdrafts of U.S. branches and agencies of foreign banks on a consolidated basis; that is, each foreign-bank family, consisting of all of the U.S. branches and agencies of a particular foreign bank, has a single daylight-overdraft cap. Intraday account balances of all the U.S. branches and agencies in a foreign-bank family are added together for purposes of monitoring against its daylight-overdraft cap, in the same way that the account balances of institutions with accounts in more than one Federal Reserve District are added together.

For purposes of real-time monitoring, however, a foreign bank that has offices in more than one District may choose to allocate a portion of its net debit cap to branches or agencies in Districts other than that of the ARB. Unless a foreign-bank family instructs otherwise, the Federal Reserve will assign the dollar value of the family's single-day daylight-overdraft cap to the branch or agency located in the District of the ARB. The foreign-bank family may indicate to the ARB the dollar amount of cap to be allocated to offices in other Districts. Any dollar amount of the cap that is not allocated to offices in other Districts will be assigned to the branch or agency in the District of the ARB. A foreign bank may revise its cap allocation from time to time by communicating the revision to its ARB, but such revisions should be infrequent.

Nonbank Banks and Industrial Banks

Institutions subject to the Competitive Equality Banking Act of 1987 (CEBA), such as nonbank banks or certain industrial banks, may not incur daylight overdrafts on behalf of affiliates, except in three circumstances. First, the prohibition does not extend to overdrafts that are a result of inadvertent computer or accounting errors beyond the control of both the nonbank bank or industrial bank and its affiliate. Second, nonbank banks are permitted to incur overdrafts on behalf of affiliates that are primary U.S. government securities dealers, provided such overdrafts are fully collateralized. Third, overdrafts incurred in connection with an activity that is financial in nature are also permitted. A nonbank bank or industrial bank loses its exemption from the definition of bank under the Bank Holding Company Act if it permits or incurs prohibited overdrafts. In enforcing these restrictions, the Federal Reserve uses a separate formula for calculating intraday Federal Reserve account positions for these institutions.

Institutions with Federal Reserve Accounts and No Access to the Federal Reserve Discount Window

Under the PSR policy, institutions that have Federal Reserve accounts but lack regular access to the discount window are not eligible for a positive daylight-overdraft cap. Institutions that do not have regular access to the discount window include Edge and agreement corporations, bankers' banks that are not subject to reserve requirements, limited-purpose trust companies, government-sponsored enterprises (GSEs), and certain international organizations. Institutions that have been assigned a zero cap by their Reserve Banks are also subject to special considerations under the PSR policy because of the risks they pose. All of these institutions are strongly discouraged from incurring any daylight overdrafts. If any such institutions were to incur an overdraft, however, the Reserve Bank would require it to pledge collateral sufficient to cover the peak amount of the overdraft for an appropriate period.

In addition to the pledge of collateral, certain institutions discussed below are subject to a penalty fee on any daylight overdrafts incurred in their Federal Reserve accounts. The penalty fee is intended to provide a strong incentive for these institutions to avoid incurring any daylight overdrafts in their Federal Reserve accounts. The penalty fee assessed is equal to the annual rate applicable to the daylight overdrafts of other institutions (36 basis points) plus 100 basis points multiplied by the fraction of a 24-hour day during which Fedwire is scheduled to operate (currently 21.5 divided by 24). The daily overdraft penalty fee is calculated by dividing the annual penalty rate by 360. The daylight-overdraft penalty rate applies to the institution's average daily daylight overdraft in its Federal Reserve account. Institutions that are subject to the daylight-overdraft penalty fee are subject to a minimum penalty fee of $25 on any daylight overdrafts incurred in their Federal Reserve accounts.

Edge Act and Agreement Corporations

Edge Act and agreement corporations[13] do not have regular access to the discount window and should refrain from incurring daylight overdrafts in their reserve or clearing accounts. If any daylight overdrafts occur, the Edge Act or agreement corporation will be required to pledge collateral to cover them. Like foreign banks, Edge Act and agreement corporations that have branches in more than one Federal Reserve District are monitored on a consolidated basis.

Bankers' Banks

Bankers' banks,[14] including corporate credit unions, are exempt from reserve requirements and do not have regular access to the discount window. Bankers' banks may voluntarily waive their exemption from reserve requirements, thus gaining access to the discount window. These bankers' banks would then be free to establish caps and would be subject to the PSR policy in the same manner as other institutions. Bankers' banks that have not waived their exemption from reserve requirements should refrain from incurring overdrafts and must pledge collateral to cover any daylight overdrafts that they incur.

Limited-Purpose Trust Companies

The Federal Reserve Act (FRA) permits the Board to grant Federal Reserve membership to limited-purpose trust companies,[15] subject to conditions the Board may prescribe pursuant to the FRA. Limited-purpose trust companies that maintain Federal Reserve accounts should refrain from incurring overdrafts and must pledge collateral to cover any daylight overdrafts that they incur.

Government-Sponsored Enterprises and Certain International Organizations

In accordance with federal statutes, the Federal Reserve Banks act as fiscal agents for certain government-sponsored enterprises (GSEs) and international organizations.[16] These institutions generally have Federal Reserve accounts and issue securities over the Fedwire Securities Service. The securities of these institutions are *not* obligations of, or fully guaranteed as to principal and interest by, the United States. Furthermore, these institutions are not subject to reserve requirements and do not have regular access to

13. These institutions are organized under section 25A of the Federal Reserve Act (12 USC 611–631) or have an agreement or undertaking with the Board of Governors under section 25 of the Federal Reserve Act (12 USC 601–604a).

14. For the purposes of the PSR policy, a bankers' bank is a financial institution that is not required to maintain reserves under the Federal Reserve's Regulation D (12 CFR 204) because it is organized solely to do business with other financial institutions, is owned primarily by the financial institutions with which it does business, and does not do business with the general public and is not an institution as defined in the Federal Reserve's Regulation A (12 CFR 201.2(a)).

15. For the purposes of the PSR policy, a limited-purpose trust company is a trust company that, because of limitations on its activities, does not meet the definition of "depository institution" in section 19(b)(1)(A) of the Federal Reserve Act (12 USC 461(b)(1)(A)).

16. The GSEs include Fannie Mae, the Federal Home Loan Mortgage Corporation (Freddie Mac), entities of the Federal Home Loan Bank System (FHLBS), the Farm Credit System, the Federal Agricultural Mortgage Corporation (Farmer Mac), the Student Loan Marketing Association (Sallie Mae), the Financing Corporation, and the Resolution Funding Corporation. The international organizations include the World Bank, the Inter-American Development Bank, the Asian Development Bank, and the African Development Bank. When Sallie Mae completes its statutorily required privatization, the Reserve Banks will no longer act as fiscal agents for new issues of Sallie Mae securities, and the new Sallie Mae will not be considered a GSE.

the discount window. Effective July 20, 2006, GSEs and certain international organizations should refrain from incurring daylight overdrafts and must post collateral to cover any daylight overdrafts they do incur. In addition to posting collateral, these institutions will be subject to the same daylight-overdraft penalty rate as other institutions that do not have regular access to the discount window.

Problem Institutions

For institutions that are in weak financial condition, the Reserve Banks will impose a zero cap. The Reserve Bank will also monitor a problem institution's activity in real time and reject or delay certain transactions that would create an overdraft. Problem institutions should refrain from incurring daylight overdrafts and must post collateral to cover any daylight overdrafts they do incur.

EFT MANAGEMENT

Economic and financial considerations have led financial institutions and their customers to recognize the need to manage cash resources more efficiently. The PSR policy calls on private networks and institutions to reduce their own credit and operational risks. It also depends on the role of the Federal Reserve and other financial institution regulators in examining, monitoring, and counseling institutions. To ensure that banking institutions are following prudent banking practices in their funds-transfer activities, examinations should focus equally on the evaluation of both credit and operational risks.

The bank should establish guidelines for types of allowable transfers. Procedures should be in effect to prevent transfers drawn against uncollected funds. Thus, banks should not transfer funds against simple ledger balances unless preauthorized credit lines have been established for that account.

Errors and omissions, as well as the fraudulent alteration of the amount of a transfer or of the account number to which funds are to be deposited, could result in losses to the bank. Losses may include total loss of the transferred funds, loss of availability of funds, interest charges, and administrative expenses associated with the recovery of the funds or correction of the problem.

Management is responsible for assessing the inherent risks in the EFT system, establishing policies and controls to protect the institution against unreasonable exposures, and monitoring the effectiveness of safeguards. Regulatory agencies will ensure that each financial institution has evaluated its own risks realistically and has adequate accounting records and internal controls to keep exposures within reasonable, established limits.

The risks associated with any computerized EFT system can be reduced if management implements the controls that are available on the system. For example, the authority to enter, verify, and send transfers can be segregated, and the dollar amount of transactions can be limited. Effective risk management requires that management establish and maintain—

- reasonable credit limits (payments in excess of these limits that involve significant credit risk must be properly approved by appropriate lending authorities),
- adequate recordkeeping to determine the extent of any intraday overdrafts and potential overnight overdrafts before releasing payments, and
- proper monitoring of respondents' accounts when the institution sets the positions of others. Responsibility for this function should be assigned to an appropriate supervisory level of management that will ensure the use of adequate internal controls.

Authentication or Verification Methods

The same due care that financial institutions use when executing EFT transactions must be used when accepting EFT requests from customers. Management must implement security procedures for ensuring that the transfer requests are authentic. As stated in Uniform Commercial Code (UCC) section 4A-201, ‘‘Authorized and Verified Payment Orders,’’ security procedures may require the use of algorithms or other codes, identifying words, or numbers; encryption; callback procedures; or similar security devices. An explanation of authorized and verified payment orders is detailed in UCC section 4A-202.

Signature Verification

One method to verify the authenticity of a customer's EFT request is to verify the customer's signature. Unfortunately, this procedure cannot be performed when the customer requests the transaction by telephone. Some financial institutions have implemented policies whereby the customer completes and signs a transfer request, and then faxes the request to the bank. However, this is not a safe EFT procedure because, although the bank can verify the signature on the faxed request, it cannot be certain that the transfer request is legitimate. Any document that is transmitted electronically can be altered (for example, by changing the amount or account number). The alteration can occur before the document is digitalized (that is, before being fed into the fax machine) or after. In most instances, these alterations cannot be detected by the receiving entity. If there is any question about a document's authenticity, the transaction should be reconfirmed through other sources.

Personal Identification Numbers

One way for financial institutions to authenticate transfers initiated over the telephone is through the use of personal identification numbers (PINs) issued to each customer. When a customer requests a transfer, his or her identity is verified by comparing the supplied PIN with the customer's PIN-request form that is on file. At a minimum, the following safeguards should be implemented for these types of transfers:

- All nonretail customers should be requested to sign an agreement whereby the bank is held harmless in the event of an unauthorized transfer if the bank follows routine authentication procedures. The customer is responsible for informing the bank about changes in who is authorized to execute EFTs. These procedures should minimize the risk to the bank if someone is able to execute a fraudulent transaction. (These procedures are described in detail in UCC section 4A-202.)
- All transactions over a specific dollar amount should be re-verified by a callback routine. The bank should require that the person being called for re-verification is someone other than the person who initially requested the transaction.
- Whenever new PINs are issued, they should be mailed in sealed, confidential envelopes (preferably computer-generated) by someone who does not have the ability to execute wire transfers.
- The number of bank employees who have access to PINs should be very limited.

Tape Recording

The tape recording of EFT requests made over the telephone is another internal control practice. When possible, verifying and recording the incoming telephone number (that is, using a caller-ID system) is also a good practice. The laws addressing telephone recording vary by state. Some states require that the caller be informed that the conversation is being recorded; others do not have this requirement. Regardless of the state's law, the bank should inform callers that, for their protection, conversations are being recorded. Moreover, banks should have in place a policy for archiving the taped telephone records and should retain them for a specified period of time, at least until the statements from the Federal Reserve or correspondent banks have been received and reconciled.

Statements of Activity

Some larger banks have implemented a procedure whereby customers are electronically sent a summary statement at the end of each day. The statement lists the transfers executed and received on their behalf. The statement can be sent through a fax machine, a personal computer, or a remote printer. This procedure quickly identifies any transfers the customer did not authorize.

Test Keys

EFT requests can be authenticated using *test keys*. A test key is a calculated number that is derived from a series of codes that are contained in a test-key book. The codes in a test-key book represent such variables as the current date, hour of the day, receiving institution, receiving account number, and amount of the transfer. The value derived from these variables equals the test key. The financial institution or corporate customer initiating the transfer will give its EFT information, along with the test-key value. The receiving bank will recalculate the test key and, if the two test keys equal the same amount, the EFT request is considered authenticated. Test-key code books should be properly secured to prevent unauthorized access or fraudulent use. The use of test keys has declined in recent years as more and more institutions implement PC-based EFT systems.

Blanket Bond

Although computer-related employee misappropriations are normally covered, financial institution blanket bond policies generally exclude certain types of EFT activities from standard coverage. Separate coverage for EFT systems is available and should be suggested to management, particularly if a significant risk exposure exists. A bank's fidelity bond insurance could be declared null and void by the carrier if a fraudulent transfer were to occur and the loss was directly attributable to weak internal controls. (See section 4040.1, "Management of Insurable Risks.")

SUPERVISORY RISK EVALUATION

Bank management is responsible for assessing the inherent risks in the EFT system (or systems) it uses. Management should establish policies and controls to protect the institution against unreasonable exposures, as well as monitor the effectiveness of the established safeguards.

Examiner Responsibilities

Examiners are responsible for ensuring that financial institutions have assessed and evaluated their risks realistically and have adopted internal controls that are adequate to keep those risks within acceptable limits. The types of risks involved in EFT systems, as well as payment systems generally, are discussed below.

Credit Risk

Credit risk is the risk that a counterparty will not settle an obligation for full value when due, nor at any time subsequently. Any time an institution extends credit to a customer or permits a customer to use provisional funds to make a payment, the institution is exposed to the risk that the customer will not be able to meet its payment obligation. If the customer is unable or unwilling to repay the credit extension, the institution could incur a financial loss. Similarly, an institution that receives a payment in provisional funds has a credit exposure to the sender until such time as the payment is settled with finality, that is, until the payment becomes unconditional and irrevocable. If an institution permits a customer to withdraw or make a payment with provisional funds received, then the institution incurs credit exposure to both the sender of the provisional funds and the customer. Those credit exposures are not extinguished until the provisional funds received are settled with finality. With respect to payment systems risk, overall credit risk consists of (1) direct-credit risk to the Federal Reserve, that is, a borrowing institution may be unable to cover its intraday overdraft arising from a transfer of funds or receipt of book-entry securities, thus causing a Federal Reserve Bank to incur a loss; (2) private direct-credit risk, or the possibility of loss to institutions extending credit; and (3) systemic risk, which is the possibility of loss to multiple creditors when borrowing institutions fail to cover their obligations to creditor institutions. Variants of credit risk include sender risk, receiver risk, and return-item risk.

Systemic risk. Stated more clearly, systemic risk occurs when one participant in a payment system, or in the financial markets generally, fails to repay its required obligation when due, and this failure prevents other private or market participants or financial institutions from meeting their settlement obligations when due. Systemic risk may result from extraneous events, actions, or reasons that are independent of the institution, or from developments in the payment system. Changes in the capital markets, domestic political or government announcements or actions, unplanned events, or sovereign actions of other countries are examples of events that may cause systemic risk.

Sender risk. Sender risk is the risk that results if a depository institution uses an extension of credit to make an irrevocable payment on behalf of a customer. This credit can be a loan or an extension of payment against uncollected or provisional funds or against insufficient balances.

Receiver risk. Receiver risk arises when an institution accepts funds from a sender who may be a customer, another institution, or the payment system. As the receiver of funds, the institution relies on the sender's ability to settle its obligations. The risk exists while payments are revocable within the system and remains until final settlement.

Return-item risk. The major risk in originating ACH debit transactions and collecting checks for customers is return-item risk. Return-item risk extends from the day funds are made available to customers until the individual items can no longer legally be returned. The receiver of ACH debit transactions, or the payer of checks, has the right to return transactions for various reasons, including insufficient funds in its customer's account. To minimize its exposure, an institution should perform credit assessments of all customers that originate large dollar volumes of ACH debit transactions, and for all customers for which the institution collects large volumes of checks. Such assessments ensure that if ACH or check items are returned after the customer has been granted use of the funds, the customer will be able to return the funds to the institution.

Liquidity Risk

Liquidity risk (or settlement risk) is the risk that a counterparty will not settle an obligation for full value when due, even though the counterparty may later settle the obligation. Liquidity risk may result from unexpected market or operational disruptions or from catastrophic or unplanned events. It may also result from sovereign actions; therefore, sovereign risk can give rise to liquidity risk.

Sovereign risk refers to the financial capacity of governments to generate foreign-currency revenues to repay their obligations. This capacity is generally limited because government assets are predominantly the discounted value of future taxes denominated in the local currency. Governments have direct access to foreign-currency revenues only when the economy is dominated by a public sector that derives most of its revenues from exports (for example, oil or gold). Sovereign risk is not limited to the country's federal government debt. It also includes debt contracted by all public and publicly guaranteed entities (such as provincial, state, or local governments and all other debt with a government's guarantee).

Actions taken by nondomestic governments can affect the payments of certain participants in a payment system, and these actions can be detrimental to other participants in the system. Soverign risk can include the imposition of exchange-control regulations on a bank participating in international foreign-exchange activities. While the bank itself may be both willing and able to settle its position, government intervention may prevent it from doing so. The risk can be controlled by regularly monitoring the payment-system laws of other countries and by taking specific alternative actions to lessen the risk. Alertness to a bank's sovereign-risk exposure to its counterparties located in other nations, and to possible alternative actions, can considerably lessen this risk.

Legal Risk

Any transaction occurring in a payment system is subject to the interpretation of courts in different countries and legal systems. This issue is normally addressed by adopting ''governing-law'' provisions in the rules of the systems themselves. These provisions provide for all disputes between members to be settled under the laws of a specific jurisdiction. However, if a local court refuses to recognize the jurisdiction of a foreign court, the rules may be of limited use. This risk is difficult to address because there is no binding system of international commercial law for electronic payments. Banks should seek a legal opinion regarding the enforceability of transactions settled through a particular system.

Operational Risk

Operational risk may arise from—

- a system failure caused by a breakdown in the hardware or software supporting the system, possibly resulting from design defects, insufficient system capacity to handle transaction volumes, or a mechanical breakdown, including telecommunications;
- a system disruption if the system is unavailable to process transactions, possibly due to system failure, destruction of the facility (from natural disasters, fires, or terrorism), or opera-

tional shutdown (from employee actions, a business failure, or government action); or
- the system being compromised as a result of fraud, malicious damage to data, or error.

Whatever the source, the loss of availability of a payment system can adversely affect major participants, their correspondents, markets, and interdependent payment mechanisms.

Banks should control operational risk through a sound system of internal controls, including physical security, data security, systems testing, segregation of duties, backup systems, and contingency planning. In addition, a comprehensive audit program is essential to assess the risks, adequacy of controls, and compliance with bank policies.

Risk-Control Issues

Bank management should consider and develop risk-management policies and procedures to address the variety of credit, liquidity, operational, and other risks that can arise in the normal course of conducting its payment business—regardless of the clearing and settlement method of the particular payment systems in which the bank participates. EFT systems differ widely in form, function, scale, and scope of activities. Consequently, the specific risk-management measures an institution employs for a particular EFT system will differ depending on the inherent risks in the system. As a general matter, an institution should adopt risk-management controls commensurate with the nature and magnitude of risks involved in a particular EFT system.

In addition to assessing the adequacy of an institution's risk-management procedures for measuring, monitoring, and controlling its risks from participating in a payment system (or systems) and from providing payment services to its customers, examiners should consider the following internal control guidelines when they review policies and procedures covering EFT activities:

- Job descriptions for personnel responsible for a bank's EFT activities should be well defined, providing for the logical flow of work and adequate segregation of duties.
- No single person in an EFT operation should be responsible for all phases of the transaction (that is, for data input, verification, and transmission or posting).
- All funds transfers should be reconciled at the end of each business day. The daily balancing process should include a reconciliation of both the number and dollar amount of messages transmitted.
- All adjustments required in the processing of a transfer request should be approved by a bank's supervisory personnel, with the reasons for the adjustment documented. Transfer requests "as of" a past or future date should require the supervisor's approval with well-defined reasons for those requests.
- Only authorized persons should have access to EFT equipment.

Considerable documentation is necessary to maintain adequate accounting records and auditing control. Many banks maintain transfer-request logs, assign sequence numbers to incoming and outgoing messages, and keep an unbroken electronic copy of all EFT messages. At the end of each business day, employees who are independent of the transfer function should compare request forms with the actual transfers to ensure that all EFT documents are accounted for. When reviewing the adequacy of internal controls, examiners should review the funds-transfer operations to determine that recordkeeping systems are accurate and reliable, all transactions are handled promptly and efficiently, duties are separated appropriately, audit coverage is adequate, and management recognizes the risks associated with these activities.

1. To determine if the bank's electronic funds transfer (EFT) objectives, policies, practices, procedures, and internal controls are adequate to control its exposure to acceptable limits of payment systems risk.
2. To determine if bank officers and other wire-transfer personnel are operating in conformance with established guidelines.
3. To determine the scope and adequacy of the audit function for the risks associated with payment and wire-transfer systems.
4. To ascertain whether senior management is informed of the current status, nature, and magnitude of risks associated with the bank's EFT operations, as well as any changes to these risks.
5. To assess the bank's ability to monitor its payment-systems position, as well as to limit its credit and other risk exposures in the system and from its customers or correspondents.
6. To determine that the board of directors has reviewed and approved the institution's use of Federal Reserve intraday credit, self-assessment (if applicable), and net debit cap, and to determine if the institution is complying with the Federal Reserve Policy Statement on Payments System Risk.
7. If the bank has a self-assessed net debit cap, to review the bank's self-assessment file and determine if the underlying analyses and methodologies are reasonable, adequate, and consistent with the institution's supervisory overview, risk assessments, and risk matrix.
8. To evaluate the quality of the bank's operational controls and determine the extent of compliance with applicable laws and regulations.
9. To initiate corrective action when objectives, policies, procedures, or internal controls are deficient or when violations of law or regulations exist.

1. Review and determine the bank's compliance with the electronic funds transfer (EFT) risk-assessment standards of the examination module, recognizing the associated risks for each. Answer the pertinent questions that refer to EFT in the internal control questionnaire.
2. Review and evaluate the work of internal or external auditors and of the compliance officer as it relates to the risks associated with payment systems and EFT activities. Determine if payment system risk is reviewed and whether the independence, scope, coverage, and frequency of internal or external reviews are adequate.
3. Based on an evaluation of internal controls and the work performed by internal or external auditors, determine the scope of the examination.
4. Test for compliance with policies, practices, procedures, and internal controls. Determine whether the management information systems and reports for the institution's payment systems and funds-transfer activities provide timely and accurate data that are sufficient for personnel to make informed and accurate decisions. From the examiner assigned to review ''Internal Control,'' obtain a listing of any deficiencies noted in the latest review conducted by internal or external auditors. Determine if bank management has taken the appropriate corrective actions for the deficiencies.
5. Obtain or construct an organizational chart and flow chart for the EFT area, and determine the job responsibilities and flow of work through that department.
6. Review the bank's standard form of agreement or other written agreements with its customers, correspondent banks, and vendors. Determine whether those agreements are current and clearly define the liabilities and responsibilities, including responsibilities during emergencies, of all parties. Agreements with the Federal Reserve Bank should refer specifically to the operating circular (or circulars) on the electronic funds transfers pursuant to subpart B of Regulation J (12 CFR 210.25 et seq.).
7. Review the bank's board of directors and senior management policies and procedures for payment-systems and EFT activities, including third-party transactions. Perform tests to determine the existence, reasonableness, and adequacy of these policies and procedures. Determine whether the policies and procedures have been disseminated to the employees who are actively responsible for and involved in performing payment-systems and EFT activities. Ascertain whether there is an active employee-training program that ensures employees have the knowledge necessary to comply with the bank's policies and procedures for payment-systems and EFT activities.
8. For transactions involving the Federal Reserve Bank, other private funds-transfer systems, and other due from bank accounts, confer with the examiner who is assigned ''Due from Banks,'' and determine the propriety of any outstanding funds-transfer items.
9. Coordinate the review of the credit exposures arising from payment-systems and EFT activities with the examiners' review of loan programs or loan portfolios. Determine whether credit personnel make and adequately document, independent of account and operations officers, periodic credit reviews of funds-transfer customers.
10. Determine where suspense items or adjustment accounts are posted and accounted for, as well as who is responsible for reviewing, resolving, and clearing out suspense items.
    a. Scan accounts for unusual or old items or abnormal fluctuations.
    b. Reconcile accounts to departmental control totals and to the general ledger.
    c. Review management reports on suspense items and unusual activity.
11. Review the income and expense accounts related to EFT operations. Determine the frequency of entries caused by late or inaccurate execution of transfer requests.
12. Observe the space and personnel allocated to the EFT area, and note the location of communications terminals. Determine whether existing conditions are adequate to provide appropriate physical security.
13. Discuss the following items with the appropriate officer (or officers), and prepare summaries in the appropriate section of the

examination report:

a. internal control exceptions, as well as deficiencies in or noncompliance with written policies, practices, and procedures
b. uncorrected audit deficiencies
c. violations of laws and regulations
d. terminology, operating arrangements, accounting procedures, and time limitations of EFT operations
e. the operating efficiency and physical security of the bank's EFT operation
f. the adequacy of controls over settlement- and credit-risk exposure
g. recommended corrective action when policies, practices, or procedures are deficient

14. Update the examination workpapers to include the bank examination activities and procedures performed and any information gathered to support the completed work, including any information that will facilitate future examinations.

RISK MANAGEMENT OF INTRADAY CREDIT EXPOSURES

1. If the bank is a CHIPS or other clearing-agency participant, determine the bank's basis for accepting customers for CHIPS-payments activity. If the examined institution is a funding participant on CHIPS, determine the criteria for accepting a non-funding participant as a respondent. Determine that the criteria are reviewed periodically.
2. Determine if appropriate intraday credit limits are imposed and monitored for those customers and counterparties with which the bank has intraday credit exposures.
3. Determine if the bank monitors and controls any intraday credit exposures to affiliates.[1]
4. Determine whether the institution periodically reviews its ability to fund its closing-position requirement on private multilateral settlement systems, such as CHIPS.

FEDERAL RESERVE INTRADAY CREDIT

1. Determine that the board of directors has reviewed and approved the institution's use of Federal Reserve intraday credit.
2. If the institution incurs daylight overdrafts in its Federal Reserve account, determine that the institution has selected an appropriate net debit cap.
3. If the institution has selected a de minimis or a self-assessed net debit cap, determine that the board-of-directors resolution follows the prescribed format and contains all of the required elements.
4. If the institution has selected a self-assessed net debit cap, review the contents of the self-assessment file to determine that the institution has applied the guidelines appropriately and diligently, that the underlying analysis and method were reasonable, and that the resulting self-assessment is generally consistent with the examination findings. Inform the appropriate Reserve Bank of any concerns about the institution's net-debit-cap level, self-assessment, or use of Federal Reserve intraday credit.
5. Review the institution's cap resolution file and ascertain that it includes (1) a copy of the board-of-directors resolution, (2) worksheets and supporting analysis used in its self-assessment of its own cap category, (3) copies of senior-management reports to the board of directors of the institution or its parent (as appropriate) regarding that self-assessment, and (4) copies of the minutes of the discussion at the appropriate board-of-directors meeting concerning the institution's adoption of a cap category.

1. An insured depository institution must establish and maintain policies and procedures reasonably designed to manage the credit exposure arising from its intraday extensions of credit to affiliates in a safe and sound manner. The policies and procedures must at a minimum provide for the monitoring and control of the credit exposure arising from the institution's intraday extensions of credit to each affiliate and all affiliates in the aggregate, and must ensure that the institution's intraday extensions of credit to affiliates comply with section 23B of the Federal Reserve Act. (See 12 CFR 250.248.)

For the preliminary review and assessment, review the bank's internal controls, policies, practices, and procedures for payment systems risk and electronic funds transfer (EFT) activities. The following procedures should be used:

1. Review previous examination reports, earlier workpapers, and correspondence exchanged with the institution to get an overview of previously identified EFT concerns.
2. Review the most recent audits and internal reviews to identify the scope and noted deficiencies.
3. Review management's actions to correct examination and audit deficiencies.
4. Discuss with management recent or planned changes in EFT activities.
5. Review management reports to determine the nature and volume of current activity.
6. Review the minutes of management committees that oversee EFT activity to determine their content and follow-up on material matters.

The bank's payment and EFT systems should be further reviewed and documented completely and concisely. Where appropriate, the preliminary review and assessment should include narrative descriptions, flowcharts, copies of forms used, and other pertinent information.

During the examination, the review of operations and internal controls of all institutions involved in funds-transfer or EFT activities should use the following procedures. Items below that are marked with an asterisk (*) require substantiation by observation or testing.

ORGANIZATION

1. Is there a current organization plan detailing the structure of the funds-transfer function?
2. Is senior management responsible for administering the operations of the funds-transfer function?
3. Does management maintain a current list of bank personnel who are authorized to initiate EFT requests?
4. Are there regular management reviews of staff compliance with the credit and personnel procedures, operating instructions, and internal controls?
5. Are activity and quality-control reports received and reviewed by management?
6. Are major new system designs and newly available hardware for the payment and EFT systems brought to the attention of and reviewed by management?

SUPERVISION BY DIRECTORS AND SENIOR MANAGEMENT

1. Are the directors and senior management kept informed about the nature and volume of transactions and the magnitude of the risks involved in the funds-transfer activity?
2. Has the board of directors or senior management reviewed and approved any limits on the risks in the funds-transfer activities? If so, when were the limits last reviewed?
3. Is senior management or the board of directors advised of any customers with—
   a. large intraday and overnight overdrafts? If so, are other extensions of credit to the same customers combined to show the total credit exposures?
   b. large drawings against uncollected funds?
4. Are management's responses to audit exceptions and recommendations adequate and timely?
5. Is there adequate insurance coverage for EFT risks? Does senior management conduct adequate reviews of insurance coverage and insurance riders for EFT operations and the overall EFT environment?

CREDIT MANAGEMENT, EVALUATION, AND APPROVAL

1. Under the bank's established board-of-directors policies and procedures, is senior management or the credit committee (or credit officers) required to review at predetermined frequencies—

   a. the volume of transactions, the creditworthiness of customers, and the risks involved in the funds-transfer activity?
   b. credit and other exposures as they relate to safe and sound banking practices?
   c. staff capabilities and the adequacy of equipment relative to current and expected volume?
2. Are procedures in place to prohibit transfers of funds against accounts that do not have collected balances or preauthorized credit availability?
3. Have counterparty and customer credit limits been established for all payment system risk exposures, including those relating to Fedwire, CHIPS, ACH, foreign exchange, and other types of payments? Do credit limits take into account intraday and overnight overdrafts?
   a. Are groups of affiliated customers included in such limits?
   b. Are limits set according to a clear and consistent methodology for credit-risk assessment?
   c. How often are the limits reviewed and updated?
   d. Does senior management monitor and review the customer limits? How frequently?
4. Are other types of credit facilities considered when establishing intraday-overdraft limits for the same customer?
5. Is an intraday-posting record kept for each customer, showing opening collected and uncollected balances, transfers in, transfers out, and the collected balances at the time payments are released?
6. If payments exceed the established limits, are steps taken in a timely manner to obtain covering funds?
7. Are there fully documented, periodic credit reviews of funds-transfer customers?
8. Are credit reviews conducted by competent credit personnel who are independent of account and operations officers?
9. Does the institution make payments in anticipation of receiving covering funds? If so, are such payments approved by officers who have the appropriate credit authority?
10. Are intraday exposures limited to amounts that are expected to be received the same day?
11. Do the limits on intraday and overnight overdrafts appear to be reasonable in view of the institution's capital position and the creditworthiness of the respective customers?
12. Does a staff supervisor approve payments in excess of established limits, following verification that the covering funds are in transit to the bank?
13. Before releasing payments, are payments against uncollected funds and intraday overdrafts in excess of established limits referred to a person with appropriate credit authority for approval, and is the reason for the overdraft determined?

PERSONNEL

1. Has the bank taken steps to ensure that screening procedures are applied to personnel that are hired for sensitive positions in the EFT departments?
2. Does the bank prohibit new or temporary employees from working in sensitive areas of the payment-systems and EFT operation?
3. Are statements of indebtedness required from employees who work in sensitive positions of the payment-systems and EFT function?
4. Does supervisory staff give special attention to employees newly assigned to work in the EFT functions?
5. Are employees subject to unannounced rotation of responsibilities, regardless of the size of the institution?
6. Are relatives of employees in the payment-systems and EFT function precluded from working in the same institution's bookkeeping or data processing departments?
7. Does the bank's policy require that employees take a minimum number of consecutive days as part of their annual vacation? Is this policy being enforced?
8. If employees have given notice of resignation or received termination notices, does management reassign them away from sensitive areas of the payment-systems and EFT function?
9. Are personnel informed of the current trends in transfer activities, including necessary internal controls, as part of a regular training program?

SIGNATURE CARDS

1. Does the bank maintain a current list or card file of authorized signers for customers who use the bank's funds-transfer services?
2. Are customer signature cards maintained under dual control or otherwise protected?
3. Do customer signature cards limit the number of authorized persons and the amount of funds that an individual is authorized to transfer?
4. Do bank personnel compare the signature on an original mail request with the authorized signature on file?

TEST KEYS

1. Do telephone requests and EFT transactions use test codes, and are the codes verified by a person other than the person receiving the request?
2. Are test codes restricted to authorized personnel?

*3. Are the files containing test-key formulas maintained under dual control or otherwise protected?

4. Are only authorized personnel permitted in the test-key area or allowed access to computers, teletapes, or terminals?
5. Does the bank maintain an up-to-date test-key file?
6. Does management maintain a list of those authorized persons who have access to test-key files?
7. Are all messages and transfer requests that require testing authenticated by the use of a test key?

*8. Are test codes verified by someone other than the person receiving the initial transfer request?

9. Are callback or other authentication procedures performed on all transfers that do not have a test key or signature card on file?
10. Do mail transfer requests include a test word as an authentication procedure?
11. Does the bank's test-key formula incorporate a sequence number resulting from an agreement between the bank and the customer?
12. Does the bank have procedures in operation for the issuance and cancellation of test keys?

*13. Is the responsibility for issuing and canceling test keys assigned to someone who is not responsible for testing the authenticity of transfer requests?

14. Are test codes maintained in a secure environment when they are not in use?
15. Is the testing area physically separated from other operations?

TELEPHONE TRANSFER REQUESTS

1. Has the bank established guidelines for what information should be obtained from a person making a funds-transfer request by telephone?
2. Does the above information include a test-word authentication code?
3. Does the bank use a callback procedure that includes a test-code authentication to verify telephone transfer requests?
4. Does the bank limit callbacks to transactions over a certain dollar amount?
5. Does the bank maintain a current list of persons who are authorized to initiate telephone funds transfers and messages?

*6. Does the bank have procedures in place to prohibit persons who receive telephone transfer requests from transmitting those requests?

7. Does the bank use devices that record all incoming and outgoing transfer requests?
8. Are prenumbered or sequentially numbered (at a central location after initiation) transfer-request forms used?
9. Is the log or record of transfer requests reviewed daily by supervisory personnel?
10. Do the records of transfer requests contain—
    a. a sequence number?
    b. an amount transferred?
    c. the person, firm, or bank making the request (also the specific transferor)?
    d. the date?
    e. the test-code authentication?
    f. paying instructions?
    g. authorizing signatures for certain types and dollar-amount transfers?

EFT REQUESTS

*1. Do different employees perform the functions of receipt, testing, and transmission of funds-transfer requests?
2. Do incoming and outgoing messages record the time, or are they sequentially numbered for control?
3. Do incoming and outgoing messages include a test word as a means of message authentication?
4. Is an unbroken copy of all messages kept throughout the business day?
5. Is the above copy reviewed and controlled by someone not connected with operations in the EFT area?

AGREEMENTS

1. With respect to EFT and payment-systems transfer operations between the bank and its hardware and software vendors, maintenance companies, customers, correspondent banks, the Federal Reserve, and other providers, are the agreements in effect and current? (The agreements with the appropriate Federal Reserve Bank should refer to the operating circulars regarding the transfer of funds pursuant to subpart B of Regulation J.)
2. Do the written agreements state the responsibilities of each party involved in the agreement?
3. Do the agreements state the vendors' liabilities for their employees' actions?

OPERATING AND PROCESSING PROCEDURES

1. Do written procedures exist for the EFT functions, and are they updated for employees in the incoming, preparation, data entry, balance-verification, transmission, accounting, reconciling, and security areas? Do these procedures include—
   a. control over test words, signature lists, and opening and closing messages?
   b. computer-terminal security and password controls?
   c. access to the funds-transfer and EFT areas and user files?
   d. origination, modification, deletion, or rejection of order transactions or messages?
   e. verification of the sequence numbers of orders?
   f. accounting for all transfer requests and message traffic at the end of the day?
   g. bank supervisory review of all adjustments, reversals, and the reasons therefor, as well as open items?
   h. planning for contingencies?
2. Are all incoming and outgoing payment orders and message requests in the EFT and funds-transfer area—
   a. time-recorded or sequentially numbered for control?
   b. logged?
   c. reviewed for test verification?
   d. reviewed for signature authenticity?
   e. reviewed to verify that the person who initiated the funds-transfer request was authorized to do so?
   f. authorized or reviewed by bank supervisory personnel?
3. Does the EFT department of the bank prepare a daily reconcilement of funds-transfer activity by dollar amount and number of messages?
4. Are all rejects or exceptions reviewed by someone who is not involved in the receipt, preparation, or transmittal of funds?
5. If the institution accepts transfer requests after the close of business or accepts transfer requests with a future value date, are they properly controlled and processed?
6. Are Federal Reserve Bank statements reviewed and reconciled daily with the bank's internal funds-transfer log to determine if there are "open" funds-transfer items and the reasons for the outstanding items?
7. Does an officer review corrections, overrides, open items, reversals, and other adjustments?
8. Does a person other than the receipt clerk review message requests and payment orders for—
   a. the propriety of the transactions?
   b. future dates, especially those for multiple transactions?
9. When reasonably feasible, does a supervisor check all transactions before the release of funds to a customer or before initiating a payment message over the EFT system?

10. At the end of a day, are all message requests and payment orders accounted for in an end-of-the-day proof to ensure that all requests have been processed?
11. Are internally rejected customer transfer requests and message requests controlled, and are they sequentially numbered for accountability?
12. Does an officer review and approve as-of adjustments, open items, reversals, and other adjustments?
13. Are key fields re-verified before transmission, and are messages released by someone other than the individual who originally entered the message?
14. Does the work flow in a one-way direction to provide adequate internal controls?
15. Are audit trails maintained from receipt through posting to a customer's account?
16. Are EFT activities adequately documented, and is there an adequate and active records-retention program?

ACCOUNTING, RECORDKEEPING, AND CONTROLS

1. Are Federal Reserve Bank, correspondent bank, and clearinghouse statements used for funds transfers reconciled daily in another area of the bank (for example, accounting or correspondent banking or by a person who is separate from any money-transfer operations) to ensure that they agree with the funds-transfer records?
2. Are all prenumbered forms, including cancellations, accounted for in the daily reconcilement, and do they include the account number and account title?
3. Is the daily reconcilement of funds-transfer and message-request activity reviewed by supervisory personnel?

*4. Is the balancing of daily activity conducted separately from the receiving, processing, and sending functions?

5. Does the EFT department verify that work sent to other bank departments agrees with its totals?
6. Are general-ledger entries, adjustments, automated transactions, or other supporting documents initialed by authorized persons?
7. Does the institution receive cables or other written communications from its customers that indicate amounts to be paid and received and the source of covering funds?
8. If the above detail of receipts is not received, do the institution's customers inform it of the total amount to be received for the day?
9. Is the information in items 7 and 8 maintained and followed for exceptions?
10. Is an intraday-posting record kept for each customer, showing opening collected and uncollected balances, transfers in, transfers out, and the collected balance at the time payments are released?
11. Are significant CHIPs or Fedwire customer payments and receipts communicated to a monitoring unit promptly during the day to provide adequate information on each customer's overall exposure?
12. Does the accounting system for demand deposits give an accurate collected-funds position?
13. Have limits been established within which a designated person may authorize release of payments after reviewing the customer's activity? Does the institution maintain a record of approvals of these releases?
14. When an overnight overdraft occurs, is a determination made as to whether a fail caused the overdraft? If so, is this determination properly documented? Are follow-up actions to obtain the covering funds in a timely manner adequate?
15. Does the institution have a record of payments it failed to make?
16. Is the above record reviewed to evaluate the efficiency of the department?
17. Is corrective action initiated when appropriate?
18. Are investigations and follow-ups for failed payments conducted by personnel who are independent of the operating unit?
19. Are customer advices issued in a timely manner? Do credit advices sent to customers clearly indicate that credits to their accounts that are received through CHIPS are conditional upon final settlement?
20. For the settling institutions on CHIPS, are the net debit positions of the nonsettling participants relayed to appropriate personnel as soon as the positions become known?
21. Are designated supervisory staff responsible for verifying that respondents' net debit positions are covered the same day?
22. Are the follow-up procedures adequate to facilitate the receipt of funds?

23. Are open-statement items, suspense accounts, receivables, or payables and interoffice accounts related to EFT activity controlled outside of the funds-transfer operations?
24. Do the following controls exist?
    a. Management prepares periodic reports on open-statement items, suspense items, and interoffice accounts.
    b. Reports include agings of open items, the status of significant items, and the resolution of prior significant items.
25. Do general-ledger tickets or other supporting documents include the initials of the originator and designated supervisory personnel?
26. Is senior management required to decide whether to refuse to cover a net debit settlement position of a respondent?
27. Has the institution devised and maintained an adequate system of internal accounting controls, as required by the Foreign Corrupt Practices Act?

AUDIT

1. Does management or the audit department undertake a periodic review to ensure that work is being performed in accordance with policy and guidelines established by the board of directors and senior management?
2. Is the audit department promptly informed when a change is made in systems or the method of operation?
3. Does the audit or independent-review program provide sufficient coverage relative to the magnitude (volume) and nature of EFT activities? Are independent reviews conducted, and do they address all areas of EFT business, including—
    a. payment-order origination (funds-transfer requests);
    b. message testing;
    c. credit evaluation;
    d. customer agreements;
    e. payment processing and accounting;
    f. personnel policies;
    g. physical and data security;
    h. contingency plans;
    i. credit evaluation and approval;
    j. incoming funds transfers;
    k. bank secrecy and foreign assets control, if applicable; and
    l. Federal Reserve payment system risk program and policy issues.

PHYSICAL SECURITY

1. Is access to the EFT area restricted to authorized personnel who have proper bank identification? In limited circumstances when visitors are necessary (such as for repairs of equipment), are they restricted, properly identified, required to sign in, and accompanied by authorized personnel at all times?
2. Is written authorization given to those employees who remain in the EFT area after normal working hours? Who gives such authority? Are security guards informed?
3. Are bank terminal operators or others in EFT operations denied access to computer areas or programs?
4. Do procedures prohibit computer personnel from gaining access to bank terminals or test-key information?
5. Does EFT equipment have physical or software locks to prohibit access by unauthorized personnel at all times?
6. Are terminals and other hardware in the EFT area shut down after normal working hours? Are they regulated by automatic time-out controls or time-of-day controls?
7. Are passwords suppressed when they are entered in terminals?
8. Are operator passwords frequently changed? If so, how often?
9. Is supervisory approval required to access terminals at other than authorized times?
10. Are passwords restricted to different levels of access, such as data files and transactions that can be initiated?
11. Are employees prohibited from taking access keys for sensitive equipment or software test keys out of the EFT area?

CONTINGENCY PLANS

1. Has management properly planned for contingencies, and has it developed a reasonable contingency plan and safeguards that are commensurate with the volume of EFT activity?

2. Does the bank maintain backup communications systems, and is supervisory approval required for their use?
3. Are procedures in place for sending and receiving transfers if the bank is forced to operate at a different site?
4. Are backup systems and equipment periodically tested by bank personnel?
5. Are there adequate procedures to ensure that data is recovered by the opening of the next business day's processing?
6. Have written contingency plans been developed and regularly tested in case of partial or complete failure of the bank's systems or of communication lines between the bank and the New York Clearing House, the Federal Reserve Bank, data centers, critical customers, or servicer companies?
7. Are contingency plans reviewed regularly and tested at least annually?
8. Has management distributed contingency plans to all personnel and stored appropriate copies off-site or in a central database?
9. If the bank processes a large volume of payments, does it maintain a backup facility that provides real-time recovery in case of a disaster or other disruption of the primary data center?
10. Are procedures in place for backup, off-site storage of critical information and for inventory control on hardware and software?
11. Do procedures exist to prevent the inadvertent release of test data into the production environment?
12. Are primary and backup telecommunication lines performance-tested frequently by authorized supervisory personnel?

For guidance and listed procedures on Fedline, EFT, and information technology standards, see chapters 18 and 19 of the *FFIEC Information Systems Examination Handbook.*

CONCLUSION

1. Is the foregoing information an adequate basis for evaluating internal control; that is, there are no significant internal-auditing procedures, accounting controls, administrative controls, or other deficiencies or circumstances in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
2. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).
3. If intraday credit is granted to any affiliates, has the bank established policies and procedures to monitor and control such exposures and ensure compliance with section 23B of the Federal Reserve Act, as required by Regulation H? (See 12 CFR 250.248.)
4. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (good, medium, or bad).
5. Will the credit risk resulting from funds transfers have an adverse impact on overall asset quality?
6. Does the allowance for loan and lease losses adequately include significant adverse credit risk that is derived from EFT activities?
7. Will the weaknesses identified from the review of payment systems risk and EFT activity have a negative impact on overall liquidity, earnings, or capital?

The role of bank regulators in supervising private-banking activities is (1) to evaluate management's ability to measure and control the risks associated with such activities and (2) to determine if the proper internal control and audit infrastructures are in place to support effective compliance with relevant laws and regulations. In this regard, the supervisors may determine that certain risks have not been identified or adequately managed by the institution, a potentially unsafe and unsound banking practice.

Private-banking functions may be performed in a specific department of a commercial bank, an Edge corporation or its foreign subsidiaries, a nonbank subsidiary, a branch or agency of a foreign banking organization, or multiple areas of an institution. Private banking may also be the sole business of an institution. Regardless of how an institution is organized or where it is located, the results of the private-banking review should be reflected in the entity's overall supervisory assessment.[1] (See SR-97-19.)

This section provides examiners with guidance for reviewing private-banking activities at all types and sizes of financial institutions. It is intended to supplement, not replace, existing guidance on the examination of private-banking activities and to broaden the examiner's review of general risk-management policies and practices governing private-banking activities. In addition to providing an overview of private banking, the general types of customers, and the various products and services typically provided, the "Functional Review" subsection describes the critical functions that constitute a private-banking operation and identifies certain safe and sound banking practices. These critical functions are supervision and organization, risk management, fiduciary standards, operational controls, management information systems, audit, and compliance. Included in the risk-management portion is a discussion of the basic "customer-due-diligence" (CDD) principle that is the foundation for the safe and sound operation of a private-banking business. The "Preparation for Examination" subsection assists in defining the examination scope and provides a list of core requests to be made in the first-day letter. Additional examination guidance can be found in this manual, the Federal Financial Institutions Examination Council's (FFIEC) *Bank Secrecy Act/Anti-Money Laundering (BSA/AML) Examination Manual* (see SR-07-15), the Federal Reserve System's *Trading and Capital-Markets Activities Manual,* and the *FFIEC Information Technology Examination Handbook*.

In reviewing specific functional and product-examination procedures (as found in the private-banking activities module that is part of the framework for risk-focused supervision of large complex institutions), all aspects of the private-banking review should be coordinated with the rest of the examination to eliminate unnecessary duplication of effort. Furthermore, this section has introduced the review of trust activities and fiduciary services, critical components of most private-banking operations, as part of the overall private-banking review. Although the product nature of these activities differs from that of products generated by other banking activities, such as lending and deposit taking, the functional components of private banking (supervision and organization, risk management, operational controls and management information systems, audit, compliance, and financial condition/business profile) should be reviewed across product lines.

Private banking offers the personal and discrete delivery of a wide variety of financial services and products to an affluent market, primarily to high net worth individuals and their corporate interests. A private-banking operation typically offers its customers an all-inclusive money-management relationship, including investment portfolio management, financial-planning advice, offshore facilities, custodial services, funds transfer, lending services, overdraft privileges, hold mail, letter-of-credit financing, and bill-paying services. As the affluent market grows, both in the United States and globally, competition to serve it is becoming more intense. Consequently, the private-banking marketplace includes banks, nonbanks, and other types of banking organizations and financial institutions. Private-banking products, services, technologies, and distribution channels are still evolving. A range of private-banking products and services may be offered to customers throughout an institution's global network of affiliated entities—including branches, subsidi-

1. Throughout this section, the word *bank* will be used to describe all types of financial institutions, and the term *board of directors* will be interchangeable with *senior management* of branches and agencies of foreign banks.

aries, and representative offices—in many different regions of the world, including offshore secrecy jurisdictions.

Typically, private-banking customers are high net worth individuals or institutional investors who have minimum investible assets of $1 million or more. Institutions often differentiate domestic from international private banking, and they may further segregate the international function on the basis of the geographic location of their international client base. International private-banking clients may be wealthy individuals who live in politically unstable nations and are seeking a safe haven for their capital. Therefore, obtaining detailed background information and documentation about the international client may be more difficult than it is for the domestic customer. Private-banking accounts may, for example, be opened in the name of an individual, a commercial business, a law firm, an investment adviser, a trust, a personal investment company (PIC), or an offshore mutual fund.

In 2001, the USA Patriot Act (the Patriot Act) established new and enhanced measures to prevent, detect, and prosecute money laundering and terrorist financing. In general, these measures were enacted through amendments to the Bank Secrecy Act (BSA). The measures directly affecting banking organizations are implemented primarily through regulations issued by the U.S. Department of the Treasury (31 CFR 103).[2] Section 326 of the Patriot Act (see the BSA at 31 USC 5318(*l*)) requires financial institutions (such as banks, savings associations, and credit unions) to have customer identification programs that include measures to—

- require that certain information be obtained at account opening (for individuals, the information would generally include their name, address, tax identification number, and date of birth);
- verify the identity of new account holders within a reasonable time period;
- ensure that a banking organization has a reasonable belief that it knows each customer's identity;
- maintain records of the information used to verify a person's identity; and
- compare the names of new customers against government lists of known or suspected terrorists or terrorist organizations.

A customer identification program is an important component of a financial institution's overall anti-money-laundering and BSA compliance program.

SR-04-13 disseminated the interagency BSA examination procedures that should be used to evaluate banking organizations' compliance with the regulation. The examination's scope can be tailored to the reliability of the banking organization's compliance-management system and to the level of risk that the organization assumes. Relevant interagency guidance (in a frequently-asked-question format) has been issued to address the customer identification program rules. (See SR-05-9.)

Private-banking accounts are usually generated on a referral basis. Every client of a private-banking operation is assigned a salesperson or marketer, commonly known as a relationship manager (RM), as the primary point of contact with the institution. The RM is generally charged with understanding and anticipating the needs of his or her wealthy clients and then recommending services and products for them. The number of accounts an RM handles varies, depending on the portfolio size or net worth of the particular accounts. RMs strive to provide a high level of support, service, and investment opportunities to their clients and tend to maintain strong, long-term client relationships. Frequently, RMs take accounts with them to other private-banking institutions if they change employment. Historically, initial and ongoing due diligence of private-banking clients is not always well documented in the institution's files because of RM turnover and confidentiality concerns.

Clients may choose to delegate a great deal of authority and discretion over their financial affairs to RMs. Given the close relationship between clients and their account officers, an integral part of the examination process is assessing the adequacy of managerial oversight of the nature and volume of transactions conducted within the private-banking department or with other departments of the financial institution, as well as determining the adequacy and

2. For banking organizations, the regulation implementing the requirements of section 326 of the Patriot Act was jointly issued by the U.S. Department of the Treasury, through the Financial Crimes Enforcement Network (FinCEN), and the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the National Credit Union Administration.

integrity of the RM's procedures. Policy guidelines and management supervision should provide parameters for evaluating the appropriateness of all products, especially those involving market risk. Moreover, because of the discretion given to RMs, management should develop effective procedures to review the activity of client accounts in order to protect the client from any unauthorized activity. In addition, ongoing monitoring of account activity should be conducted to detect activity that is inconsistent with the client profile (for example, frequent or sizable unexplained transfers flowing through the account).

Finally, as clients develop a return-on-assets (ROA) outlook to enhance their returns, the use of leveraging and arbitrage is becoming more evident in the private-banking business. Examiners should be alert to the totality of the client relationship product by product, in light of increasing client awareness and use of derivatives, emerging-market products, foreign exchange, and margined accounts.

Products and Services

Personal Investment Companies, Offshore Trusts, and Token-Name Accounts

Private-banking services almost always involve a high level of confidentiality for clients and their account information. Consequently, it is not unusual for private bankers to help their clients achieve their financial-planning, estate-planning, and confidentiality goals through offshore vehicles such as personal investment companies (PICs), trusts, or more-exotic arrangements, such as hedge fund partnerships. While these vehicles may be used for legitimate reasons, without careful scrutiny, they may camouflage illegal activities. Private bankers should be committed to using sound judgment and enforcing prudent banking practices, especially when they are assisting clients in establishing offshore vehicles or token-name accounts.

Through their global network of affiliated entities, private banks often form PICs for their clients. These "shell" companies, which are incorporated in offshore secrecy jurisdictions such as the Cayman Islands, Channel Islands, Bahamas, British Virgin Islands, and Netherlands Antilles, are formed to hold the customer's assets as well as offer confidentiality by opening accounts in the PIC's name. The "beneficial owners" of the shell corporations are typically foreign nationals. The banking institution should know and be able to document that it knows the beneficial owners of such corporations and that it has performed the appropriate due diligence to support these efforts. Emphasis should be placed on verifying the source or origin of the customer's wealth. Similarly, offshore trusts established in these jurisdictions should identify grantors of the trusts and sources of the grantors' wealth. *Anonymous relationships or relationships in which the RM does not know and document the beneficial owner should not be permitted.*

PICs are typically passive personal investment vehicles. However, foreign nationals have established PICs as operating accounts for business entities they control in their home countries. Accordingly, financial institutions should use extra care when dealing with beneficial owners of PICs and associated trusts; these vehicles can be used to conceal illegal activities.

Deposit Taking

A client's private-banking relationship frequently begins with a deposit account and then expands into other products. In fact, many institutions require private-banking customers to establish a deposit account before maintaining any other accounts. Deposit accounts serve as conduits for a client's money flows. To distinguish private-banking accounts from retail accounts, institutions usually require significantly higher minimum account balances and assess higher fees. The private-banking function or institution should have account-opening procedures and documentation requirements that must be fulfilled before a deposit account can be opened. (These standards are described in detail in the "Functional Review" subsection.)

Most private banks offer a broad spectrum of deposit products, including multicurrency deposit accounts that are used by clients who engage in foreign-exchange, securities, and derivatives transactions. The client's transaction activity, such as wire transfers, check writing, and cash deposits and withdrawals, is conducted through deposit accounts (including current accounts). It is very important that the transaction activity into and out of these deposit accounts (including internal transfers between affiliated deposity accounts) be closely monitored for suspicious transactions that are inconsistent with the client's profile of usual transactions. Suspicious transactions could warrant the filing of a Suspicious Activity Report for Depository Institutions (SAR-DI) form. A bank holding company or any nonbank subsidiary thereof, or a foreign bank that is subject to the Bank Holding Company Act (or any nonbank subsidiary of such a foreign bank operating in the United States), is required to file a SAR-DI form in accordance with the provision of section 208.62 of the Federal Reserve Board's Regulation H (12 CFR 208.62) when suspicious transactions or activities are initially discovered and warrant or require reporting. See the reporting requirements discussed in SR-07-2 and the attached June 2007 SAR-DI form and instructions as well as the expanded procedures for private banking in the FFIEC's *BSA/AML Examination Manual.*

On March 15, 2006, the Board approved a revision to Regulation K (effective April 19, 2006) that incorporates by reference into sections 211.5 and 211.24 of Regulation K section 208.63 of Regulation H. The incorporation results in the requirement that Edge and agreement corporations and other foreign banking organizations (that is, Federal Reserve supervised U.S. branches, agencies, and representative offices of foreign banks) must establish and maintain procedures reasonably designed to ensure and monitor compliance with the Bank Secrecy Act and related regulations. Each of these banking organizations' compliance programs must include, at a minimum (1) a system of internal controls to ensure ongoing compliance, (2) independent testing of compliance by the institution's personnel or by an outside party, (3) the designation of an individual or individuals responsible for coordinating and monitoring day-to-day compliance, and (4) training for appropriate personnel. (See SR-06-7.)

Investment Management

In private banking, investment management usually consists of two types of accounts: (1) discretionary accounts in which portfolio managers make the investment decisions on the basis of recommendations from the bank's investment research resources and (2) nondiscretionary (investment advisory) accounts in which clients make their own investment decisions when conducting trades. For nondiscretionary clients, the banks typically offer investment recommendations subject to the client's written approval. Discretionary accounts consist of a mixture of instruments bearing varying degrees of market, credit, and liquidity risk that should be appropriate to the client's investment objectives and risk appetite. Both account types are governed under separate agreements between the client and the institution.

Unlike depository accounts, securities and other instruments held in the client's investment accounts are not reflected on the balance sheet of the institution because they belong to the client. These managed assets are usually accounted for on a separate ledger that is segregated according to the customer who owns the assets. For regulatory reporting, domestic trust departments and foreign trust departments of U.S. banks are required to report trust assets annually using FFIEC Form 001 (Annual Report of Trust Assets) and FFIEC Form 006 (Annual Report of International Fiduciary Activities). On the other hand, the fiduciary activities of foreign banking organizations operating in the United States currently are not reported on any FFIEC regulatory report.

Credit

Private-banking clients may request extensions of credit on either a secured or an unsecured basis. Loans backed by cash collateral or managed assets held by the private-banking function are quite common, especially in international private banking. Private-banking clients may pledge a wide range of their assets, including cash, mortgages, marketable securities, land, or buildings, to securitize their loans. Management should demonstrate an understanding of the purpose of the credit, the source of repayment, the loan tenor, and the collateral used in the financing. When lending to individuals with high net worths, whether on a secured or an unsecured basis, the creditworthiness determination is bolstered by a thorough and well-structured customer-due-diligence process. If that process is not thorough, collateral derived from illicit activities may be subject to government forfeiture.

Borrowing mechanisms are sometimes established to afford nonresident-alien customers the ability to keep financial assets in the United States and to use such assets (via collateralized borrowing arrangements) to provide operating capital for businesses they own and operate in their home countries. Such arrangements enable these customers to keep the existence of the financial assets secret from their home-country authorities and others, while they continue to use the funds (via collateralized borrowings) to fund the businesses at home.

Private bankers need to maintain in the United States adequate CDD information on such nonresident-alien customers and their primary business interests. A well-documented CDD file may include information on the customer from "who's who" and similar services, Internet research, foreign tax returns and financial statement, checks conducted by the Office of Foreign Assets Control (OFAC), and written and appropriately documented Call Reports prepared by the RM.

While these lending mechanisms may be used for legitimate reasons, management needs to determine whether the arrangements are being used primarily to obfuscate the beneficial ownership of collateral assets, making it difficult for the customer's home-country government to identify who owns the assets. If so, management needs to further determine whether the practice varies from both the appropriate standards of international cooperation for transparency issues and with prudent banking practices, and if so, whether the institution is exposed to elevated legal risk.

Payable-Through Accounts

Another product that may be available in private-banking operations is payable-through accounts (PTAs). PTAs are transaction deposit accounts through which U.S. banking entities ("payable-through banks") extend check-writing privileges to the customers of a foreign bank. The foreign bank ("master account holder") opens a master checking account with the U.S. bank and uses this account to provide its customers with access to the U.S. banking system. The master account is divided into "subaccounts," each in the name of one of the foreign bank's customers. The foreign bank extends signature authority on its master account to its own customers, who may not be known to the U.S. bank. Consequently, the U.S. bank may have customers who have not been subject to the same account-opening requirements imposed on its U.S. account holders. These subaccount customers are able to write checks and make deposits at the U.S. banking entity. The number of subaccounts permitted under this arrangement may be virtually unlimited.

U.S. banking entities engage in PTAs primarily because they attract dollar deposits from the domestic market of their foreign correspondents without changing the primary bank-customer relationship; PTAs also provide substantial fee income. Generally, PTAs at U.S. banking entities have the following characteristics: they are carried on the U.S. banking entity's books as a correspondent bank account, their transaction volume is high, checks passing through the account contain wording similar to "payable through XYZ bank," and the signatures appearing on checks are not those of authorized officers of the foreign bank. See the expanded examination procedures for PTAs in the FFIEC's *BSA/AML Examination Manual.*

Personal Trust and Estates

In trust and estate accounts, an institution offers management services for a client's assets. When dealing with trusts under will, or "testamentary trusts," the institution may receive an estate appointment (executor) and a trustee appointment if the will provided for the trust from the probate. These accounts are fully funded at origination with no opportunity for an outside party to add to the account, and all activities are subject to review by the probate or surrogates' court. On the other hand, with living trusts, or "grantor trusts," the customer (grantor) may continually add to and, in some instances, has control over the corpus of the account. Trusts and estates require experienced attorneys, money managers, and generally well-rounded professionals to set up and maintain the accounts. In certain cases, bankers may need to manage a customer's closely held business or sole proprietorship. In the case of offshore trust facilities, recent changes in U.S. law have imposed additional obligations on those banks that function as trustees or corporate management for offshore trusts and PICs.

A critical element in offering personal trust and estate services is the fiduciary responsibility of the institutions to their customers. This responsibility requires that institutions always act in the best interest of the clients pursuant to the trust documentation, perhaps even to the detriment of the bank. In these accounts, the bank is the fiduciary and the trust officer serves as a representative of the institution. Fiduciaries are held to higher standards of conduct than other bankers. Proper administration of trusts and estates includes strict controls over assets, prudent investment and management of assets, and meticulous recordkeeping. See the expanded examination procedures for trust and asset-management services in the FFIEC's *BSA/AML Examination Manual.*

Custody Services

Custodial services offered to private-banking customers include securities safekeeping, receipt and disbursement of dividends and interest, recordkeeping, and accounting. Custody relationships can be established in many ways, including by referrals from other departments in the bank or from outside investment advisers. The customer or a designated financial adviser retains full control of the investment management of the property subject to the custodianship. Sales and purchases of assets are made by instruction from the customer, and cash disbursements are prearranged or as instructed. Custody accounts involve no investment supervision and no discretion. However, the custodian may be responsible for certain losses if it fails to act properly according to the custody agreement. Therefore, procedures for proper administration should be established and reviewed.

An escrow account is a form of custody account in which the institution agrees to hold cash or securities as a middleman, or a third party. The customer, for example, an attorney or a travel agency, gives the institution funds to hold until the ultimate receiver of the funds "performs" in accordance with the written escrow agreement, at which time the institution releases the funds to the designated party.

Funds Transfer

Funds transfer, another service offered by private-banking functions, may involve the transfer of funds between third parties as part of bill-paying and investment services on the basis of customer instructions. The adequacy of controls over funds-transfer instructions that are initiated electronically or telephonically, such as by facsimile machine, telex, telegram, and telephone, is extremely important. Funds-transfer requests are quickly processed and, as required by law, funds-transfer personnel may have limited knowledge of the customers or the purpose of the transactions. Therefore, strong controls and adequate supervision over this area are critical.

Hold Mail, No Mail, and Electronic-Mail Only

Hold-mail, no-mail, or electronic-mail-only accounts are often provided to private-banking customers who elect to have bank statements and other documents maintained at the institution rather than mailed to their residence. Agreements for hold-mail accounts should be in place, and the agreements should indicate that it was the customer's choice to have the statements retained at the bank and that the customer will pick up his or her mail at least annually. Variations of hold-mail services include delivery of mail to a prearranged location (such as another branch of the bank) by special courier or the bank's pouch system.

Bill-Paying Services

Bill-paying services are often provided to private-banking customers for a fee. If this service is provided, an agreement between the bank and the customer should exist. Typically, a customer may request that the bank debit a deposit account for credit card bills, utilities, rent, mortgage payments, or other monthly consumer charges. In addition, the increased use of the Internet has given rise to the "electronic-mail-only" account, whereby customers elect to have statements, notices, etc., sent to them only by e-mail.

FUNCTIONAL REVIEW

When discussing the functional aspects of a private-banking operation, *functional* refers to managerial processes and procedures, such as reporting lines, quality of supervision (including involvement of the board of directors), information flows, policies and procedures, risk-management policies and methodologies, segregation of duties, management information systems, operational controls (including BSA/AML monitoring), and audit coverage. The examiner should be able to draw sound conclusions about the quality and culture of management and stated private-banking policies after reviewing the functional areas described below. Specifically, the institution's risk-identification process and risk appetite should be carefully defined and assessed. Additionally, the effectiveness of the overall control environment maintained by management should be evaluated by an internal or external audit. The effectiveness of the following functional areas is critical to any private-banking operation, regardless of its size or product offerings.

Supervision and Organization

As part of the examiner's appraisal of an organization, the quality of supervision of private-banking activities is evaluated. The appraisal of management covers the full range of functions and activities related to the operation of the private bank. The discharge of responsibilities by bank directors should be effected through an organizational plan that accommodates the volume and business services handled, local business practices and the bank's competition, and the growth and development of the institution's private-banking business. Organizational planning is the joint responsibility of senior bank and private-bank management, should be integrated with the long-range plan for the institution, and should be consistent with any enterprise-wide-risk-management program.

Both the directors and management have important roles in formulating policies and establishing programs for private-banking products, operations, internal controls, and audits. However, management alone must implement policies and programs within the organizational framework instituted by the board of directors.

Risk Management

Sound risk-management processes and strong internal controls are critical to safe and sound banking generally and to private-banking activities in particular. Management's role in ensuring the integrity of these processes has become increasingly important as new products and technologies are introduced. Similarly, the client-selection, documentation, approval, and account-monitoring processes should adhere to sound and well-identified practices.

The quality of risk-management practices and internal controls is given significant weight in the evaluation of management and the overall condition of private-banking operations. A bank's failure to establish and maintain a risk-management framework that effectively identifies, measures, monitors, and controls the risks associated with products and services should be considered unsafe and unsound conduct. Furthermore, well-defined management practices should indicate the types of clients that the institution will and will not accept and should establish multiple and segregated levels of authorization for accepting new clients. Institutions that follow sound practices will be better positioned to design and deliver products and services that match their clients' legitimate needs, while reducing the likelihood that unsuitable clients might enter their client account base. Deficiencies noted in this area are weighted in context of the relative risk they pose to the institution and are appropriately reflected in the appraisal of management.

The private-banking function is exposed to a number of risks, including reputational, fiduciary, legal, credit, operational, and market. A brief description of some of the different types of risks follows:

- *Reputational risk* is the potential that negative publicity regarding an institution's business practices and clients, whether true or not, could cause a decline in the customer base, costly litigation, or revenue reductions.
- *Fiduciary risk* refers to the risk of loss due to the institution's failure to exercise loyalty; safeguard assets; and, for trusts, to use assets productively and according to the appropriate standard of care. This risk generally exists in an institution to the extent that it exercises discretion in managing assets on behalf of a customer.
- *Legal risk* arises from the potential of unenforceable contracts, client lawsuits, or adverse judgments to disrupt or otherwise negatively affect the operations or condition of a banking organization. One key dimension of legal risk is supervisory action that could result in costly fines or other punitive measures being levied against an institution for compliance breakdowns.
- *Credit risk* arises from the potential that a borrower or counterparty will fail to perform on an obligation.
- *Operational risk* arises from the potential that inadequate information systems, operational problems, breaches in internal controls, fraud,

or unforeseen catastrophes will result in unexpected losses.

Although effective management of all of the above risks is critical for an institution, certain aspects of reputational, legal, and fiduciary risks are often unique to a private-banking function. In this regard, the following customer-due-diligence policies and practices are essential in the management of reputational and legal risks in the private-banking functions. (In addition, sound fiduciary practices and conflicts-of-interest issues that a private-banking operation may face in acting as fiduciary are described in the subsection on fiduciary standards.)

Customer-Due-Diligence Policy and Procedures

Sound customer-due-diligence (CDD) policies and procedures are essential to minimize the risks inherent in private banking. The policies and procedures should clearly describe the target client base in terms such as ''minimum investable net worth'' and ''types of products sought,'' as well as specifically indicate the type of clientele the institution will or will not accept. Policies and procedures should be designed to ensure that effective due diligence is performed on all potential clients, that client files are bolstered with additional CDD information on an ongoing basis, and that activity in client accounts is monitored for transactions that are inconsistent with the client profile and may constitute unlawful activities, such as money laundering. The client's identity, background, and the nature of his or her transactions should be documented and approved by the back office before opening an account or accepting client monies. Certain high-risk clients like foreign politicians or money exchange houses should have additional documentation to mitigate their higher risk.

Money laundering is associated with a broad range of illicit activities: the ultimate intention is to disguise the money's true source—from the initial placement of illegally derived cash proceeds to the layers of financial transactions that disguise the audit trail—and make the funds appear legitimate. Under U.S. money-laundering statutes, a bank employee can be held personally liable if he or she is deemed to engage in ''willful blindness.'' This condition occurs when the employee fails to make reasonable inquiries to satisfy suspicions about client account activities.

Since the key element of an effective CDD policy is a comprehensive knowledge of the client, the bank's policies and procedures should clearly reflect the controls needed to ensure the policy is fully implemented. CDD policies should clearly delineate the accountability and authority for opening accounts and for determining if effective CDD practices have been performed on each client. In addition, policies should delineate documentation standards and accountability for gathering client information from referrals among departments or areas within the institution as well as from accounts brought to the institution by new RMs.

In carrying out prudent CDD practices on potential private-banking customers, management should document efforts to obtain and corroborate critical background information. Private-banking employees abroad often have local contacts who can assist in corroborating information received from the customer. The information listed below should be corroborated by a reliable, independent source, when possible:

- The customer's current address and telephone number for his or her primary residence, which should be corroborated at regular intervals, can be verified through a variety of methods, such as—
  - — visiting the residence, office, factory, or farm (with the RM recording the results of the visit or conversations in a memorandum);
  - — checking the information against the telephone directory; the client's residence, as indicated on his or her national ID card; a mortgage or bank statement or utility or property tax bill; or the electoral or tax rolls;
  - — obtaining a reference from the client's government or known employer or from another bank;
  - — checking with a credit bureau or professional corroboration organization; or
  - — any other method verified by the RM.
- Sufficient business information about the customer should be gathered so that the RM understands the profile of the customer's commercial transactions. This information should include a description of the nature of the customer's business operations or means of generating income, primary trade or business

areas, and major clients and their geographic locations, as well as the primary business address and telephone number. These items can be obtained through a combination of any of the following sources:
- — a visit to the office, factory, or farm
- — a reliable third party who has a business relationship with the customer
- — financial statements
- — Dun and Bradstreet reports
- — newspaper or magazine articles
- — LexisNexis reports on the customer or customer's business
- — "Who's Who" reports from the home country
- — private investigations

- Although it is often not possible to get proof of a client's wealth, an RM can use his or her good judgment to derive a reasonable estimate of the individual's net worth.
- As part of the ongoing CDD process, the RM should document in memos or "call reports" the substance of discussions that take place during frequent visits with the client. Additional information about a client's wealth, business, or other interests provides insight into potential marketing opportunities for the RM and the bank, and updates and strengthens the CDD profile.

As a rule, most private banks make it a policy not to accept walk-in clients. If an exception is made, procedures for the necessary documentation and approvals supporting the exception should be in place. Similarly, other exceptions to policy and procedures should readily identify the specific exception and the required due-diligence and approval process for overriding existing procedures.

In most instances, all CDD information and documentation should be maintained and available for examination and inspection at the location where the account is located or where the financial services are rendered. If the bank maintains centralized customer files in locations other than where the account is located or the financial services are rendered, complete customer information, identification, and documentation must be made available at the location where the account is located or where the financial services are rendered within 48 hours of a Federal Reserve examiner's request. Off-site storage of CDD information will be allowed only if the bank has adopted, as part of its customer-due-diligence program, specific procedures designed to ensure that (1) the accounts are subject to ongoing Office of Foreign Assets Control screening that is equivalent to the screening afforded other accounts, (2) the accounts are subject to the same degree of review for suspicious activity, and (3) the bank demonstrates that the appropriate review of the information and documentation is being performed by personnel at the offshore location.

CDD procedures should be no different when the institution deals with a financial adviser or other type of intermediary acting on behalf of a client. To perform its CDD responsibilities when dealing with a financial adviser, the institution should identify the beneficial owner of the account (usually the intermediary's client, but in rare cases, it is the intermediary itself) and perform its CDD analysis with respect to that beneficial owner. The imposition of an intermediary between the institution and counterparty should not lessen the institution's CDD responsibilities.

The purpose of all private-banking relationships should also be readily identified. Incoming customer funds may be used for various purposes, such as establishing deposit accounts, funding investments, or establishing trusts. The bank's CDD procedures should allow for the collection of sufficient information to develop a transaction or client profile for each customer, which will be used in analyzing client transactions. Internal systems should be developed for monitoring and identifying transactions that may be inconsistent with the transaction or client profile for a customer and which may thus constitute suspicious activity.

Suspicious Activity Reports by Depository Institutions. The proper and timely filing of Suspicious Activity Reports by Depository Institutions (SAR-DI) forms is an important component of a bank's CDD program. Since 1996, the federal financial institution supervisory agencies and the Department of the Treasury's Financial Crimes Enforcement Network (FinCEN) have required banking organizations to report known or suspected violations of law as well as suspicious transactions on a suspicious activity report or SAR-DI form. See the Board's SAR-DI form regulation (Regulation H, section 208.62 (12 CFR 208.62)).[3] Law enforcement agencies use

3. The Board's SAR-DI form rules apply to state member banks, bank holding companies and their nonbank subsidiaries that do not report on a different SAR form (for example,

the information reported on the form to initiate investigations, and Federal Reserve staff use the SAR-DI form information in their examination and oversight of supervised institutions.

A member bank is required to file a SAR-DI form with the appropriate federal law enforcement agencies and the Department of the Treasury. A SAR-DI form must be prepared in accordance with the form's instructions. (See SR-07-2 and the attached June 2007 SAR-DI form and instructions.) The completed SAR-DI form is to be sent to FinCEN when an institution detects—

- insider abuse involving any amount,
- violations aggregating $5,000 or more in which a suspect can be identified,
- violations aggregating $25,000 or more regardless of a potential suspect, or
- transactions aggregating $5,000 or more that involve potential money laundering or violations of the Bank Secrecy Act.

When a SAR-DI form is filed, the management of a member bank must promptly notify its board of directors or a committee thereof.

A SAR-DI form must be filed within 30 calendar days after the date of initial detection of the facts that may constitute a basis for filing a SAR-DI form. If no suspect was identified on the date of detection of the incident requiring the filing, a member bank may delay filing a SAR-DI form for an additional 30 calendar days in order to identify the suspect. Reporting may not be delayed more than 60 calendar days after the date of initial detection of a reportable transaction. In situations involving violations requiring immediate attention, such as when a reportable violation is ongoing, the financial institution is required to immediately notify an appropriate law enforcement authority in addition to its timely filing of a SAR-DI form.

A bank's internal systems for capturing suspicious activities should provide essential information about the nature and volume of activities passing through customer accounts. Any information suggesting that suspicious activity has occurred should be pursued, and, if an explanation is not forthcoming, the matter should be reported to the bank's management. Examiners should ensure that the bank's approach to SAR-DI forms is proactive and that well-established procedures cover the SAR-DI form process. Accountability should exist within the organization for the analysis and follow-up of internally identified suspicious activity; this analysis should conclude with a decision on the appropriateness of filing a SAR-DI form. See SR-07-2 and the attached SAR-DI form and instructions. See also the core procedures concerning suspicious-activity-reporting requirements in the FFIEC *BSA/AML Examination Manual.*

broker-dealers), Edge and agreement corporations, and the U.S. branches and agencies of foreign banks supervised by the Federal Reserve.

Credit-Underwriting Standards

The underwriting standards for private-banking loans to high net worth individuals should be consistent with prudent lending standards. The same credit policies and procedures that are applicable to any other type of lending arrangement should extend to these loans. At a minimum, sound policies and procedures should address the following: all approved credit products and services offered by the institution, lending limits, acceptable forms of collateral, geographic and other limitations, conditions under which credit is granted, repayment terms, maximum tenor, loan authority, collections and charge-offs, and prohibition against capitalization of interest.

An extension of credit based solely on collateral, even if the collateral is cash, does not ensure repayment. While the collateral enhances the bank's position, it should not substitute for regular credit analyses and prudent lending practices. If collateral is derived from illegal activities, it is subject to forfeiture through the seizure of assets by a government agency. The bank should perform its due diligence by adequately and reasonably ascertaining and documenting that the funds of its private-banking customers were derived from legitimate means. Banks should also verify that the use of the loan proceeds is for legitimate purposes.

In addition, bank policies should explicitly describe the terms under which "margin loans," loans collateralized by securities, are made and should ensure that they conform to applicable regulations. Management should review and approve daily MIS reports. The risk of market deterioration in the value of the underlying collateral may subject the lender to loss if the collateral must be liquidated to repay the loan. In the event of a "margin call," any shortage should be paid for promptly by the customer from other sources pursuant to the terms of the margin agreement.

In addition, policies should address the acceptance of collateral held at another location, such as an affiliated entity, but pledged to the private-banking function. Under these circumstances, management of the private-banking function should, at a minimum, receive frequent reports detailing the collateral type and current valuation. In addition, management of the private-banking function should be informed of any changes or substitutions in collateral.

Fiduciary Standards

Fiduciary risk is managed through the maintenance of an effective and accountable committee structure; retention of technically proficient staff; and development of effective policies, procedures, and controls. In managing its fiduciary risk, the bank must ensure that it carries out the following fiduciary duties:

- *Duty of loyalty.* Trustees are obligated to make all decisions based exclusively on the best interests of trust customers. Except as permitted by law, trustees cannot place themselves in a position in which their interests might conflict with those of the trust beneficiaries.
- *Avoidance of conflicts of interest.* Conflicts of interest arise in any transaction in which the fiduciary simultaneously represents the interests of multiple parties (including its own interests) that may be adverse to one another. Institutions should have detailed policies and procedures regarding potential conflicts of interest. All potential conflicts identified should be brought to the attention of management and the trust committee, with appropriate action taken. Conflicts of interest may arise throughout an institution. Care should be taken by fiduciary business lines, in particular, to manage conflicts of interest between fiduciary business lines and other business lines (including other fiduciary business lines). Consequently, management throughout the institution should receive training in these matters. For more information on the supervision of fiduciary activities, see section 4200.0 in this manual and section 3120.0 of the *Bank Holding Company Supervision Manual.*
- *Duty to prudently manage discretionary trust and agency assets.* Since 1994, the majority of states have adopted laws concerning the prudent investor rule (PIR) with respect to the investment of funds in a fiduciary capacity. PIR is a standard of review that imposes an obligation to prudently manage the portfolio as a whole, focusing on the process of portfolio management, rather than on the outcome of individual investment decisions. Although this rule only governs trusts, the standard is traditionally applied to all accounts for which the institution is managing funds.

Operational Controls

To minimize any operational risks associated with private-banking activities, management is responsible for establishing an effective internal control infrastructure and reliable management information systems. Critical operational controls over any private-banking activity include the establishment of written policies and procedures, segregation of duties, and comprehensive management reporting. Throughout this section, specific guidelines and examination procedures for assessing internal controls over different private-banking activities are provided. Listed below are some of those guidelines that cover specific private-banking services.

Segregation of Duties

Banking organizations should have guidelines on the segregation of employees' duties in order to prevent the unauthorized waiver of documentation requirements, poorly documented referrals, and overlooked suspicious activities. Independent oversight by the back office helps to ensure compliance with account-opening procedures and CDD documentation. Control-conscious institutions may use independent units, such as compliance, risk management, or senior management to fill this function in lieu of the back office. The audit and compliance functions of the private-banking entity should be similarly independent so that they can operate autonomously from line management.

Inactive and Dormant Accounts

Management should be aware that banking laws in most states prohibit banks from offering services that allow deposit accounts to be inactive for prolonged periods of time (generally, 12 or more months with no externally generated account-balance activity). These regulations are based on the presumption that inactive and dormant accounts may be subject to manipulation and abuse by insiders. Policies and procedures should delineate when inactivity occurs and when inactive accounts should be converted to dormant status. Effective controls over dormant accounts should include a specified time between the last customer-originated activity and its classification as dormant, the segregation of signature cards for dormant accounts, dual control of records, and the blocking of the account so that entries cannot be posted to the account without review by more than one member of senior management.

Pass-Through Accounts and Omnibus Accounts

Pass-through accounts (PTAs) extend checking-account privileges to the customers of a foreign bank; several risks are involved in providing these accounts. In particular, if the U.S. banking entity does not exercise the same due diligence and customer vetting for PTAs as it does for domestic account relationships, the use of PTAs may facilitate unsafe and unsound banking practices or illegal activities, including money laundering. Additionally, if accounts at U.S. banking entities are used for illegal purposes, the entities could be exposed to reputational risk and risk of financial loss as a result of asset seizures and forfeitures brought by law enforcement authorities. As stated in SR-95-10, it is recommended that U.S. banking entities terminate a payable-through arrangement with a foreign bank in situations in which (1) adequate information about the ultimate users of PTAs cannot be obtained, (2) the foreign bank cannot be relied on to identify and monitor the transactions of its own customers, or (3) the U.S. banking entity is unable to ensure that its payable-through accounts are not being used for money laundering or other illicit purposes.

Omnibus, or general clearing, accounts may also exist in the private-banking system. They may be used to accommodate client funds before an account opening to expedite a new relationship, or they may fund products such as mutual funds in which client deposit accounts may not be required. However, these accounts could circumvent an audit trail of client transactions. Examiners should carefully review a bank's use of such accounts and the adequacy of its controls on their appropriate use. Generally, client monies should flow through client deposit accounts, which should function as the sole conduit and paper trail for client transactions.

Hold-Mail, No Mail, and E-mail-Only Controls

Controls over hold-mail, no-mail, and e-mail-only accounts are critical because the clients have relinquished their ability to detect unauthorized transactions in their accounts in a timely manner. Accounts with high volume or significant losses warrant further inquiry. Hold-mail, no-mail, and e-mail-only account operations should ensure that client accounts are subject to dual control and are reviewed by an independent party.

Funds Transfer—Tracking Transaction Flows

One way that institutions can improve their customer knowledge is by tracking the transaction flows into and out of customer accounts and payable-through subaccounts. Tracking should include funds-transfer activities. Policies and procedures to detect unusual or suspicious activities should identify the types of activities that would prompt staff to investigate the customer's activities and should provide guidance on the appropriate action required for suspicious activity. The following is a checklist to guide bank personnel in identifying some potential abuses:

- indications of frequent overrides of established approval authority or other internal controls
- intentional circumvention of approval authority by splitting transactions
- wire transfers to and from known secrecy jurisdictions
- frequent or large wire transfers for persons who have no account relationship with the bank, or funds being transferred into and out of an omnibus or general clearing account instead of the client's deposit account

- wire transfers involving cash amounts in excess of $10,000
- inadequate control of password access
- customer complaints or frequent error conditions

Custody—Detection of Free Riding

Custody departments should monitor account activity to detect instances of *free-riding,* the practice of offering the purchase of securities without sufficient capital and then using the proceeds of the sale of the same securities to cover the initial purchase. Free-riding poses significant risk to the institution and typically occurs without the bank's prior knowledge. Free-riding also violates margin rules (Regulations T, U, and X) governing the extension of credit in connection with securities transactions. (See SR-93-13.)

Management Information Systems

Management information systems (MIS) should accumulate, interpret, and communicate information on (1) the private-banking assets under management, (2) profitability, (3) business and transaction activities, and (4) inherent risks. The form and content of MIS for private-banking activities will be a function of the size and complexity of the private-banking organization. Accurate, informative, and timely reports that perform the following functions may be prepared and reviewed by RMs and senior management:

- aggregate the assets under management according to customer, product or service, geographic area, and business unit
- attribute revenue according to customer and product type
- identify customer accounts that are related to or affiliated with one another through common ownership or common control
- identify and aggregate customer accounts by source of referral
- identify beneficial ownership of trust, PIC, and similar accounts

To monitor and report transaction activity and to detect suspicious transactions, management reports may be developed to—

- monitor a specific transaction criterion, such as a minimum dollar amount or volume or activity level;
- monitor a certain type of transaction, such as one with a particular pattern;
- monitor individual customer accounts for variations from established transaction and activity profiles based on what is usual or expected for that customer; and
- monitor specific transactions for BSA and SAR-DI form compliance.

In addition, reports prepared for private-banking customers should be accurate, timely, and informative. Regular reports and statements prepared for private-banking customers should adequately and accurately describe the application of their funds and should detail all transactions and activity that pertain to the customers' accounts.

Furthermore, MIS and technology play a role in building new and more direct channels of information between the institution and its private-banking customers. Active and sophisticated customers are increasing their demand for data relevant to their investment needs, which is fostering the creation of online information services. Online information can satisfy customers' desire for convenience, real-time access to information, and a seamless delivery of information.

Audit

An effective audit function is vital to ensuring the strength of a private bank's internal controls. As a matter of practice, internal and external auditors should be independently verifying and confirming that the framework of internal controls is being maintained and operated in a manner that adequately addresses the risks associated with the activities of the organization. Critical elements of an effective internal audit function are the strong qualifications and expertise of the internal audit staff and a sound risk-assessment process for determining the scope and frequency of specific audits. The audit process should be risk-focused and should ultimately determine the risk rating of business lines and client CDD procedures. Compliance with CDD policies and procedures and the detailed testing of files for CDD documentation are also key elements of the audit function.

Finally, examiners should review and evaluate management's responsiveness to criticisms by the audit function.

Compliance

The responsibility for ensuring effective compliance with relevant laws and regulations may vary among different forms of institutions, depending on their size, complexity, and availability of resources. Some institutions may have a distinct compliance department with the centralized role of ensuring compliance institution-wide, including private-banking activities. This arrangement is strongly preferable to a situation in which an institution delegates compliance to specific functions, which may result in the management of private-banking operations being responsible for its own internal review. Compliance has a critical role in monitoring private-banking activities; the function should be independent of line management. In addition to ensuring compliance with various laws and regulations such as the Bank Secrecy Act and those promulgated by the Office of Foreign Assets Control, compliance may perform its own internal investigations and due diligence on employees, customers, and third parties with whom the bank has contracted in a consulting or referral capacity and whose behavior, activities, and transactions appear to be unusual or suspicious. Institutions may also find it beneficial for compliance to review and authorize account-opening documentation and CDD adequacy for new accounts. The role of compliance is a control function, but it should not be a substitute for regular and frequent internal audit coverage of the private-banking function. Following is a description of certain regulations that may be monitored by the compliance function.

Office of Foreign Assets Control

The Office of Foreign Assets Control (OFAC) of the U.S. Department of the Treasury administers and enforces economic and trade sanctions based on U.S. foreign policy and national security goals. Sanctions are imposed against targeted foreign countries, terrorists, international narcotics traffickers, and those engaged in activities related to the proliferation of weapons of mass destruction. OFAC acts under presidential wartime and national emergency powers, as well as under authority granted by specific legislation, to impose controls on transactions and freeze foreign assets under U.S. jurisdiction. Many of the sanctions are based on United Nations and other international mandates, are multilateral in scope, and involve close cooperation with allied governments. Under the International Emergency Economic Powers Act, the President can impose sanctions, such as trade embargoes, the freezing of assets, and import surcharges, on certain foreign countries and the "specially designated nationals" of those countries.

A "specially designated national" is a person or entity who acts on behalf of one of the countries under economic sanction by the United States. Dealing with such nationals is prohibited. Moreover, their assets or accounts in the United States are frozen. In certain cases, the Treasury Department can issue a license to a designated national. This license can then be presented by the customer to the institution, allowing the institution to debit his or her account. The license can be either general or specific.

OFAC screening may be difficult when transactions are conducted through PICs, token names, numbered accounts, or other vehicles that shield true identities. Management must ensure that accounts maintained in a name other than that of the beneficial owner are subject to the same level of filtering for OFAC specially designated nationals and blocked foreign countries as other accounts. That is, the OFAC screening process must include the account's beneficial ownership as well as the official account name.

Any violation of regulations implementing designated national sanctions subjects the violator to criminal prosecution, including up to 12 years in prison and $1 million in corporate fines and $250,000 in individual fines, per incident. Any funds frozen because of OFAC orders should be placed in a blocked account. Release of those funds cannot occur without a license from the Treasury Department.

Bank Secrecy Act

Guidelines for compliance with the Bank Secrecy Act (BSA) can be found in the FFIEC *BSA/AML Examination Manual.* See also SR-07-2 and its attachments, SR-04-13, SR-01-29 (the customer identification program requirements), and the question-and-answer format interpretations (SR-05-9) of the U.S. Department of Treasury's regulation (31 CFR 103) for banking organizations, which is based on section 326 of the Patriot Act. In addition, the procedures for conducting BSA examinations of foreign offices of U.S. banks are detailed in the FFIEC Bank Secrecy Act/Anti-Money Laundering Examination Manual. The SAR-DI form filing requrements for nonbank subsidiaries of bank holding companies and state member banks are also set forth in SR-02-24.

PREPARATION FOR EXAMINATION

The following subsections provide examiners with guidance on preparing for the on-site examination of private-banking operations, including determination of the examination scope and drafting of the first-day-letter questionnaire that is provided to the institution.

Preexamination Review

To prepare the examiners for their assignments and to determine the appropriate staffing and scope of the examination, the following guidelines should be followed during the preexamination planning process:

- Review the prior report of examination and workpapers for the exam scope; structure and type of private-banking activities conducted; and findings, conclusions, and recommendations of the prior examination. The prior examination report and examination plan should also provide insight to key contacts at the institution and to the time frame of the prior private-banking review.
- Obtain relevant correspondence sent since the prior examination, such as management's response to the report of examination, any applications submitted to the Federal Reserve, and any supervisory action.
- Research press releases and published news stories about the institution and its private-banking activities.
- Review internal and external audit reports and any internal risk assessments performed by the institution on its private-banking activities. Such reports should include an assessment of the internal controls and risk profile of the private-banking function.
- Contact the institution's management to ascertain what changes have occurred since the last exam or are planned in the near future. For example, examiners should determine if there have been changes to the strategic plan; senior management; or the level and type of private-banking activities, products, and services offered. If there is no mention of private banking in the prior examination report, management should be asked at this time if they have commenced or plan to commence any private-banking activities.
- Follow the core examination procedures in the FFIEC *BSA/AML Examination Manual* in order to establish the base scope for the examination of private-banking activities. Review and follow the expanded procedures for private banking and any other expanded procedures that are deemed necessary.

Examination Staffing and Scope

Once the exam scope has been established and before beginning the new examination, the examiner-in-charge and key administrators of the examination team should meet to discuss the private-banking examination scope, the assignments of the functional areas of private banking, and the supplemental reviews of specific private-banking products and services. If the bank's business lines and services overlap and if its customer base and personnel are shared throughout the organization, examiners may be forced to go beyond a rudimentary review of private-banking operations. They will probably need to focus on the policies, practices, and risks within the different divisions of a particular institution and throughout the institution's global network of affiliated entities.

Reflection of Organizational Structure

The review of private-banking activities should be conducted on the basis of the financial institution's organizational structure. These structures may vary considerably, depending on the size and sophistication of the institution, its country of origin and the other geographic markets in which it competes, and the objectives and strategies of its management and board of directors. To the extent possible, examiners should understand the level of consolidated private-banking activities an institution conducts in the United States and abroad. This broad view is needed to maintain the "big picture" impact of private banking for a particular institution.

Risk-Focused Approach

Examiners reviewing the private-banking operations should implement the risk-focused examination approach. The exam scope and degree of testing of private-banking practices should reflect the degree of risk assumed, prior exam findings on the implementation of policies and procedures, the effectiveness of controls, and an assessment of the adequacy of the internal audit and compliance functions. If initial inquiries into the institution's internal audit and other assessment practices raise doubts about the internal system's effectiveness, expanded analysis and review are required—and examiners should perform more transaction testing. Examiners will usually need to follow the core examination procedures in the FFIEC *BSA/AML Examination Manual* as well as the expanded procedures for private banking. Other expanded procedures should be followed if circumstances dictate.

First-Day Letter

As part of the examination preparation, examiners should customize the first-day-letter (FDL) questionnaire to reflect the structure and type of private-banking activities of the institution and the scope of the exam. The following is a list of requests regarding private banking that examiners should consider including in the FDL. Responses to these items should be reviewed in conjunction with responses to the BSA, fiduciary, audit, and internal control inquiries:

- organizational chart for the private bank on both a functional and legal-entity basis
- business or strategic plan
- income and expense statements for the prior fiscal year and current year to date, with projections for the remainder of the current and the next fiscal year, and income by product division and marketing region
- balance-sheet and total assets under management (list the most active and profitable accounts by type, customer domicile, and responsible account officer)
- most recent audits for private-banking activities
- copies of audit committee minutes
- copy of the CDD and SAR-DI form policies and procedures
- list of all new business initiatives introduced last year and this year, relevant new-product-approval documentation that addresses the evaluation of the unique characteristics and risk associated with the new activity or product, and an assessment of the risk-management oversight and control infrastructures in place to manage the risks
- list of all accounts in which an intermediary is acting on behalf of clients of the private bank, for example, as financial advisers or money managers
- explanation of the methodology for following up on outstanding account documentation and a sample report
- description of the method for aggregating client holdings and activities across business units throughout the organization
- explanation of how related accounts, such as common control and family link, are identified
- name of a contact person for information on compensation, training, and recruiting programs for relationship managers
- list of all personal investment company accounts
- list of reports that senior management receives regularly on private-banking activities
- description and sample of the management information reports that monitor account activity
- description of how senior management monitors compliance with global policies for worldwide operations, particularly for offices operating in secrecy jurisdictions
- appropriate additional items from the core and expanded procedures for private banking, as set forth in the FFIEC *BSA/AML Examination Manual,* as well as any other items from the expanded procedures that are needed to gauge the adequacy of the BSA/AML program for private-banking activities.

1. To determine if the policies, practices, procedures, and internal controls regarding private-banking activities are adequate for the risks involved.
2. To determine if the bank's officers and employees are operating in conformance with established guidelines for conducting private-banking activities.
3. To assess the financial condition and income-generation results of the private-banking activities.
4. To determine the scope and adequacy of the audit function for private-banking activities.
5. To determine compliance with applicable laws and regulations for private banking.
6. To initiate corrective action when policies, practices, procedures, or internal controls are deficient, or when violations of laws or regulations are found.

As appropriate, the examiner-in-charge should supplement the following procedures with the examination procedures for private banking set forth in the FFIEC's *BSA/AML Examination Manual.* See that manual's core examination procedures for the BSA/AML compliance program and the expanded examination procedures for private banking.

PRIVATE-BANKING PREEXAMINATION PROCEDURES

1. As the examiner-in-charge, conduct a meeting with the lead members of the private-banking examination team and discuss—
   a. the private-banking examination scope (The examination may need to extend beyond a rudimentary review of private-banking operations if the bank's business lines and services overlap and if its customer base and personnel are shared throughout the organization. Examiners will probably need to focus on the policies, practices, and risks within the different divisions of the bank and, if applicable, throughout the bank's domestic or foreign-affiliated entities.);
   b. examiner assignments for the functional areas of private banking; and
   c. the supplemental reviews of specific private-banking products and services.
2. Review the prior report of examination and the previous examination's workpapers; description of the examination scope; structure and type of private-banking activities conducted; and findings, conclusions, and recommendations of the prior examination. The prior examination report and examination plan should also provide information and insight on key contacts at the bank and on the time frame of the prior private-banking review.
3. Review relevant correspondence exchanged since the prior examination, such as management's response to the report of examination, any applications submitted to the Federal Reserve, and any supervisory actions.
4. Research press releases and published news stories about the bank and its private-banking activities.
5. Review internal and external audit reports and any internal risk assessments performed by the bank's internal or external auditors on its private-banking activities. Review information on any assessments of the internal controls and risk profile of the private-banking function.
6. Contact management at the bank to ascertain what changes in private-banking services have occurred since the last examination or if there are any planned in the near future.
   a. Determine if the previous examination or examination report(s) mention private banking; if not, ask management if they have commenced or plan to commence any private-banking activities within any part of the bank's organization.
   b. Determine if there have been any changes to the strategic plan; senior management; or the level and type of private-banking activities, products, and services offered.
   c. During the entire examination of private-banking activities, be alert to the totality of the client relationship, product by product, in light of increasing client awareness and use of derivatives, emerging-market products, foreign exchange, and margined accounts.

FULL-EXAMINATION PHASE

1. After reviewing the private-banking functional areas, draw sound conclusions about the quality and culture of management and stated private-banking policies.
2. Evaluate the adequacy of risk-management policies and practices governing private-banking activities.
3. Assess the organization of the private-banking function and evaluate the quality of management's supervision of private-banking activities. An appraisal of management covers the—
   a. full range of functions (i.e., supervision and organization, risk management, fiduciary standards, operational controls, management information systems, audit, and compliance) and activities related to

the operation of the private-banking activities and
   b. discharge of responsibilities by the bank's directors through a long-range organizational plan that accommodates the volume and business services handled, local business practices and the bank's competition, and the growth and development of the bank's private-banking business.
4. Determine if management has effective procedures for conducting ongoing reviews of client-account activity to detect, and protect the client from, any unauthorized activity and any account activity that is inconsistent with the client's profile (for example, frequent or sizable unexplained transfers flowing through the account).
5. Determine if the bank has initiated private-banking account-opening procedures and documentation requirements that must be satisfied before an account can be opened. Determine if the bank maintains internal controls over these procedures and requirements.
6. Determine if the bank requires its subsidiary entities and affiliates to maintain and adhere to well-structured customer-due-diligence (CCD) procedures.
7. Determine if the bank has proper controls and procedures to ensure its proper administration of trust and estates, including strict controls over assets, prudent investment and management of assets, and meticulous recordkeeping. Review previous trust examination reports and consult with the designated Federal Reserve System trust examiners.
8. Ascertain whether the bank adequately supervises its custody services. The bank should ensure that it, and its nonbank entities, have established and currently maintain procedures for the proper administration of custody services, including the regular review of the services on a preset schedule.
9. Determine whether the bank's nonbank subsidiaries and affiliates are required to, and actually maintain, strong controls and supervision over funds transfers.
10. Ascertain if the bank's management and staff are required to perform due diligence, that is, to verify and document that the funds of its private-banking customers were derived through legitimate means, and when extending credit, to verify that the use of loan proceeds was legitimate.
11. Review the bank's use of deposit accounts.
    a. Assess the adequacy of the bank's controls and whether they are appropriately used.
    b. Determine if client monies flow through client deposit accounts and whether the accounts function as the sole conduit and paper trail for client transactions.
12. Determine and ensure that the bank's approach to Suspicious Activity Reports by Depository Institutions (SAR-DI) forms is proactive and that it has well-established procedures covering the SAR-DI form process. Establish whether there is accountability within the organization for the analysis and follow-up of internally identified suspicious activity (this analysis includes a sound decision on whether the bank needs to file, or is required by regulation to file, a SAR-DI) form.

INTRODUCTION

The Securities Act of 1933 requires that adequate and reliable information be made available about securities originally offered for sale to the public. The act requires registration of any sale with the Securities and Exchange Commission (SEC) unless it is specifically exempted. Section 4(2) of the act exempts ‘‘transactions by an issuer not involving any public offering.’’ That exemption created a type of business in the securities industry known as ‘‘private placements.’’

Securities placed privately have certain advantages and disadvantages for both investor and issuer. Through negotiation, both parties may tailor the offering to meet their needs. The issuer saves securities registration costs and obtains alternative financing. The investor makes an investment for a specified length of time at a stated rate of return. Both investor and issuer complete the transaction without being subject to regulatory and public scrutiny.

The major disadvantage of private placements to the investor is the general lack of a secondary market. Thus, the investor may be unable to liquidate the holding until maturity. Additionally, the investor must rely on her or his own expertise when deciding on a purchase. Unlike registered securities, private placements are not reviewed by the SEC. A disadvantage to the issuer is the limitation on the amount of capital that may be raised since the number of investors is usually small. Moreover, advisory fees may be high relative to the size of the issue.

The matching of issuers with investors is usually done by an individual or firm acting as either an agent or an advisor. In the agent relationship, the firm has authority to commit the issuer. An advisor has no such power. Regardless of whether the firm is agent or advisor, it must act prudently and disclose all pertinent information to the investor. Furthermore, the firm must avoid possible conflicts of interest. Agents, usually investment bankers, participate in negotiations between the issuer and investor, and their fee is dependent on their involvement. Agreements between the firm and all other parties should specifically state whom the firm represents as agent.

In 1974, the SEC classified what constitutes an offering exempted from its registration requirements through the issuance of Rule 146. An offering may be a private placement, under that rule, if the following minimum criteria are met:

- The securities are purchased by no more than 35 persons. A person purchasing at least $150,000 of an offering need not be counted in the number of purchasers.
- There is no general advertising and no oral or written solicitation of persons other than eligible offerees.
- The securities are offered and sold only to those persons who the issuer believes are (1) sufficiently experienced to evaluate the merits and risks of the investment or (2) able to bear the risk of the investment. Before the sale, purchasers should have the services of an experienced representative.
- Each offeree either has access to or is furnished with the type of information that would be supplied in a registration statement.
- The issuer takes certain specified steps to ensure that the securities are not resold by the purchasers, except according to the rules governing resales.

When all requirements of Rule 146 are met, an offering may still be subject to registration if it is part of a plan to evade SEC registration provisions. The restrictions placed on commercial banks for the private placement of commercial paper are discussed in ‘‘Bank Dealer Activities,’’ section 2030.

PRIVATE-PLACEMENT ACTIVITIES BY BANKS

A commercial bank’s board of directors assumes additional responsibilities when private-placement services are offered. Private-placement activities, like any other banking function, should be subject to adequate safeguards and policy considerations. When drafting a policy, the board of directors should ensure that self-dealing practices or conflict-of-interest charges cannot develop. Procedures should be developed to monitor private-placement activity whenever such services are provided by the bank or a subsidiary. Moreover, procedures should be in effect to detect any transactions that could have an adverse effect on the bank’s other functions, such as loan or trust department activities.

A bank acting as advisor or agent assumes the risk of a potential conflict-of-interest charge whenever the proceeds from the placement are used to reduce a criticized loan at the bank. Furthermore, the bank must exercise due diligence to disclose relevant information, especially if the issuer is borrowing from the bank and is experiencing financial difficulty. Although the bank may not commit funds in a private-placement transaction, the potential for financial loss or damage to its reputation does exist if the bank does not prudently deal with all parties to the transaction by disclosing all relevant facts.

The examiner should evaluate the bank's involvement and expertise in private-placement activities by reviewing policies, practices, and procedures. The examiner should also check for compliance with applicable laws and regulations and determine if any significant loss exposure or risk could result from the bank's involvement in private placement.

1. To determine if policies, practices, procedures, and internal controls for private placements are adequate and prudent.
2. To determine if bank officers and employees are operating in conformance with established guidelines.
3. To determine the scope and adequacy of the audit function.
4. To evaluate the overall effectiveness and quality of bank management in advising and completing private placements.
5. To initiate corrective action when policies, practices, procedures, or internal controls are deficient.

1. If selected for implementation, complete or update the Private Placements section of the Internal Control Questionnaire.
2. Based upon the evaluation of internal controls and the work performed by internal/external auditors, determine the scope of the examination.
3. Test for compliance with policies, practices, procedures and internal controls in conjunction with performing the remaining examination procedures. Also, obtain a listing of any deficiencies noted in the latest review done by internal/external auditors and determine if corrections have been accomplished.
4. Request the following information from appropriate personnel:
   a. A list of all private placements advised by the bank since the last examination to include:
      - Name of issuer.
      - Name of investor(s), including banks.
      - Fee and how it was determined.
      - Amount, rate, maturity of issue.
   b. A list of any funds managed by the bank or its trust department, subsidiaries or affilates that have been used to purchase private placements advised by the bank or an affiliate.
   c. A letter from bank counsel regarding legality of the bank's involvement in private placement activities.
   d. A list of the person(s) performing private placement advisory services and their previous experience.
   e. A list of investors that the bank normally deals with in placing private offerings and their stated investment requirements.
   f. A copy of the bank's standard form agreements used in private placement transactions.
   g. A list of any borrowers whose loans were partially or fully repaid from the sale of private placements advised by the bank since the last examination.
   h. A list of participations purchased or sold in loans used to fund private placements advised by the bank.
5. Review pertinent information received in performing step 4 and compare it to the list of criticized assets from the previous examination.
6. Forward list of placements to the examiner assigned loan portfolio management and request that he or she determine if any loans were made to fund the investment in the private placement.
7. Review opinions of legal counsel regarding private placements and determine if there are any material deficiencies.
8. Determine if former banking relationships exist for both issuer and investor and determine if fees charged for loans or paid on deposits are within normal bank policy.
9. Review files related to a representative sample of all placement transactions and determine if the bank evaluates both the issuer and investor in a private placement transaction, including the suitability of the investment to the stated investment requirements of the investor.
10. Confer with examiner assigned "Duties and Responsibilities of Directors" and determine if potential conflicts of interest exist between bank-advised placements and interests of directors and principal officers.
11. Discuss with appropriate officer(s) and prepare summaries in appropriate report form of:
    a. Deficiencies in policies, practices and internal controls.
    b. Any hazardous or potentially hazardous placement activities.
    c. Recommended corrective action.
12. Update the workpapers with any information that will facilitate future examinations.

Review the bank's internal controls, policies, practices and procedures for private placement activities. The bank's system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used and other pertinent information.

POLICIES

1. Does the bank, bank subsidiary(s) or affiliate(s) provide private placement advisory services?
2. Has the board of directors adopted written policies for private placement activities that:
   a. Define objectives?
   b. Provide guidelines for fee determinations based on:
      - Size of transaction?
      - Anticipated degree of difficulty or time involved?
      - Payment of negotiated fees at various stages of the transaction?

      and not solely on:
      - Deposits on balances or the profitabity of the client's other banking relationships?
      - Successful completion of the transaction?
   c. Require that bank officers act in an advisory rather than agent capacity in all negotiations?

      (An advisor will advise and assist a client, an agent has the authority to commit a client.)
   d. Recognize possible conflicts of interest and establish appropriate procedures regarding:
      - The purchase of bank-advised private placements with funds managed by the bank or an advisory affiliate?
      - Loans to investors to purchase private placements?
      - Use of proceeds of an advised placement to repay the issuer's debts to the bank?
      - Dealings with unsophisticated or non-institutional investors who have other business relationships with the bank?
   e. Require legal review of each placement prior to completion?
   f. Direct officers to obtain certified financial statements from the seller?
   g. Require distribution of certified financial statements to interested investors?
   h. Require officers to request a written statement of investment objectives or requirements from interested investors?
   i. Provide for a supervisory management review to determine if a placement is suitable for the investor?

CONCLUSION

3. Is the foregoing information considered adequate as the basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly and indicate any additional examination procedures deemed necessary.
4. Based on a composite evaluation as evidenced by answers to the foregoing questions, the degree of control by main office management is considered (adequate/inadequate).

INTRODUCTION

Congress developed a new regulatory framework in 1991 to address the problems associated with troubled depository institutions with the intent of minimizing the long-term cost to the deposit insurance fund. This legislation led to the enactment of the prompt-corrective-action statute, which is contained in the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) and added section 38 to the Federal Deposit Insurance Act (the FDI Act), as amended (12 USC 1831*o*).

Section 38 requires regulators to administer timely corrective action to banks when their capital position declines or is deemed to have declined below certain threshold levels as a result of an unsafe or unsound condition or practice. The prompt-corrective-action (PCA) framework specifies mandatory actions that regulators must take, as well as discretionary actions they must consider taking.

In order to implement PCA as it applies to state member banks, the Federal Reserve added subpart D to its Regulation H (12 CFR 208.40 to 208.45). The Federal Reserve also revised its Rules of Practice for Hearings (12 CFR 263) to establish procedures for the issuance of notices, directives, and other actions authorized under section 38 of the FDI Act and Regulation H.

PCA utilizes capital ratios to trigger specific actions that are designed to restore a bank to financial health. One of the primary sources of these ratios is the Consolidated Reports of Condition and Income (Call Report), which gives added importance to the review of a bank's records for accuracy during an examination. Under the PCA statute a bank is assigned to one of five capital categories: (1) well capitalized, (2) adequately capitalized, (3) undercapitalized, (4) significantly undercapitalized, and (5) critically undercapitalized. The law provides for increasingly stringent corrective provisions as a bank is placed in progressively lower capital categories.

PCA CATEGORIES

PCA uses the total risk-based capital, tier 1 risk-based capital, leverage, and tangible equity ratios for assigning state member banks to the five capital categories.[1] These ratios are defined in the Federal Reserve's Capital Adequacy Guidelines for State Member Banks, appendix A (Risk-Based Measure) and appendix B (Tier 1 Leverage Measure) (12 CFR 208). Determining a bank's PCA category is based upon capital ratios derived from the following: (1) the filing of a quarterly Call Report, (2) receipt of a Federal Reserve or state examination report, (3) information obtained in the application process, or (4) other reports filed by the bank under banking or securities laws.

In general, a bank is deemed to be notified of its PCA category based upon the time of its submission or receipt of—

- the Call Report, as of the date the Call Report is required to be filed,
- the Federal Reserve or state examination report, as of the third day following the date of the transmittal letter accompanying the examination report, and
- other information upon the bank's receipt of written notice by the Board that its capital category has changed.

Notifying a bank of its PCA category is important since any bank falling in the undercapitalized or lower categories is subject to certain mandatory provisions, and may be subject to certain discretionary provisions, immediately upon notification that it is undercapitalized, significantly undercapitalized, or critically undercapitalized. These mandatory and discretionary provisions are described in detail later.

Each PCA category is described below. See the table at the end of this section for a summary of framework definitions. A bank is—

- *well capitalized* if the bank has a total risk-based capital ratio of 10.0 percent or greater, a tier 1 risk-based capital ratio of 6.0 percent or

1. The total risk-based capital ratio is defined as the ratio of qualifying total capital to risk-weighted assets; the tier 1 capital ratio is the ratio of tier 1 capital to risk-weighted assets; and the tier 1 leverage ratio is the ratio of tier 1 capital to total average consolidated assets (the Federal Reserve may use period-end total consolidated total assets whenever necessary, on a case-by-case basis). The tangible equity ratio is defined as core capital elements plus cumulative perpetual preferred stock, net of all intangible assets except those amounts of mortgage servicing assets allowable in tier 1 capital. See section 3020.1 for more detailed information on the capital calculations and requirements.

greater, and a leverage ratio of 5.0 percent or greater, and the bank is not subject to an order, written agreement, capital directive, or prompt-corrective-action directive to meet and maintain a specific capital level for any capital measure.
- *adequately capitalized* if the bank has a total risk-based capital ratio of 8.0 percent or greater, a tier 1 risk-based capital ratio of 4.0 percent or greater, and a leverage ratio of 4.0 percent or greater (or a leverage ratio of 3.0 percent or greater if the bank is rated composite 1 under the CAMELS rating system in its most recent report of examination), and the bank is not experiencing or anticipating significant growth and does not meet the definition of a ''well-capitalized'' bank.
- *undercapitalized* if the bank has a total risk-based capital ratio that is less than 8.0 percent, a tier 1 risk-based capital ratio that is less than 4.0 percent, or a leverage ratio that is less than 4.0 percent (or a leverage ratio that is less than 3.0 percent if the bank is rated composite 1 under the CAMELS rating system in its most recent report of examination) and the bank is not experiencing or anticipating significant growth.
- *significantly undercapitalized* if the bank has a total risk-based capital ratio that is less than 6.0 percent, a tier 1 risk-based capital ratio that is less than 3.0 percent, or a leverage ratio that is less than 3.0 percent.
- *critically undercapitalized* if the bank has a ratio of tangible equity to total assets that is equal to or less than 2.0 percent.

On July 13, 1998, the Board approved technical amendments to its prompt-corrective-action rules (effective October 1, 1998). The definition of ''total assets,'' as used in section 208.41(i), was revised to provide the Federal Reserve with the option of using period-end rather than average total assets for state member banks. Another change was to add ''Sensitivity to market risk'' as the ''S'' in the CAMEL[S] bank rating system component. See 1998 *Fed. Reg.* 37,634 (volume 63, no. 133).

EXAMINATION CONSIDERATIONS

If it is determined that a bank is undercapitalized, significantly undercapitalized, or critically undercapitalized, examiners should discuss the PCA provisions with management during the examination. Additionally, examiners should caution banks when their capital ratios approach those found in the undercapitalized category to ensure that proposed dividend or management fee payments do not cause the bank to violate the statute. Any PCA-related comments should be noted on the ''Examination Comments and Conclusions'' page of the examination report and in the ''Summary to Directors of Examination Findings'' report. The comments should be limited to the mandatory provisions of the statute, reflect the immediacy of these provisions, and clearly indicate that the receipt of the report of examination serves as notification that the bank is subject to PCA provisions.

Capital Adequacy Page

In the report of examination, the PCA capital ratios appear on the ''Capital Adequacy'' page and are generally calculated using the bank's most recent Call Report. In situations where the impact of examination findings (for example, loan-loss-reserve adjustments or other losses) cause the bank to fall into a lower PCA category, the narrative portion of this page should explicitly state the adjusted PCA ratios and reconcile the adjustments that were made.

RECLASSIFICATION

A bank's PCA category is normally defined by its capital ratios indicated in the preceding definitions. The finding of an unsafe or unsound *condition or practice*, however, may lead to a bank's reclassification to the next lower category than it would otherwise qualify for based solely on its capital ratios. In these circumstances, the Federal Reserve may—

- reclassify a well-capitalized bank to the adequately capitalized category.
- require an adequately capitalized bank to comply with one or more supervisory actions specified by PCA as though it is an undercapitalized bank.
- impose on an undercapitalized bank one or more supervisory actions authorized for a significantly undercapitalized bank.

While the latter two actions do not strictly represent reclassifications from one category to another, they are nonetheless collectively referred to as "reclassifications" for PCA purposes.

Thus, section 38 does not automatically subject a bank that has been reclassified to the next lower capital category to the mandatory restrictions of the lower category. These mandatory restrictions can only be imposed through the use of a directive, and only those mandatory and discretionary provisions deemed appropriate by the Federal Reserve will be imposed. *A bank can only be reclassified to the next lower capital category and cannot be classified as critically undercapitalized on any basis other than its tangible equity ratio.*

The reclassification of a bank for PCA purposes may affect the bank's ability to accept brokered deposits. If a well- or adequately capitalized bank is reclassified, the bank must obtain an FDIC waiver to accept brokered deposits, regardless of its actual capital level. (Sections 3000.1 contains a detailed discussion on the capital requirements relating to brokered deposit activities.)

An "unsafe or unsound condition" is not defined in the PCA statute and assessment thereof is left to the discretion of the Federal Reserve. Banks determined to be in an unsafe or unsound condition based on the results of the most recent report of examination or Call Report will be reclassified. On the other hand, an "unsafe or unsound practice" is defined as a less-than-satisfactory rating for any of the AMELS (Asset quality, Management, Earnings, Liquidity or Sensitivity to market risk) components in the bank's most recent examination report that have not been corrected since the examination. In particular, a bank should be considered for reclassification if the imposition of the available PCA provisions would assist the return of the bank to a safe or sound condition or institute safe or sound practices.

The Federal Reserve recognizes that certain banks that are candidates for reclassification may have taken favorable actions that are consistent with the purposes of PCA. In these cases, reclassification may not be warranted—

- if the bank has raised or can demonstrate current efforts to raise enough capital to become and remain well capitalized for the foreseeable future and
- if the bank has attempted to be in substantial compliance with all provisions of any outstanding informal or formal enforcement action, if management is addressing existing problems and is considered satisfactory, and if the bank's condition is stable and shows signs of improvement.

In those instances where reclassification is determined to be appropriate, the Federal Reserve will provide the bank with a written notice specifying its intention to reclassify the bank, along with an explanation of the reasons for the downgrade. The date of the reclassification and the required PCA provisions can be made effective either at a specified future date or, under certain circumstances, immediately, at the discretion of the Federal Reserve. A bank is entitled to an appeal, including an informal hearing, challenging a reclassification following the receipt of a written notice. The appeal and hearing procedures are set out in subpart H of part 263 of the Board's Rules of Practice for Hearings in section 263.203 (12 CFR 263.203).

PCA PROVISIONS

Provisions Applicable to All Banks

While well-capitalized and adequately capitalized banks are generally not subject to any restrictions, they are subject to *two provisions that are applicable to all banks:*

- A bank may not pay dividends or make any other capital distributions that would leave it undercapitalized.[2]
- A bank may not pay a management fee to a controlling person if, after paying the fee, the bank would be undercapitalized. Management fees subject to this restriction include those relating to supervisory, executive, managerial, or policymaking functions, other than compensation to an individual in the individual's capacity as an officer or employee of the bank. This does not include fees relating to nonmanagerial services provided by the control-

2. The statute (section 38 (d)(1)(B)) requires that the Federal Reserve consult with the FDIC before approving a capital distribution under this section. Section 38 also contains a limited exception to the restrictions on capital distributions for certain types of stock redemptions that (1) the Federal Reserve has approved, (2) are made in connection with an equivalent issue of additional shares or obligations, and (3) will improve the bank s financial condition. The Federal Reserve may also impose restrictions on capital distributions on any company that controls a significantly undercapitalized bank.

ling person, such as data processing, trust activities, mortgage services, audit and accounting, property management, or similar services.

Restrictions on Advertising

The Federal Reserve prohibits a bank from advertising its PCA category. A bank may not describe itself in an advertisement or in promotional material as falling within the well-capitalized category, nor may the bank advertise that the Federal Reserve has determined it to be well capitalized. However, a bank is not restricted from advertising its capital levels or financial condition.

Provisions Applicable to Undercapitalized Banks

A bank categorized as undercapitalized is subject to several *mandatory* provisions that become effective upon notification of the bank. Under the mandatory provisions, an undercapitalized bank—

- must cease paying dividends.
- is prohibited from paying management fees to a controlling person (see the previous subsection for exceptions).
- is subject to increased monitoring by the Federal Reserve and periodic review of the bank's efforts to restore its capital.
- must file and implement a capital restoration plan generally within 45 days. Undercapitalized banks that fail to submit or implement a capital restoration plan are also subject to the provisions applicable to significantly undercapitalized banks.
- may acquire interest in a company, open any new branch offices, or engage in a new line of business only if the following three requirements are met:
  - — the Federal Reserve has accepted its capital restoration plan,
  - — any increase in total assets is consistent with the capital restoration plan, and
  - — the bank's ratio of tangible equity to assets increases during the calendar quarter at a rate sufficient to enable the bank to become adequately capitalized within a reasonable time.
- may not make any acquisition, acquire any company or depository institution, establish new branches, or engage in any new line of business unless the Federal Reserve determines that such action is consistent with its capital plan or the FDIC determines that such action will further the purposes of PCA.

In addition to the mandatory provisions, a number of *discretionary* provisions may be imposed on an undercapitalized bank. These include—

- requiring one or more of the following:
  - — That the bank sell enough additional capital or debt to ensure that it would be adequately capitalized after the sale.
  - — That the aforementioned additional capital be voting shares.
  - — That the bank accept an offer to be acquired by another institution or company, or that any company that controls the bank be required to divest itself of the bank.
- restricting transactions between the bank and its affiliates.
- restricting the interest rates paid on deposits collected by the bank to the prevailing rates paid on comparable amounts in the region where the bank is located.
- restricting the bank's asset growth or requiring the bank to reduce its total assets.
- requiring the bank or any of its subsidiaries to terminate, reduce, or alter any activity determined by the Federal Reserve to pose excessive risk to the bank.
- ordering a new election of the board of directors, dismissing certain senior executive officers, or hiring new officers.
- prohibiting the acceptance, renewal, and rollover of deposits from correspondent depository institutions.
- prohibiting any bank holding company that controls the bank from making any capital distribution, including but not limited to dividend payment, without the prior approval of the Federal Reserve.
- requiring the bank to divest or liquidate any subsidiary that is in danger of becoming insolvent and that poses a significant risk to the bank, or is likely to cause significant dissipation of its assets or earnings.
- requiring any company that controls the bank to divest or liquidate any affiliate of the bank (other than another insured depository institution) if the Federal Reserve determines that the affiliate is in danger of becoming insolvent

and poses a significant risk to the bank, or is likely to cause significant dissipation of the bank's assets or earnings.

- requiring the bank to take any other action that would more effectively carry out the purpose of PCA than the above actions.

Provisions Applicable to Significantly Undercapitalized Banks

The mandatory restrictions applicable to undercapitalized banks also apply to banks that are significantly undercapitalized. In addition, a significantly undercapitalized bank is restricted in paying bonuses or raises to senior executive officers of the bank unless it receives prior written approval from the Federal Reserve. If a bank fails to submit an acceptable capital restoration plan, however, no such bonuses or raises may be paid until an acceptable plan has been submitted.

The Federal Reserve, as directed by the PCA statute, must take the following actions unless it is determined that these actions would not further the purpose of PCA:

- Require one or more of the following:
  - — That the bank sell enough additional capital or debt to ensure that it would be adequately capitalized after the sale.
  - — That the aforementioned additional capital be voting shares.
  - — That the bank accept an offer to be acquired by another institution or company, or that any company that controls the bank be required to divest itself of the bank.
- Restrict the bank's transactions with affiliates.
- Restrict the interest rates paid on deposits collected by the bank to the prevailing rates paid on comparable amounts in the region where the bank is located.

In addition to these mandatory provisions, one or more of the discretionary provisions for undercapitalized banks must be imposed on a significantly undercapitalized bank. Moreover, other measures (including the provisions for critically undercapitalized banks) may be required if the Federal Reserve determines that such actions will advance the purposes of PCA.

Provisions Applicable to Critically Undercapitalized Banks

A critically undercapitalized bank must be placed in conservatorship (with the concurrence of the FDIC) or receivership within 90 days, unless the Federal Reserve and the FDIC concur that other action would better achieve the purposes of PCA. The decision to defer placing a critically undercapitalized bank in conservatorship or receivership must be reviewed every 90 days, and an explanation must be provided about why deferring this decision would better achieve the purposes of the statute (preventing losses to the bank insurance fund).

A bank must be placed in receivership if it continues to be critically undercapitalized on average[3] during the fourth calendar quarter following the period that it initially became critically undercapitalized, unless the Federal Reserve, with the FDIC's concurrence, determines that—

- the bank has a positive net worth.
- the bank has been in substantial compliance with its capital restoration plan since the date of the plan's approval.
- the bank is profitable or has a sustainable upward trend in earnings.
- the bank has reduced its ratio of nonperforming loans to total loans.
- the Chairman of the Federal Reserve and the chairperson of the FDIC both certify that the bank is viable and not expected to fail.

Critically undercapitalized banks are also prohibited, beginning 60 days after becoming critically undercapitalized, from making any payment of principal or interest on subordinated debt issued by the bank without the prior approval of the FDIC. Unpaid interest, however, may continue to accrue on subordinated debt under the terms of the debt instrument. The FDIC is also required, at a minimum, to prohibit a critically undercapitalized bank from doing any of the following without the prior written approval of the FDIC—

- entering into any material transaction not in the usual course of business. Such activities

3. This is determined by adding the sum of the total tangible equity ratio at the close of business on each day during this quarter and dividing that sum by the number of business days in that quarter.

include any investment, expansion, acquisition, sale of assets, or other similar action where the bank would have to notify the Federal Reserve.
- extending credit for any highly leveraged transaction.
- amending the bank's charter or bylaws, except to the extent necessary to carry out any other requirement of any law, regulation, or order.
- making any material change in accounting methods.
- engaging in any covered transaction under section 23A(b) of the Federal Reserve Act.
- paying excessive compensation or bonuses.
- paying interest on new or renewed liabilities that would increase the bank's weighted average cost of funds to a level significantly exceeding the prevailing rates of interest paid on insured deposits in the bank's normal market area.

Capital Restoration Plans

A bank that is undercapitalized, significantly undercapitalized, or critically undercapitalized must submit a capital restoration plan to the Federal Reserve. The plan should aim to restore the bank's capital to at least the minimum capital levels required for adequately capitalized banks. This plan must be submitted in writing and specify—

- the steps the bank will take to become adequately capitalized.
- the levels of capital the bank expects to attain each year that the plan is in effect.
- how the bank will comply with the restrictions and requirements imposed on it under section 38.
- the types and levels of activities in which the bank will engage.
- any other information required by the Federal Reserve.

A capital restoration plan *cannot be accepted unless* the plan—

- contains the information required in the preceding five points.
- is based on realistic assumptions and is likely to succeed in restoring the bank's capital.
- would not appreciably increase the risk (including credit risk, interest-rate risk, and other types of risk) to which the bank is exposed.
- contains a guarantee from each company that controls the bank, specifying that the bank will comply with the plan until it has been adequately capitalized on average during each of four consecutive calendar quarters, and each company has provided appropriate assurances of performance. (See the subsequent subsection, Capital Restoration Plan Guarantee, for additional information.)

Submission and Review of Capital Plans

The Federal Reserve has established rules regarding a uniform schedule for the filing and review of capital restoration plans. These rules require a bank to submit a capital restoration plan within 45 days after the bank has received notice, or has been deemed to have been notified, that it is undercapitalized, significantly undercapitalized, or critically undercapitalized. The Federal Reserve may change this period in individual cases, provided it notifies the bank that a different schedule has been adopted. PCA also requires the Federal Reserve to—

- review each capital restoration plan within 60 days of submission of the plan unless it extends the review time.
- provide written notice to the bank about whether it has approved or rejected the capital plan.
- provide a copy of each acceptable capital restoration plan, and amendments thereto, to the FDIC within 45 days of accepting the plan.

There are two cases where a capital restoration plan may not be required:

- When a bank has capital ratios consistent with those corresponding to the adequately capitalized category but, due to unsafe or unsound conditions or practices, has been reclassified to the undercapitalized category. (If the Federal Reserve requires a plan solely due to such a reclassification, the plan should specify the steps the bank will take to correct the unsafe or unsound condition or practice.)
- When a bank's capital category changes, but the bank is already operating under a capital restoration plan accepted by the Federal Reserve.

The Federal Reserve will examine the circumstances of each of the above cases to determine whether a revised plan must be submitted.

Capital Restoration Plan Guarantee

The Federal Reserve cannot approve a capital restoration plan unless each company that controls the bank has guaranteed the bank's compliance with the plan and has provided reasonable assurances of performance. The Federal Reserve will consider on a case-by-case basis the appropriate type of guarantee for multi-tier holding companies, or parent holding companies that are shell companies or that have limited resources. A guarantee that is backed by a contractual pledge of resources from a parent company may satisfy the requirements of section 38, particularly in situations involving the ownership of an insured bank by a foreign holding company through a wholly owned domestic shell holding. In other situations, a third-party guarantee made by a party with adequate financial resources may be satisfactory.

PCA also contains several provisions that clarify the capital restoration plan guarantee:

- Limitation on liability. The aggregate amount of liability under the guarantee for all companies that control a specific bank is limited to the lesser of (1) an amount equal to 5 percent of the bank's total assets, or (2) the amount necessary to restore the relevant capital ratios of the bank to the level required for the bank to be categorized as adequately capitalized.
- Limitation on duration. The guarantee and limit on liability expires after the Federal Reserve notifies the bank that it has remained adequately capitalized for each of the previous four consecutive calendar quarters.
- Collection of guarantee. Each company that controls a given bank is jointly and severally liable for the guarantee.
- Failure to provide a guarantee. A bank will be treated as if it had not submitted an acceptable capital restoration plan if its capital plan does not contain the required guarantee.
- Failure to perform under a guarantee. A bank will be treated as if it failed to implement the capital restoration plan if any company that controls the bank fails to perform its guarantee.

Failure to Submit an Acceptable Capital Plan

An undercapitalized bank that fails to submit or implement, in any material respect, an acceptable capital restoration plan within the required period is subject to the same provisions applicable to a bank that is significantly undercapitalized. If a bank's capital restoration plan is rejected, the bank is required to submit a new capital plan within the time period specified by the Federal Reserve. During the period following notice of the rejection, and before Federal Reserve approval of a new or revised capital plan, the bank is treated in the same manner as a significantly undercapitalized bank.

ISSUANCE OF PCA DIRECTIVES

The Federal Reserve must provide a state member bank, or company controlling a state member bank (company), a written notice of proposed action under section 38 (referred to as a directive), unless the circumstances of a particular case indicate that immediate action is necessary to serve the purpose of PCA. These directives are issued for reasons such as reclassifying a bank and implementing discretionary provisions, the latter of which includes the dismissal of directors or senior executive officers.

A notice of intent to issue a directive should include—

- a statement of the bank's capital measures and levels.
- a description of the restrictions, prohibitions, or affirmative actions that the Federal Reserve proposes to impose or require.
- the proposed date when such restrictions or prohibitions would be effective or the proposed date for completion of such affirmative actions.
- the date by which the bank or company subject to the directive may file with the Federal Reserve a written response to the notice.

When a directive becomes effective at a future date, the Federal Reserve must provide the bank or company an opportunity to appeal the directive before taking final action. This requires the bank to submit information relevant to the decision within the time period set by the Federal Reserve, which must be at least 14 calendar days from the date of the notice, unless the Federal Reserve determines that a shorter period is appropriate in light of the financial condition of the bank or other relevant circumstances.

In the case of a directive that is immediately effective upon notification of the bank, the Federal Reserve's rules provide an opportunity for the bank or company to seek an expedited modification or rescission of the directive. A bank or company that appeals a directive effective immediately is required to file a written appeal within 14 days of receiving the notice, and the Board of Governors will consider the appeal within 60 days of receiving it. During the period that the appeal is under review the directive remains in effect, unless the effectiveness of the directive is delayed by the Federal Reserve.

Dismissal of Directors or Senior Executive Officers

The Federal Reserve's rules establish a special procedure permitting an opportunity for senior executive officers and directors dismissed from a state member bank as a result of a PCA directive to petition for reinstatement. A director or senior executive officer who is required to be dismissed in compliance with a Federal Reserve directive may have the dismissal reviewed by filing, within 10 days, a petition for reinstatement with the Federal Reserve. The petitioner will also be given the opportunity to submit written materials in support of the petition and to appear at an informal hearing before representatives of the Federal Reserve. The date for the hearing and for the ultimate decision follows the same timeframe as that indicated for the appeals process in the preceding paragraph.

Enforcement of Directives

PCA directives may be enforced in the federal courts, and may cause any bank, company, or bank-affiliated party that violates the directive to be subject to civil money penalties or other enforcement actions. The failure of a bank to implement a capital restoration plan, or the failure of a company having control of a state member bank to fulfill a guarantee that the company has given in connection with a capital plan accepted by the Federal Reserve, could subject the bank or company or any of their bank-affiliated parties to a civil money penalty assessment.

TABLE—SUMMARY OF SPECIFICATIONS OF CAPITAL CATEGORIES FOR PROMPT CORRECTIVE ACTION

Capital category	*Total risk-based ratio*	*Tier 1 risk-based ratio*	*Leverage ratio*	*Additional criteria*
Well capitalized	10% or above; plus	6% or above; plus	5% or above; plus	is not subject to a capital directive to meet a specific level for any capital measure
Adequately capitalized	8% or above; plus	4% or above; plus	4% or above;[1] plus	does not meet the definition of well capitalized
Under-capitalized	under 8%; or	under 4%; or	under 4%[2]	
Significantly under-capitalized	under 6%; or	under 3%; or	under 3%	
Critically under-capitalized	not applicable	not applicable	not applicable	can only be assigned to this category if the ratio of tangible equity to total assets is equal to or less than 2%[3]

1. Three percent or above for banks rated composite 1 in their most recent report of examination and that are not experiencing or anticipating significant growth.

2. Under 3 percent for banks rated composite 1 in their most recent report of examination and that are not experiencing or anticipating significant growth.

3. Tangible equity is defined as core capital elements plus cumulative perpetual preferred stock, net of all intangible assets except those amounts of mortgage-servicing assets allowable into tier 1 capital.

Prompt Corrective Action
Examination Objectives
Effective date November 1994

1. To determine if prompt-corrective-action (PCA) provisions are necessary.
2. To determine if the policies, practices, and procedures are in place to ensure compliance with PCA mandatory and discretionary provisions.
3. To ensure that undercapitalized, significantly undercapitalized, and critically undercapitalized banks have effective capital restoration plans that comply with PCA.

1. During on-site examinations, validate the state member bank's capital levels, risk-weighted assets, and capital ratios in compliance with primary capital provisions of section 38 of the Federal Deposit Insurance Act (FDI Act) and the Federal Reserve's respective capital adequacy rules. (See section 3020.1 and 12 CFR 208, appendices A, B, and E.) Verify that the bank's—
   a. capital instruments are appropriate for inclusion in tier 1 or tier 2 capital.
   b. assets were properly risk weighted and that the appropriate credit equivalent measure (for example, the credit-conversion factors, credit-rating factors, etc.) were assigned for the bank's off-balance-sheet assets or transactions.
2. When a state member bank is considered undercapitalized, significantly undercapitalized, or critically undercapitalized, discuss with the bank's management the prompt corrective action restrictions under Section 38 of the FDI Act and the Board's Regulation H (12 CFR 208, subpart D)
3. When a state member bank is operating with an amount of consolidated capital that is near the undercapitalized levels, caution the board of directors and senior management about their ensuring that any proposed dividend or management fee payments do not cause the bank to violate section 38 of the FDI Act.
4. When the impact of the bank's examination findings (for example, loan-loss-reserve adjustments or other losses) will cause the bank to fall into a lower prompt-corrective-action category, explicitly state in the narrative portion of the Capital examination report page the adjusted prompt-corrective-action capital ratios with a clear account of the adjustments that were made to the quarter-end or period-end ratios.
5. Include in the ''Comments and Conclusions'' report page of the state member bank examination report and the Director's Summary any comments regarding the applicability of section 38 and Regulation H pertaining to prompt corrective action. With regard to prompt corrective action, limit the comments to the mandatory restrictions of the statute and the immediacy of those provisions. State that the receipt of the state member bank examination report serves as notification that the bank is subject to prompt corrective action.

The Board's long-standing policy on real estate appraisals emphasizes the importance of sound appraisal policies and procedures in a bank's real estate lending activity. In December 1987, the Board and the other banking regulatory agencies jointly adopted guidelines for real estate appraisal policies and review procedures. With the passage of title XI (12 USC 3331) of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), the Board as well as the other federal financial regulatory agencies adopted regulations in August 1990 on the performance and use of appraisals by federally regulated financial institutions. The Board and the other agencies amended the regulations on June 7, 1994. (See SR-94-35.) In September 1992, the Board issued revised guidelines for real estate appraisal and evaluation programs, which were reissued on October 27, 1994. (See SR-94-55.) The Board's real estate lending and appraisal standards are found in Regulation H, subpart E, 12 CFR 208.50–51. The standards primarily focus on the responsibilities of the bank's board of directors for developing and issuing lending policies. The Board and the other federal banking and thrift regulatory agencies jointly issued on October 27, 2003, the statement on Independent Appraisal and Evaluation Functions. (See SR-03-18. See also SR-95-16, SR-95-27, and SR-99-26.)

The intent of title XI and the Board's regulation is to protect federal financial and public policy interests in real estate–related financial transactions that require the services of an appraiser in connection with federally related transactions. The statute also requires that real estate appraisals be in writing and be performed in accordance with uniform standards and by individuals with demonstrated competency whose professional conduct is subject to effective supervision. In this regard, each state may establish a program for certifying and licensing real estate appraisers who are qualified to perform appraisals in connection with federally related transactions. Additionally, title XI designated the Appraisal Qualifications Board and the Appraisal Standards Board of the Appraisal Foundation, a nonprofit appraisal industry group, as the authority for establishing qualifications criteria for appraiser certification and standards for the performance of an appraisal. However, the statute left to the states the authority to establish qualification standards for licensing. The statute established the Appraisal Subcommittee of the Federal Financial Institutions Examination Council (FFIEC). It was designated to monitor the requirements established to meet the intent of title XI. If the Appraisal Subcommittee issues a finding that the policies, practices, or procedures of a state are inconsistent with title XI, the services of licensed or certified appraisers from that state may not be used in connection with federally related transactions.

Effective Date

The Board's appraisal regulation[1] (Regulation H, 12 CFR 208) requires that appraisals performed in connection with federally related transactions after the effective date of August 9, 1990, comply with the regulation. Appraisals for real estate–related financial transactions entered into before this date do not have to comply with the regulation. However, the bank would have had to adhere to the Board's supervisory guidelines, issued in 1987, for such real estate appraisals as well as to safe and sound banking practices. Transactions are deemed to have been entered into and a loan is deemed to have been originated if there was a binding commitment to perform before the effective date. The requirement to use a state-certified or -licensed appraiser was effective December 31, 1992. States had the flexibility to adopt an earlier implementation date for their requirements that an appraiser be certified or licensed to perform an appraisal within the state. Financial institutions doing business in a state that had an earlier effective date for mandatory use of a certified or licensed appraiser than the federally mandated effective date would have had to abide by the state law.

BANK APPRAISAL AND EVALUATION POLICY

An institution's board of directors is responsible for adopting policies and procedures that establish effective real estate appraisal and evaluation

1. Subpart E of Regulation H prescribes standards for real estate lending to be used by member banks in adopting internal real estate lending policies. The standards applicable to appraisals rendered in connection with federally related transactions entered into by member banks are set forth in 12 CFR 225, subpart G (Regulation Y).

programs. Analyzing real estate collateral at a loan's inception and over its life requires a sufficient understanding of appraisals and evaluations in order to fully assess credit risk. While the appraisal plays an important role in the loan-approval process, the bank should not unduly rely on the value of collateral in lieu of an adequate assessment of the borrower's repayment ability. However, when a credit becomes troubled, the primary source of repayment often shifts from the borrower's capacity to repay to the value of the collateral. For these reasons, it is important that banks have sound appraisal policies and procedures.

Appraisal and Evaluation Program

An institution's appraisal and evaluation program should be tailored to the institution's size, location, and the nature of its real estate market and attendant real estate–related activity. The program should establish prudent standards and procedures that ensure written appraisals or evaluations are obtained and analyzed for real estate–related financial transactions before the bank makes its final credit decision.

The bank's appraisal and evaluation program should also establish the manner in which the institution selects, evaluates, and monitors individuals who perform real estate appraisals or evaluations. The key elements of the institution's program should ensure that individuals are fairly considered for the assignment, possess the requisite expertise to satisfactorily complete the assignment, hold the proper state certification or license, if applicable, and are capable of rendering a high-quality written appraisal or evaluation.

Compliance Procedures

To ensure the bank is complying with the regulation and supervisory guidelines, the bank should have established regulatory compliance procedures for all appraisals and evaluations. The compliance review may be part of a loan officer's overall credit analysis and may take the form of a narrative or a checklist. The individual who prepared the appraisal or evaluation should take corrective action for noted deficiencies. Unreliable appraisals or evaluations should be replaced before the final credit decision.

Additionally, a bank should have comprehensive analytical procedures that focus on certain types of loans, such as large-dollar credits, loans secured by complex or specialized properties, nonresidential construction loans, or out-of-area real estate. These comprehensive analytical procedures should be designed to verify the appropriateness of the methods and approaches used and to assess the reasonableness of the analysis, opinions, and conclusions. The bank should maintain formal documentation or evidence of the review. An individual performing the review, either an employee of the bank or an outside consultant, should have real estate–related training or experience and be independent of the transaction. The individual may not change the appraisal's or evaluation's estimate of value as a result of the review unless that person is appropriately licensed or certified and performs the review in accordance with the review procedures in Standard 3 of the Uniform Standards of Professional Appraisal Practice (USPAP).

FEDERALLY RELATED FINANCIAL TRANSACTIONS

A federally related transaction is defined in the statute (12 USC 3350(4)) as a real estate–related financial transaction that (1) a federal financial institutions regulatory agency or any regulated institution engages in or contracts for and (2) requires the services of an appraiser. The statute defines a real estate–related financial transaction as any transaction involving the sale, lease, purchase, investment in or exchange of real property, including interests in property, or the financing thereof; the refinancing of real property or interests in real property; or the use of real property or interests in property as security for a loan or investment, including mortgage-backed securities. (See 12 USC 3350(5).)

The Board recognizes that not all real estate–related financial transactions require the services of an appraiser. In this regard, the Board has determined that certain categories of real estate–related financial transactions do not require the services of a certified or licensed appraiser and as such are not considered federally related transactions. However, for certain transactions that do not require a certified or licensed appraisal, an evaluation of the underlying collateral is required under the Board's supervisory guidelines.

Transaction Value

The transaction value is defined as the amount of the loan or extension of credit under consideration. For a pool of loans or a mortgage-backed security, the transaction value is the amount of each individual loan. In determining transaction value, the senior and junior debt are considered separate transactions under the appraisal rule. However, a series of related transactions will be considered as one transaction if it appears that an institution is attempting to avoid the appraisal requirement by structuring the transactions below the appraisal threshold.

Transactions Not Requiring the Services of a Licensed or Certified Appraiser

An appraisal performed by a state-certified or -licensed appraiser is required for all real estate–related financial transactions except those in which—

- the transaction value is $250,000 or less;
- a lien on real estate has been taken as collateral in an abundance of caution;
- the transaction is not secured by real estate;
- a lien on real estate has been taken for purposes other than the real estate's value;
- the transaction is a business loan that has a transaction value of $1 million or less and is not dependent on the sale of, or rental income derived from, real estate as the primary source of repayment;
- a lease of real estate is entered into, unless the lease is the economic equivalent of a purchase or sale of the leased real estate;
- the transaction involves an existing extension of credit at the lending institution, provided that there has been no obvious and material change in market conditions or physical aspects of the property that threatens the adequacy of the institution's real estate collateral protection after the transaction, even with the advancement of new monies, or there is no advancement of new monies, other than funds necessary to cover reasonable closing costs;
- the transaction involves the purchase, sale, investment in, exchange of, or extension of credit secured by a loan or interest in a loan, pooled loans, or interests in real property, including mortgage-backed securities, and each loan or interest in a loan, pooled loan, or real property interest met the Board's regulatory requirements for appraisals at the time of origination;
- the transaction is wholly or partially insured or guaranteed by a U.S. government agency or U.S. government–sponsored agency;
- the transaction either qualifies for sale to a U.S. government agency or U.S. government–sponsored agency, or involves a residential real estate transaction in which the appraisal conforms to the Federal National Mortgage Association or Federal Home Loan Mortgage Corporation appraisal standards applicable to that category of real estate;
- the regulated institution is acting in a fiduciary capacity and is not required to obtain an appraisal under other law; or
- the Board determines that the services of an appraiser are not necessary to protect federal financial and public policy interests in real estate–related financial transactions or to protect the safety and soundness of the institution.

For transactions that do not require title XI appraisals because they are below the appraisal threshold or because they qualify for the $1 million or less business-loan exemption or the existing extension-of-credit exemption, the Board still requires an appropriate evaluation of the real property collateral that is consistent with safe and sound banking practices.

The Board reserves the right to require a bank to obtain an appraisal on an exempt transaction whenever it is necessary to address safety-and-soundness concerns. Whether a bank will be required to obtain an appraisal for a particular transaction or an entire group of credits will depend on the condition of the bank. For example, if a bank is in troubled condition that is attributable to underwriting problems in its real estate loan portfolio, the Board may require the bank to obtain an appraisal for all *new* transactions below the threshold. However, regardless of a bank's condition, an examiner may require a bank to obtain an appraisal for a particular real estate–related transaction to address safety-and-soundness concerns.

Obtaining an Appraisal

The bank or its agent is responsible for engaging the appraiser and obtaining the appraisal in sufficient time to be analyzed before the bank arrives at its final credit or other decision. (See the discussion below under the ''Selection of an Appraiser'' heading.) A bank may not accept an appraisal prepared for a potential borrower as the appraisal for a federally related transaction. However, a bank may use an appraisal prepared by an appraiser engaged directly by another regulated or nonregulated financial services institution as long as the bank has established procedures for reviewing appraisals, the review indicates that the appraisal meets the regulation, and the review is documented in writing.

For a multiphased development or construction loan, the appraisal of an earlier phase cannot be used for a new phase due to the change in risk to the bank. However, if the original appraisal was prepared for all phases of the project, the bank may use the project appraisal if the appraisal's value for the new phase is still valid at the time the bank extends the additional credit.

APPRAISAL REQUIREMENTS

The objective of an appraisal is to communicate the appraiser's reasoning and conclusions in a logical manner so that the reader is led to the appraiser's opinion of market value. The contents of appraisals should conform to the standards of the Board's appraisal regulation and the current Uniform Standards of Professional Appraisal Practice (USPAP), promulgated by the Appraisal Standards Board (ASB) of the Appraisal Foundation. The actual form, length, and content of appraisal reports may vary, depending on the type of property being appraised and the nature of the assignment. Standard forms completed in compliance with the rule and USPAP are also acceptable. A bank is responsible for obtaining an appraisal that is appropriate for the particular federally related transaction. The appraisal must consider the risk and complexity of the transaction. The level of detail should be sufficient to understand the appraiser's analysis and opinion of the property's market value. In accordance with USPAP, appraisers are responsible for establishing the scope of work to perform in rendering an opinion of the property's market value and have available three different reporting options. The appraiser's scope of work should be consistent with the valuation methodology employed for similar property types, market conditions, and transactions.

Interagency Statement on the 2006 USPAP

The federal banking and thrift agencies[2] issued an interagency statement, The 2006 Revisions to Uniform Standards of Professional Appraisal Practice, on June 22, 2006. (See SR-06-9.) The statement provides an overview of the USPAP revisions and the ramifications of the revisions to regulated institutions' compliance with the agencies' appraisal regulations.

The ASB revised the USPAP in 2006, effective July 1, 2006, and incorporated certain prominent revisions,[3] including a new Scope of Work Rule. It also deleted the Departure Rule and its associated terminology (such as ''binding'' and ''specific'' requirements and ''complete'' and ''limited'' appraisals). The Scope of Work Rule clarifies the standards for the type and extent of research and analysis performed by the appraiser in an appraisal assignment. The ASB noted that the appraisal process was not changed and that there is a greater emphasis on the appraiser's process of problem identification and the development of an appropriate scope of work.

Under the USPAP's Scope of Work Rule, an appraiser must determine an appropriate scope of work that should be performed to produce ''credible assignment results.'' According to the USPAP Advisory Opinion 29, credible assignment results depend on the scope of work meeting or exceeding both (1) the expectations of parties who are regularly intended users for similar assignments and (2) what an appraiser's peers' actions would be in performing the same or a similar assignment. Further, the appraisal report must contain sufficient disclosure to allow intended users to understand the scope of work performed. (Appraisers may continue to label

2. The Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the National Credit Union Administration.

3. The 2006 USPAP and other ASB documents are available on the Appraisal Foundation web site at www.appraisalfoundation.org/s_appraisal/sec.asp?CID=3&DID=3.

appraisal reports as self-contained, summary, or restricted use.)

A bank may use an engagement letter in ordering an appraisal to facilitate communications with the appraiser and to document the expectations of each party to the appraisal assignment. To determine an appraisal's acceptability, a bank should review the report to assess the adequacy of the appraiser's scope of work given the intended use of the appraisal. In accordance with the Board's appraisal regulation, a bank must determine that the appraisal report contains sufficient information and analysis to support the credit decision.

Appraisal Standards

The statute prescribes the minimum standard for appraisals performed in connection with federally related transactions as those standards set forth in USPAP as well as any other appropriate standards that the Board deems necessary. At a minimum, the Board's appraisal regulation requires that an appraisal—

- conform to generally accepted appraisal standards as evidenced by USPAP, unless principles of safe and sound banking require compliance with stricter standards;
- be written and contain sufficient information and analysis to support the bank's decision to engage in the transaction;
- analyze and report appropriate deductions and discounts for proposed construction or renovation, partially leased buildings, nonmarket lease terms, and tract developments with unsold units;
- be based upon the definition of market value as set forth in the regulation; and
- be performed by state-licensed or -certified appraisers in accordance with the requirements in the regulation.

From the appraiser's perspective, these regulatory appraisal requirements are ''supplemental standards'' to USPAP. If an appraiser knowingly fails to comply with supplemental standards, the appraiser is in violation of the USPAP Ethics Rule. When ordering appraisals, a bank should convey to an appraiser that these supplemental standards remain applicable.

Prior to July 1, 2006, the Board's appraisal regulation permitted banks to use appraisals prepared in accordance with the former USPAP Departure Provision. The Departure Provision permitted limited exceptions to ''specific guidelines'' in USPAP. Under the former Departure Provision, the appraisal amendment would be considered a complete or limited appraisal. In a complete appraisal assignment, an appraiser must meet all USPAP standards and guidelines in estimating market value. In a limited appraisal assignment, the appraiser elects to depart from certain specific guidelines by invoking the Departure Provision.

Appraisal Reports

The appraisal report usually includes a disclosure of sales history and an opinion as to the highest value and best use of the property. After preparing a report, appraisers must certify that—

- statements of fact are true and correct;
- limiting conditions have been disclosed;
- they have no interest (present or future) in the transaction or property;
- compensation is not contingent on rendering a specified value;
- they have complied with USPAP;
- an inspection of the property was or was not performed; and
- assistance was or was not received in the preparation of the appraisal.

There are three different report formats that can be used to report the results of an appraisal assignment: a self-contained report, a summary report, and a restricted report. Since USPAP requires all appraisal reports to encompass all aspects of the assignment, differences among these reports relate to the degree of detail presented. The self-contained appraisal report provides the most detail; the summary appraisal report condenses the information; and the restricted appraisal report contains a minimal presentation of information with the supporting details maintained in the appraiser's work files.

The restricted report is not appropriate for a significant number of federally related transactions because the minimal amount of information limits the usefulness of the document for underwriting, compliance, and other decision-making purposes. However, it might be appropriate to use this type of appraisal report when providing ongoing collateral monitoring of a bank's real estate transactions and under other circumstances when a bank's program requires an evaluation.

Appraisal Content

The appraisal must reflect a market value of the real estate. The regulation defines market value as the most probable price that a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller each acting prudently and knowledgeably, and assuming the price is not affected by undue stimulus.

Implicit in this definition is the consummation of a sale as of a specified date and the passing of title from the seller to the buyer under conditions whereby—

- buyer and seller are typically motivated;
- both parties are well informed or well advised, and acting in what they consider their own best interests;
- a reasonable time is allowed for exposure in the open market;
- payment is made in terms of cash in U.S. dollars or in terms of financial arrangements comparable thereto; and
- the price represents the normal consideration for the property sold unaffected by special or creative financing or sales concessions granted by anyone associated with the sale.

To properly underwrite a construction loan, a bank may need to know a prospective value of a property in addition to the market value as of the date of the appraisal. A prospective value is based upon events yet to occur, such as completion of construction or renovation, reaching stabilized occupancy, or some other event yet to be determined. Thus, more than one value may be reported in an appraisal as long as all values are clearly described and reflect the projected dates when future events could occur.

APPRAISAL VALUATION APPROACHES

The appraiser typically utilizes three market-value approaches to analyze the value of property:

- cost approach
- market data or direct comparable sales approach
- capitalization of income approach

All three approaches have particular merits depending upon the type of real estate being appraised. For single-family residential property, the cost and comparable sales approaches are most frequently used since the common use of the property is the personal residence of the owner. However, if a single-family residential property is intended to be used as a rental property, the appraiser would have to consider the income approach as well. For special-use commercial properties, the appraiser may have difficulty obtaining sales data on comparable properties and may have to base the value estimate on the cost and capitalization of income approaches.

If an approach is not used in the appraisal, the appraiser should disclose the reason the approach was not used and whether this affects the value estimate.

Cost Approach

In the cost approach to value estimation, the appraiser obtains a preliminary indication of value by adding the estimated depreciated reproduction cost of the improvements to the estimated land value. This approach is based on the assumption that the reproduction cost is the upper limit of value and that a newly constructed building would have functional and mechanical advantages over an existing building. The appraiser would evaluate any functional depreciation (disadvantages or deficiencies) of the existing building in relation to a new structure.

The cost approach consists of four basic steps: (1) estimate the value of the land as though vacant, (2) estimate the current cost of reproducing the existing improvements, (3) estimate depreciation and deduct from the reproduction cost estimate, and (4) add the estimate of land value and the depreciated reproduction cost of improvements to determine the value estimate.

Market Data or Direct Comparable Sales Approach

The essence of the market data or direct comparable sales approach is to determine the price at which similar properties have recently sold on the local market. Through an appropriate adjustment for differences in the subject property and the selected comparable properties, the appraiser estimates the market value of the subject property based on the sales price of the comparable properties. The process used in determining the degree of comparability of two or more properties involves judgment about their similarity with respect to age, location, condition, construction, layout, and equipment. The sales price or list price of those properties deemed most comparable tend to set the range for the value of the subject property.

Capitalization of Income Approach

The income approach estimates the project's expected income over time converted to an estimate of its present value. The income approach is typically used to determine the market value of income-producing properties such as office buildings, apartment complexes, hotels, and shopping centers. In the income approach, the appraiser can use several different capitalization or discounted cash-flow techniques to arrive at a market value. These techniques include the band-of-investments method, mortgage-equity method, annuity method, and land-residual technique. Which technique is used depends on whether there is project financing, whether there are long-term leases with fixed-level payments, and whether the value is being rendered for a component of the project such as land or buildings.

The accuracy of the income-approach method depends on the appraiser's skill in estimating the anticipated future net income of the property and in selecting the appropriate capitalization rate and discounted cash flow. The following data are assembled and analyzed to determine potential net income and value:

- Rent schedules and the percentage of occupancy for the subject property and for comparable properties for the current year and several preceding years. This provides gross rental data and shows the trend of rentals and occupancy, which are then analyzed by the appraiser to estimate the gross income the property should produce.
- Expense data such as taxes, insurance, and operating costs being paid from revenues derived from the subject property and by comparable properties. Historical trends in these expense items are also determined.
- A timeframe for achieving stabilized, or normal, occupancy and rent levels (also referred to as a holding period).

Basically, the income approach converts all expected future net operating income into present-value terms. When market conditions are stable and no unusual patterns of future rents and occupancy rates are expected, the direct capitalization method is used to value income properties. This method calculates the value of a property by dividing an estimate of its stabilized annual income by a factor called a cap rate. Stabilized income is generally defined as the yearly net operating income produced by the property at normal occupancy and rental rates; it may be adjusted upward or downward from today's actual market conditions. The cap rate—usually defined for each property type in a market area—is viewed by some analysts as the required rate of return stated as a percent of current income.

The use of this technique assumes that the use of either the stabilized income or the cap rate accurately captures all relevant characteristics of the property relating to its risk and income potential. If the same risk factors, required rate of return, financing arrangements, and income projections are used, explicit discounting and direct capitalization should yield the same results.

For special-use properties, new projects, or troubled properties, the discounted cash flow (net present value) method is the more typical approach to analyzing a property's value. In this method, a timeframe for achieving a stabilized, or normal, occupancy and rent level is projected. Each year's net operating income during that period is discounted to arrive at the present value of expected future cash flows. The property's anticipated sales value at the end of the period until stabilization (its terminal or reversion value) is then estimated. The reversion value represents the capitalization of all future income streams of the property after the projected occupancy level is achieved. The terminal or reversion value is then discounted to its present value and added to the discounted income stream to arrive at the total present market value of the property.

Most importantly, the analysis should be based on the ability of the project to generate income over time based upon reasonable and supportable assumptions. Additionally, the discount rate should reflect reasonable expectations about the rate of return that investors require under normal, orderly, and sustainable market conditions. For further discussion, see the ''Real Estate Loans'' section.

Value Correlation

The three value estimates—cost, market, and income—must be evaluated by the appraiser and correlated into a final value estimate based on the appraiser's judgment. Correlation does not imply averaging the value estimates obtained by using the three different approaches. Where these value estimates are relatively close together, correlating them and setting the final market value estimate presents no special problem. It is in situations where widely divergent values are obtained by using the three appraisal approaches that the examiner must exercise judgment in analyzing the results and determining the estimate of market value.

Other Definitions of Value

While the Board's appraisal regulation requires that the appraisal contain the market value of the real estate collateral, there are other definitions of value that are encountered in appraising and evaluating real estate transactions. These include the following.

Fair Value. This is an accounting term that is generally defined as the amount in cash or cash-equivalent value of other consideration that a real estate parcel would yield in a current sale between a willing buyer and a willing seller (the selling price), that is, other than in a forced or liquidation sale.[4] According to accounting literature, fair value is generally used in valuing assets in nonmonetary transactions, troubled debt restructuring, quasi-reorganizations, and business combinations accounted for by the purchase method. An accountant generally defines fair value as market value; however, depending on the circumstances, these values may not be the same for a particular property.

Investment Value. This is based on the data and assumptions that meet the criteria and objectives of a particular investor for a specific property or project. The investor's criteria and objectives are often substantially different from participants' criteria and objectives in a broader market. Thus, investment value can be significantly higher than market value in certain circumstances and should not be used in credit analysis decisions.

Liquidation Value. This assumes that there is little or no current demand for the property but the property needs to be disposed of quickly, resulting in the owner sacrificing potential property appreciation for an immediate sale.

Going-Concern Value. This is based on the value of a business entity rather than the value of just the real estate. The valuation is based on the existing operations of the business that has a proven operating record, with the assumption that the business will continue to operate.

Assessed Value. This represents the value on which a taxing authority bases its assessment. The assessed value and market value may differ considerably due to tax assessment laws, timing of reassessments, and tax exemptions allowed on properties or portions of a property.

Net Realizable Value (NRV). This is recognized under generally accepted accounting principles as ''the estimated selling price in the ordinary course of business less estimated costs of completion (to the stage of completion assumed in determining the selling price), holding, and disposal.''[5] The NRV is generally used to evaluate the carrying amount of assets being held for disposition and properties representing collateral. While the market value or future selling price are generally used as the basis for the NRV calculation, the NRV also reflects the current owner's costs to complete the project and to hold and dispose of the property. For this reason, the NRV will generally be less than the market value.

4. FASB Statement of Standards No. 67, ''Accounting for Costs and Initial Rental Operations of Real Estate Projects,'' appendix A.

5. FASB Statement of Standards No. 67, ''Accounting for Costs and Initial Rental Operations of Real Estate Projects,'' appendix A.

EVALUATION REQUIREMENTS

The Board's appraisal regulation allows banks to use evaluations for real estate–related financial transactions that do not require title XI appraisals for certain exempt transactions. Exempt transactions include—

- transactions below the $250,000 threshold,
- transactions qualifying for the exemption for the business loans of $1 million or less where income from real estate is not the primary source of repayment, and
- subsequent transactions resulting from an existing extension of credit (for example, renewals and refinancings).

An evaluation should provide a general estimate of the value of the real estate and need not meet the detailed requirements of a title XI appraisal.[6] An evaluation must provide appropriate information to enable the bank to make a prudent decision regarding the transaction. Moreover, a bank is not precluded from obtaining an appraisal that conforms to the regulation for any exempt transaction.

At a minimum, an evaluation should—

- describe the real estate collateral, including its condition and current use,
- describe the source(s) of information used in the analysis,
- describe the analysis and supporting information, and
- provide an estimate of the real estate's market value, with any limiting conditions.

Form and Content of Evaluations

Since a bank must tailor evaluations to provide appropriate information for different types of transactions, the content and form of evaluations will vary for different transactions. The documentation for evaluations should fully support the estimate of value and include sufficient information to understand the analysis and assumptions. There is no requirement that the evaluation be based on a particular form or valuation approach, but the analysis should be applicable to the type of property and fully explain the value rendered.

Prudent practices require that as the bank's exposure in a real estate–related financial transaction increases, a more detailed evaluation should be performed. An evaluation for a transaction that needs a more detailed analysis should fully describe the property and discuss its use, especially for nonresidential property.

An evaluation for a transaction that requires a less-detailed analysis may be based upon information such as comparable property sales information from sales data services (for example, the multiple listing service) or current tax-assessed value in appropriate situations.[7] An evaluation may also be based on the bank's own real estate loan portfolio experience and value estimates prepared for recent loans on comparable properties where appraisals meeting the requirements of the regulation were obtained. Regardless of the method, the bank must document its analysis and findings in the loan file.

An evaluation must be in writing, signed, dated, and include the preparer's name and address. The evaluation should include a presentation of the calculations, supporting assumptions for the estimate of value, and, if utilized, a discussion of comparable property sales.

USEFUL LIFE OF APPRAISALS OR EVALUATIONS

Since a bank may wish to use an existing appraisal or evaluation for a subsequent loan or investment, the bank's appraisal and evaluation program should include criteria to determine the validity of an existing appraisal or evaluation. When deciding if an appraisal or evaluation may be used for a subsequent transaction, a bank should determine if there has been any material change to the underlying assumptions that would affect the original estimate of value.

The useful life of an appraisal or evaluation will vary depending upon the circumstances affecting the property and the marketplace. Examples of factors that could cause material changes to reported values include the passage

6. An appraisal means the kind of specialized opinion as to the value of real estate, containing certain formal elements recognized by appraisal industry practices and standards.

7. Because assessed values for tax purposes may be a specified fraction of market value as determined by the tax assessor, tax-assessed values should be adjusted to a market-value equivalent. In cases where the assessed value does not have a reliable correlation to current value, the use of assessed value would be inappropriate as the basis for an evaluation.

of time; the volatility of the local market; the availability of financing; the inventory of competing properties; new improvements to, or lack of maintenance of, the subject or competing, surrounding properties; change in zoning; or environmental contamination.

The bank should document its information sources and analyses used to determine if an existing appraisal or evaluation remains valid and if the bank will be using the appraisal or evaluation in a subsequent transaction.

REAPPRAISALS OR REEVALUATIONS

Real estate formerly pledged as collateral to secure an extension of credit that has been acquired by a bank through foreclosure proceedings, or that has been deeded to the bank in lieu of foreclosure proceedings, qualifies for the appraisal exemption for existing extensions of credit. In these circumstances, although a bank is *not* required to obtain an appraisal, it is required to obtain an evaluation, generally before entering into the transaction. In the interest of protecting the value of its collateral, however, a bank may initiate foreclosure action and obtain the evaluation in a reasonable period of time after taking title to the property.

The bank should develop criteria for obtaining reappraisals or reevaluations as part of a program of prudent portfolio review and monitoring techniques—even when additional financing is not being contemplated. Examples of such types of situations include large credit exposures and out-of-area loans.

The decision to reappraise or reevaluate the real estate collateral for a subsequent transaction should be guided by the appraisal exemption for renewals, refinancings, and other subsequent transactions. Loan workouts, debt restructurings, loan assumptions, and similar transactions involving the addition or substitution of borrowers may qualify for the exemption for renewals, refinancings, and other subsequent transactions. Use of this exemption depends upon the condition and quality of the loan, the soundness of the underlying collateral, and the validity of the existing appraisal or evaluation.

A bank may renew or refinance a loan based on a valid appraisal or evaluation if the planned future use of the property is consistent with the use identified in the appraisal or evaluation. However, if the property has reportedly appreciated because of a planned change in use, such as rezoning, an appraisal would be required for a federally related transaction unless another exemption applied, such as the amount financed is below the appraisal threshold.

While the Board's appraisal regulation generally allows appropriate evaluations of real estate collateral in lieu of an appraisal for loan renewals and refinancings, in certain situations an appraisal is required. If new funds are advanced over reasonable closing costs, a bank would be expected to obtain a new appraisal for the renewal of an existing transaction when there is a material change in market conditions that threatens the bank's real estate collateral protection.

For loan workouts involving the modification of the terms and conditions of an existing extension of credit, including the acceptance of new or additional real estate collateral, that facilitates the orderly collection of the credit or reduces the bank's risk of loss, a reappraisal or reevaluation may be prudent, even if it is obtained after the modification occurs. In a troubled-loan situation, a reappraisal would not be required when a bank advances funds to protect its interest in a property, such as to repair damaged property, because these funds should be used to restore the damaged property to its original condition.

QUALIFICATIONS CRITERIA FOR APPRAISERS AND INDIVIDUALS PERFORMING EVALUATIONS

The accuracy of an appraisal or evaluation depends on the competence and integrity of the individual performing the appraisal or evaluation, as well as the individual's expertise at developing and interpreting pertinent data for the subject property. The individual should have adequate training, experience, and knowledge of the local real estate market to make sound judgments about the value of a particular property. The level of training, experience, and knowledge should be commensurate with the type and complexity of the property to be valued. Additionally, the individual should be independent of the credit decision, have no interest in the property being valued, and have no affiliations or associations with the potential borrower. Absent absolute lines of independence, a bank must be able to demonstrate that it has prudent safeguards in place to isolate its collateral-evaluation process from influence or interference from the loan-production process.

Appraiser Qualifications

Under title XI (12 USC 1331), two classifications of appraisers were identified to be used in federally related transactions: state-certified appraiser and state-licensed appraiser. For a certified appraiser, the statute contemplated that the states would adopt similar standards for certification based on the qualification criteria of the Appraiser Qualifications Board of the Appraisal Foundation. These standards set forth minimum educational, testing, experience, and continuing education requirements. For a licensed appraiser, the states have some latitude in establishing qualification standards provided that the criteria are adequate to protect federal financial and public policy interest.

The Appraisal Subcommittee of the FFIEC is responsible for monitoring the states for compliance with the statute. The Board also has the authority to impose additional certification and licensing requirements to those standards adopted by a given state.

Selection of an Appraiser

An independent appraisal is one in which the appraiser is not participating in the administration of the credit or in the approval of the transaction and has no interest, financial or otherwise, in the property. In certain instances involving small banks, officers and directors who perform appraisals must take appropriate steps to ensure independence from the transaction under consideration.

In selecting an appraiser for an appraisal assignment, a bank is expected to consider whether the individual holds the proper state certification or license and has the appropriate experience and educational background to complete the assignment. Financial institutions may not exclude a qualified appraiser from consideration for an appraisal assignment solely because the appraiser lacks membership in a particular appraisal organization or does not hold a particular designation from an appraisal association, organization, or society.

In that regard, banks are expected to treat all appraisers fairly and equitably in determining whether the institution will use the services of a particular appraiser. Generally, banks have established procedures for selecting appraisers and maintaining an approved appraiser list. The practice of preapproving appraisers for ongoing appraisal work and maintaining an approved appraiser list is acceptable so long as all appraisers are required to follow the same approval process. However, a bank that requires appraisers who are not members of a particular appraisal organization to formally apply, pay an application fee, and submit samples of previous appraisal reports for review—but does not have identical requirements for appraisers who are members of certain appraisal organizations—would be viewed as having a discriminatory selection process.

Appraisals Performed by Certified or Licensed Appraisers

A bank is required to use a certified appraiser for—

- all federally related transactions over $1 million,
- nonresidential federally related transactions more than $250,000, and
- complex residential federally related transactions more than $250,000.[8]

A bank may use either a state-certified or a state-licensed appraiser for noncomplex residential federally related transactions that are under $1 million.

Other Appraiser Designations

Some states have adopted other appraiser designations that may cause confusion about whether a particular appraiser holds the appropriate designation for a given appraisal assignment. Additionally, some states use designations such as ‘‘certified residential’’ appraiser and ‘‘certified general’’ appraiser, which leads to further confusion. Other states have no speci-

8. Complex one- to four-family residential property appraisal means that the property to be appraised, the form of ownership, or market conditions are atypical.

fied license designation but use the term ''certified residential,'' based on the standards for licensing. For this reason, the bank needs to understand the qualifications criteria set forth by the state appraiser regulatory body and whether these standards are the equivalent to the federal designations as accepted by the Appraisal Subcommittee.

Currently, the Appraisal Subcommittee has recognized four state appraiser designations: certified general, certified residential, licensed, and transitional licensed. For the certified residential appraiser, the minimum qualification standards are those established by the Appraiser Qualifications Board for ''certified residential real estate appraiser.'' Under the Board's regulation, a certified residential appraiser would be permitted to appraise real estate in connection with a federally related transaction designated for a ''certified'' appraiser so long as the individual is competent for the particular appraisal assignment.

The Appraisal Subcommittee and the Board have also expressed their willingness to recognize a transitional license, which would allow a state to issue a license to an appraiser provided that the individual has passed an examination and has satisfied either the education or experience requirement. A transitional-licensed appraiser is permitted to appraise real estate collateral in connection with a federally related transaction as if licensed. The transitional-licensed appraiser is expected to complete his or her education or experience requirement within a set time frame or the license expires. The recognition of a transitional license was believed to be necessary to ease the initial problems and inefficiencies resulting from the establishment of a new regulatory program. The Appraisal Subcommittee has advised the states that the use of the transitional license should be phased out over time once the appraiser regulatory program is fully established. As a result, use of the transitional license and the applicable time frame will vary from state to state.

Qualifications of Individuals Who May Perform Evaluations

Evaluations may be performed by a competent person who has experience in real estate–related activities, which includes but is not limited to appraisals, real estate lending experience, real estate consulting, and real estate sales. A bank may also augment in-house expertise by hiring an outside consultant familiar with a certain market or a particular type of real estate. The bank's evaluation procedures should have established standards for selecting qualified individuals to perform evaluations and for confirming their qualifications and independence to perform an evaluation for a particular transaction. An individual performing an evaluation need not be licensed or certified. However, if a bank desires, it may use state-licensed or -certified appraisers to prepare evaluations.

SUPERVISORY POLICY

A bank's appraisal and evaluation policies and procedures are reviewed as part of the examination of an institution's overall real estate–related activities. This includes a review of the procedures for selecting an individual for a particular appraisal or evaluation assignment and confirming that the individual is qualified, independent, and, if applicable, licensed or certified to undertake the assignment. If an institution maintains a list of qualified real estate appraisers who are acceptable for the bank's use, the examiner should ascertain whether the board of directors or senior management has reviewed and approved the list.

If a bank is in troubled condition that is attributable to underwriting problems in its real estate loan portfolio, the Board may require the bank to obtain appraisals for all *new* real estate–related financial transactions below the threshold that are not subject to another exemption. The Reserve Bank will determine if a particular bank will have to obtain appraisals below the threshold.

When analyzing individual credits, examiners look at appraisals or evaluations to determine if the methods, assumptions, findings, and conclusions are reasonable and in compliance with the Board's rule, policies, and supervisory guidelines. Examiners should not challenge underlying assumptions, including discount rates and capitalization rates used in appraisals, that differs slightly from norms that would generally be associated with the property under review. Additionally, an examiner is not bound to accept the results of the appraisal or evaluation, regardless of whether a new appraisal or evaluation was requested during the examination. If an examiner concludes that an appraisal or evaluation is deficient for any reason, that fact will be taken into account in reaching a judgment on the quality of the credit.

When the examiner can establish that the underlying facts or assumptions are inappropriate and can support alternative assumptions, the examiner may adjust the estimated value of the property for credit-analysis purposes. It is important to emphasize that an examiner's overall analysis and classification of a credit may be based on other credit or underwriting standards, even if the loan is secured by real property whose value is supported by an appraisal or evaluation. (See sections 2060.1, ''Classification of Credits,'' and 2090.1, ''Real Estate Loans,'' for further discussion of the examiner's assessment of value for loan classification.)

Significant failures to meet standards and procedures as outlined above will be criticized and corrective action will be required. Furthermore, inadequate appraisal and evaluation procedures may be considered an unsafe and unsound banking practice if the failure to accurately reflect the value of assets on a timely basis misrepresents the bank's financial condition. In this situation, formal corrective measures will be pursued as appropriate.

The appraisal regulation and guidelines require that banks use the services of qualified, independent certified or licensed appraisers to perform appraisals. Furthermore, a bank that knowingly uses the services of an individual who is not properly certified or licensed to perform an appraisal in connection with a federally related transaction is in violation of applicable law. Any action of a state-certified or -licensed appraiser that is contrary to the Board's appraisal regulation or applicable law should be reported by the examiner to the Federal Reserve Bank for referral to the appropriate state appraiser regulatory agency for investigation.

INDEPENDENT APPRAISAL AND EVALUATION FUNCTIONS

On October 27, 2003, the federal bank and thrift agencies[9] (the agencies) jointly issued the statement Independent Appraisal and Evaluation Functions. The statement addresses concerns about the independence of the collateral-valuation process that were identified during examinations. This statement applies to all real estate–related financial transactions originated or purchased by a regulated institution for its own portfolio or as assets held for sale. It further clarifies and should be reviewed in conjunction with the agencies' appraisal and real estate lending regulations[10] and the Interagency Appraisal and Evaluation Guidelines (the guidelines).[11]

An institution's board of directors is responsible for reviewing and adopting policies and procedures that establish and maintain an effective, independent real estate appraisal and evaluation program (the program) for all of its lending functions. The real estate lending functions include commercial real estate mortgage departments, capital-market groups, and asset-securitization and -sales units. Concerns about the independence of real estate appraisals and evaluations include the risk that appraisals by biased or compromised appraisers may undermine the integrity of credit-underwriting processes. More broadly, an institution's lending functions should not have undue influence that might compromise the program's independence.

Selecting Individuals to Perform Appraisals or Evaluations

The guidelines establish minimum standards for an effective program, including standards for selecting individuals who may perform appraisals or evaluations. Among other considerations, the selection criteria must provide for the independence of the individual performing the appraisal or evaluation. That is, the individual has neither a direct nor indirect interest, finan-

9. The Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), the Office of Thrift Supervision (OTS), and the National Credit Union Administration (NCUA).

10. OCC: 12 CFR 34, subparts C and D; FRB: 12 CFR 208, subpart E and appendix C, and 12 CFR 225, subpart G; FDIC: 12 CFR 323 and 12 CFR 365; OTS: 12 CFR 564, 12 CFR 560.100, and 12 CFR 560.101; and NCUA: 12 CFR 722.5.

11. The interagency guidelines may be found in SR-94-55 for the FRB, the OCC's *Comptroller's Handbook for Commercial Real Estate and Construction Lending*; FIL-74-94 for the FDIC; and Thrift Bulletin 55a for the OTS. NCUA was not a party to the guidelines; however, the NCUA applies the content to credit unions, when applicable.

cial or otherwise, in the property or transaction. Institutions also need to ensure that the individual selected is competent to perform the assignment. Consideration should be given to the individual's qualifications, experience, and educational background. Selection occurs when, based on an oral or written agreement, the individual accepts the assignment to appraise or evaluate a particular property. Moreover, appraisal or evaluation preparatory work should not commence until the institution finalizes the selection process.

The appraisal regulations address appraiser independence and require that an institution, or its agent, directly engage the appraiser. The only exception to this requirement is that an institution may use an appraisal prepared for another financial services institution, provided that the institution determines that the appraisal conforms to the agencies' appraisal regulations and is otherwise acceptable. Independence is compromised when an institution uses an appraiser who is recommended by the borrower or allows the borrower to select the appraiser from the institution's list of approved appraisers.

Institutions may not use an appraisal prepared by an individual who was selected or engaged by a borrower. An institution's use of a borrower-ordered appraisal violates the agencies' appraisal regulations. Likewise, institutions may not use ''readdressed appraisals''—appraisal reports that are altered by the appraiser to replace any references to the original client with the institution's name. Altering an appraisal report in a manner that conceals the original client or intended users of the appraisal is misleading and violates the agencies' appraisal regulations and the Uniform Standards of Professional Appraisal Practice (USPAP).

It is also important to ensure that the program is safeguarded from internal influence and interference from an institution's loan-production staff. Individuals independent of the loan-production area should oversee the selection of appraisers and individuals providing evaluation services. The agencies recognize that it may not be possible or practical for small institutions to separate the collateral-valuation and loan-production processes. To ensure independence, loan officials, officers, or directors with the responsibility for ordering appraisals and evaluations should not have sole approval authority for granting the loan request.

When selecting and engaging appraisers, an institution needs to identify the assignment and order the appropriate appraisal or evaluation, as discussed in the guidelines. To foster control and accountability, institutions are encouraged to use written engagement letters when ordering appraisals, especially for large, complex, or out-of-area commercial real estate properties. An institution should include a copy of the written engagement letter in the permanent loan file. An appraiser may also incorporate an engagement letter in the appraisal report. The engagement letter confirms that the assignment was made in a manner that complies with the institution's procedures and the appraisal regulations and guidelines.

Appraisal and Evaluation Compliance Reviews

An institution's appraisal and evaluation program must maintain effective internal controls that promote compliance with program standards and the appraisal regulations and guidelines. Internal controls should, among other criteria, confirm that appraisals and evaluations are reviewed by qualified and adequately trained individuals who are not involved in the loan-production processes. The institution's standards for and the depth of such reviews should reflect the risk of the transaction and the process through which the appraisal or evaluation is obtained. An institution should establish more in-depth review procedures for appraisals of large, complex, or out-of-area commercial real estate credits and for those appraisals and evaluations that are ordered by agents of the institution, such as loan brokers or another financial services institution.

Even in small institutions when absolute lines of independence cannot be achieved, effective internal controls should be implemented to ensure that no single person has sole authority to render credit decisions involving loans on which they ordered or reviewed the appraisal or evaluation. Further, lending officials, officers, or directors should abstain from any vote or approval involving loans for which they performed the appraisal or evaluation.

Supervisory Approach

Examiners will review an institution's standards of independence, taking into consideration the size of the institution and the nature and complexity of its real estate–related activities. Examiners will consider whether policies and procedures are comprehensive and applied uniformly to all units engaging in federally related transactions.

If an institution suspects that a licensed or certified appraiser is violating applicable laws or USPAP, or is otherwise engaging in other unethical or unprofessional conduct, the institution should refer the matter directly to the appropriate state appraiser regulatory authorities. Examiners finding evidence of unethical or unprofessional conduct, including improperly prepared appraisals or evaluations and readdressed appraisals, should forward their findings and their recommendations to their supervisory office for appropriate disposition and referral to the state appraiser regulatory authority, as necessary. Institutions and institution-affiliated parties, including lenders, staff, and fee appraisers, are reminded that they could be subject to enforcement actions, which include removal/prohibition orders, cease-and-desist orders, and civil money penalties, for violations of the agencies' appraisal and real estate lending regulations.

Interagency Responses to Questions on the Agencies' Appraisal Regulations and on the Interagency Statement on Independent Appraisal and Evaluation Functions

On March 22, 2005, the Federal Reserve and the other federal financial institutions regulatory agencies issued interpretive responses (in a question-and-answer format) to questions raised by federally regulated financial institutions about the agencies' real estate appraisal regulations. The topics include—

- selecting an appraiser,
- ordering an appraisal,
- accepting a transferred appraisal,
- reviewing appraisals, and
- evaluation and other appraisal topics.

The interpretive responses address common questions on the requirements of the appraisal regulations and the October 2003 interagency statement, Independent Appraisal and Evaluation Functions (the interagency statement).[12] (See SR-05-5 and its attachment.)

On September 8, 2005, the Federal Reserve and other federal financial institutions regulatory agencies jointly issued additional interpretive responses (also in a question-and-answer format) to assist regulated institutions in complying with the agencies' appraisal regulations and real estate lending requirements when financing residential construction in a tract development.[13] (See SR-05-14 and its attachment.) The topics include the—

- definition of residential tract development, including clarification of a residential unit and pre-sold unit;
- appraisal requirements for residential tract development, raw land, residential lots, and condominium buildings;
- clarification of loan amount and collateral value for purposes of calculating the loan-to-value ratio for residential tract development loans;
- acceptable use of an appraisal of a model home;
- underwriting characteristics of a revolving line of credit in which a borrowing base sets the availability of funds to the borrower; and
- appraisal requirements for transactions financing the construction of single-family homes in a residential tract development.

Refer to these interpretive documents when questions arise about the appraisal regulations, the interagency statement, and appraisals involving residential tract lending.

12. See also the Board's appraisal regulations (12 CFR 208 subpart E and 12 CFR 225 subpart G) and related guidance, including SR-94-55 and SR-03-18.

13. See the Interagency Appraisal and Evaluation Guidelines (SR-94-55) and the real estate lending standards regulation and guidelines, 12 CFR 208 subpart E and appendix C.

1. To determine whether policies, practices, procedures, and internal controls regarding real estate appraisals and evaluations for real estate–related financial transactions are adequate.
2. To determine whether bank officers and employees are operating in conformance with the board of director's appraisal policies.
3. To determine that appraisals performed in connection with federally related transactions comply with the minimum standards of the Board's regulation and the Uniform Standards of Professional Appraisal Practice.
4. To determine that appraisers used in connection with federally related transactions are certified or licensed as appropriate.
5. To determine that appraisers are competent to render appraisals in federally related transactions, and are independent of the transaction, or other lending, investment, or collection functions as appropriate.
6. To initiate corrective action when policies, practices, procedures, or internal controls are deficient, or when violations of laws or regulations or noncompliance with provisions of supervisory guidelines have been noted.

1. On the basis of the evaluation of internal controls and the work performed by internal or external auditors, determine the scope of the examination.
2. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examination procedures. Obtain a listing of any deficiencies noted in the latest review performed by internal or external auditors and determine if appropriate corrections have been made.
   a. Provide copies of the bank's appraisal and evaluation policies and procedures to examiners assigned to functional areas in which real estate–related transactions may require the services of an appraiser or evaluator.
   b. When individual real estate–related transactions such as loan or other real estate owned (OREO) transactions are examined, appraisals and evaluations should be reviewed for compliance with the Board's appraisal regulation, the interagency appraisal guidelines, and the bank's appraisal and evaluation programs.
   c. When real estate–related transactions are examined on a portfolio basis, the appraisal and evaluation processes for the activity should be examined. Examiners should determine whether these processes ensure that appraisals and evaluations comply with the Board's appraisal regulation, the interagency appraisal guidelines, and the bank's appraisal and evaluation programs.
3. Review the appraisal and evaluation program and determine the following:
   a. The board of directors has adopted policies and procedures that—
      - establish and maintain an effective, independent appraisal and evaluation program for all of the institution's lending functions;
      - are sufficiently comprehensive; and
      - are applied uniformly to all units engaged in federally related transactions.
   b. The programs include appraisal and evaluation critique procedures.
   c. The appraisal and evaluation programs establish the selective criteria the bank uses to select, evaluate, monitor, and ensure the independence of the individuals who perform or critique real estate appraisals and evaluations.
   d. The appraisal program considers the independent appraiser's qualifications, experience, and educational background; ensures that appraisals are not used if they were prepared by an individual recommended or selected by the borrower (including those individuals listed by the bank as approved appraisers); and ensures that appraisals conform to the Board's appraisal regulation.
   e. The evaluation program ensures that evaluations conform to the Board's guidance on evaluations.
   f. The programs are adequate for the bank's size and location and for the nature and complexity of its real estate lending and other real estate–related activities.
   g. The policies and procedures require that independent appraisals and evaluations be written.
   h. The board or senior management reviews annually its appraisal and evaluation related policies and procedures and records such review in its minutes.
4. Evaluate the bank's appraisal and evaluation program with respect to the following:
   a. the adequacy of written appraisals and evaluations
   b. the manner in which bank officers are operating in conformance with established policy
   c. internal control deficiencies or exceptions, including lack of independence of the collateral-appraisal and -evaluation process from the loan-production function
   d. the integrity of the appraisal and evaluation process, including appraisal and evaluation compliance procedures
   e. the integrity of individual appraisals and evaluations, including the adequacy, reasonableness, and appropriateness of the methods, assumptions, and techniques used and whether the appraisals and evaluations comply with the Board's appraisal regulation and interagency real estate appraisal and evaluation guidelines

f. the eligibility of the bank to assign a 50 percent risk weight to certain one- to four-family residential mortgage loans for risk-based capital purposes (See section 3020.1, ‘‘Assessment of Capital Adequacy.’’)
g. recommended corrective action when policies, practices, or procedures are found to be deficient
h. the degree of violations, if any, of the Board’s appraisal regulation and the extent of noncompliance with the interagency appraisal guidelines, if noted
i. other matters of significance:
   - misrepresentation of data, such as the omission of information on favorable financing, seller concessions, sales history, feasibility, zoning, easements, or deed restrictions
   - inadequate techniques of analysis, that is, failure to use the cost, comparable-sales, or income approach in an appraisal when the approach is appropriate for the type of property
   - use of dissimilar comparables in the comparable-sales approach to valuation, for example, the age, size, quality, or location of the comparable is significantly different from the subject property, making reconciliation of value difficult
   - underestimation of factors such as construction cost, construction period, lease-up period, and rent concessions
   - use of best-case assumptions for the income approach to valuation without performing a sensitivity analysis on the factors that would identify the lender’s downside risk
   - overly optimistic assumptions such as a high absorption rate in an overbuilt market
   - the nonreconcilement of demographic factors (such as existing housing inventory, projected completions, and expected market share to the value rendered) and the discussion of demographic factors as background information

5. Report any instances of questionable conduct by appraisers, along with the supporting documentation, to the Reserve Bank for possible referral to the appropriate state appraisal authorities.
6. Update workpapers with any information that will facilitate future examinations.

Review the bank's internal controls, policies, practices, and procedures for real estate appraisals and evaluations. The bank's system should be accurately and fully documented and should include, where appropriate, narrative descriptions, flow charts, copies of forms used, and other pertinent information. Items marked with an asterisk require substantiation by observation or testing.

POLICIES

1. Has the board of directors, consistent with its duties and responsibilities, adopted written appraisal and evaluation policies that define the following:
   a. bank management's responsibility for selecting, evaluating, monitoring, and ensuring the independence of the individual who is performing the appraisal or evaluation?
   b. the basis for selecting staff appraisers and engaging fee appraisers for a particular appraisal assignment and for ensuring that the individual is independent of the transaction; possesses the requisite qualifications, expertise, and educational background; and has the required state certification or license if applicable?
   c. procedures for when to obtain appraisals and evaluations?
   d. procedures for when to obtain an independent reappraisal or reevaluation, including the frequency and scope?
   e. appraisal and evaluation compliance procedures to determine that appraisals and evaluations are reviewed by qualified and adequately trained individuals who are not involved in the loan-production process and that the appraisals comply with the Board's regulation, policies, and guidelines?
   f. appraisal and evaluation review procedures to ensure that the bank's appraisals and evaluations are consistent with the standards of the Uniform Standards of Professional Appraisal Practice (USPAP) and the Board's regulation and guidelines?
   g. internal controls to prevent officers, loan officers, or directors who order or review appraisals and evaluations from having the sole authority for approving the requested loans?
2. Does the board of directors annually review its appraisal, evaluation, and review policies and procedures to ensure that the appraisal and evaluation policies and procedures meet the needs of the bank's real estate lending activity?

APPRAISALS

*1. Are appraisals in writing, dated, and signed?

*2. Does the appraisal meet the minimum standards of the Board's regulation and USPAP, including the appraisal's purpose, market value, effective date, and marketing period and the sales history of the subject property? Does the appraisal—
   a. reflect a valuation using the cost, income, and comparable-sales approaches?
   b. evaluate and correlate the three approaches into a final value estimate based on the appraiser's judgment?
   c. explain why an approach is inappropriate and not used in the appraisal?
   d. fully support the assumptions and the value rendered through adequate documentation?

*3. Are appraisals received before the bank makes its final credit or other credit decision (for example, is the date the loan committee approved the credit later than the date of the appraisal)?

*4. If the bank is depending on an appraisal obtained for another federally regulated financial institution as support for its transaction, does the bank have appraisal review procedures to ensure that the appraisal meets the standards of the appraisal regulation? (These types of transactions would include loan participations and mortgage-backed securities.)

*5. If an appraisal for one transaction is used for a subsequent transaction, does the bank sufficiently document its determination that the appraiser is independent, the appraisal complies with the appraisal regulations, and the appraisal is still valid?

APPRAISERS

1. Are appraisers fairly considered for assignments regardless of their membership or lack of membership in a particular appraisal organization?
2. Before they accept an assignment, do appraisers have the requisite qualifications, education, and experience to complete the appraisal?
3. The following items apply for large, complex, or out-of-area commercial real estate properties:
   a. Are written engagement letters used when ordering appraisals, and are copies of the letters retained?
   b. Are more in-depth review procedures used for appraisals and evaluations ordered by agents of the bank?
4. Are appraisers independent of the transaction?
   a. Are staff appraisers independent of the lending, investment, and collection functions and not involved, except as an appraiser, in the federally related transaction? Has a determination been made that they have no direct or indirect interest, financial or otherwise, in the property?
   b. Are fee appraisers engaged directly by the bank or its agent? Has a determination been made that they have no direct or indirect interest, financial or otherwise, in the property or transaction?
   c. Are any appraisers recommended or selected by the borrower (applicant)?
5. If staff appraisers are used, does the bank periodically have independent appraisers make test appraisals to check the bank's knowledge of trends, values, and markets?
6. If fee appraisers are used by the bank, does the bank investigate their qualifications, experience, education, background, and reputations?
7. Is the status of an appraiser's state certification or license verified with the state appraiser regulatory authority to ensure that the appraiser is in good standing?
8. Are fee appraisers paid the same fee whether or not the loan is granted?
9. If the transaction is outside the local geographic market of the bank, does the bank engage an appraiser who has knowledge of the market where the real estate collateral is located?

EVALUATIONS

1. Are the individuals performing evaluations independent of the transaction?

*2. Are the evaluations required to be in writing, dated, and signed?

*3. Does the bank require sufficient information and documentation to support the estimate of value and the evaluator's analysis?

*4. If an evaluation obtained for one transaction is used for a subsequent transaction, does the bank sufficiently document its determination that the evaluation is still valid?

*5. Are evaluations received before the bank enters into a commitment?

*6. If the bank is depending on an evaluation obtained for another federally regulated financial institution as support for its transaction, does the bank have evaluation review procedures to ensure that the evaluation meets the Board's regulation and guidance?

EVALUATORS

1. Are individuals who perform evaluations competent to complete the assignment?
2. Are evaluations prepared by individuals who are independent of the transaction?

REAPPRAISALS AND REEVALUATIONS

1. Does the bank follow a formal reappraisal and reevaluation program?
2. Does the bank sufficiently document and follow its criteria for obtaining reappraisals or reevaluations?

Review of Regulatory Reports

Effective date October 2008

Section 4150.1

The Federal Reserve System relies on the timely and accurate filing of regulatory reports by domestic and foreign financial institutions. Data collected from regulatory reports facilitate early identification of problems that can threaten the safety and soundness of reporting institutions; ensure timely implementation of the prompt-corrective-action provisions required by law; and serve other legitimate supervisory purposes. Certain regulatory report information is used for public disclosure so investors, depositors, and creditors can better assess the financial condition of the reporting banks. Information that comes primarily from the Consolidated Reports of Condition and Income (Call Reports) is used to prepare the Uniform Bank Performance Report (UBPR), which employs ratio analyses to detect unusual or significant changes in a bank's financial condition as of the reporting dates. The UBPR is also used to detect changing patterns of behavior in the entire banking system; consequently, any inaccurate data in the regulatory reports may result in ratios that conceal deteriorating trends in the bank or the industry.

Generally, all regulatory reports of financial condition and income that domestic and foreign banking organizations file with the Federal Reserve are required by statute or regulation. The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) and the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) amended various banking statutes to enhance the Federal Reserve's authority to assess civil money penalties against state member banks, bank holding companies, and foreign institutions that file "late," "false," or "misleading" regulatory reports. The civil money penalties also can be assessed against individuals who cause or participate in such filings.

The Federal Reserve has identified a late regulatory report as an official copy of a report that is not received by the Reserve Bank or its designated electronic collection agent in a timely manner. Each bank must file its Call Report in one of the following two ways:

- A bank may use computer software to prepare its report and then submit the report directly to the Federal Financial Institutions Examination Council's (FFIEC) Central Data Repository (CDR), an Internet-based system for data collection or
- The institution may complete its reports in paper form and arrange with a software vendor or another party to convert its paper reports into the electronic format that can be processed by the CDR. The software vendor or other party then must electronically submit the data file containing the bank's Call Report to the CDR.

The filing of a Call Report in paper form directly with the FDIC or with the appropriate Federal Reserve Bank is not an acceptable method of submission.

Reserve Banks will monitor the filing of all regulatory reports to ensure that they are filed, as required, on a timely basis and that they are accurate and not misleading. The Federal Reserve System's Committee on Current Series Reporting, which consists of staff from the statistics functions at each of the Reserve Banks and at the Board, will play an active role in this process. (See SR-04-15.) Many reporting errors can be screened through validity edit checks. Also, Reserve Banks have additional monitoring procedures that they use to confirm the timely submission of reports and to confirm that the reports are accurate and not misleading. On a case-by-case basis, the Reserve Banks will continue to determine if and when a financial institution or other banking organization is a chronic late, inaccurate, or false reporter; in these cases, the Banks will determine what supervisory action, if any, to recommend for a noncompliant reporter.

The filing of a false report generally involves the submission of mathematically incorrect data, such as addition errors or transpositions, or the submission of a regulatory report without its appropriate schedules. Conversely, the filing of a misleading report involves some degree of negligent behavior on the part of the filer that results in the submission of inaccurate information to the Federal Reserve.

REVIEW AND REFILING OF REGULATORY REPORTS

Review of regulatory reports involves determining whether the management of the member bank has submitted all required reports to the Federal Reserve in a timely and accurate manner. The examiner assigned to a specific area of examination is responsible for reviewing the reports relating to that area and for verifying that they are accurate and meet statutory and regulatory requirements. If the examiner finds a material difference in the reports, management should be instructed to refile corrected copies, if appropriate.

Examiners should discuss on the ''Examination Conclusions and Comments'' and ''Matters Requiring Board Attention'' pages of the examination report material errors or the filing of chronically late reports. (See section 6000.1.) They should also discuss with Reserve Bank staff any regulatory report filing that is considered misleading, such a report could lead to the issuance of criminal referrals against the involved individuals. In addition, management should be reminded that civil money penalties or other enforcement proceedings could occur as a result of chronically late or false regulatory report filing.

Banks should maintain effective manual or automated internal systems and procedures to ensure that reporting meets the appropriate regulatory requirements. Banks should develop clear, concise, and orderly workpapers to support the compilation of data. Preparation of proper workpapers provides not only a logical tie between report data and the bank's financial records but also facilitates accurate reporting and verification. Ideally, as part of an effective internal control program, bank management should implement a procedure to verify the compilation of the data. At a minimum, an independent person or department should verify the data that have been compiled for inclusion in the report.

A bank's internal control and audit programs for regulatory reports should be sufficient to ensure that all required reports are submitted on time and are accurate. The specific internal controls a bank employs to meet those objectives depend largely on the volume of reports, the scope of a bank's operations, and the complexity of its accounting system.

COMMONLY REQUIRED REGULATORY REPORTS

This section describes the regulatory reports most commonly required either to be submitted by the member bank to the Federal Reserve Bank or the Board, or to be maintained by the member bank for review during an examination.

Consolidated Reports of Condition and Income

Under 12 USC 324 and the Board's Regulation H, all state member banks are required to file Consolidated Reports of Condition and Income (Call Reports) as of the last day of each calendar quarter. The specific reporting requirements, including the reporting form to be used (for example, FFIEC 031 or FFIEC 041), depend on the asset size of the bank and whether it has a foreign office. Details of the appropriate reporting guidelines, along with the specific reporting form to be filed, are found in the instructions for preparation of Reports of Condition and Income. The reporting forms and instructions can be found on the FFIEC's website: www.ffiec.gov.

The bank should submit completed Call Reports to the CDR no later than 30 calendar days after the report date. Any bank with more than one foreign office, other than a shell branch or international banking facility, must submit data to the CDR no later than 35 days after the report date. State member banks are *not* required to publish their Reports of Condition or Income, according to federal statute. However, a state member bank may be required to publish its Report of Condition under state law.

The Report of Condition provides consolidated, detailed financial information on assets, liabilities, capital, and off-balance-sheet activity, which permits a uniform analysis and comparison of the reporting bank's data to that of other insured banks. The report also aggregates certain figures on loans to executive officers, directors, principal shareholders, and their related interests. The Report of Income provides information such as consolidated earnings, changes in capital accounts and the allowance for loan and lease losses, and charge-offs and recoveries.

The examiner should carefully review both reports to ensure that all pertinent data have been reported and are properly categorized in accordance with the instructions. To understand a particular bank's Call Report, the examiner must understand the bank's accounting methods as well as the information located in, and the relationships between, the bank's general books and subsidiary ledgers. This understanding can be obtained only by a careful review of the workpapers used in the preparation of these reports and their supplementary schedules.

REPORTS REQUIRED BY THE MONETARY CONTROL ACT OF 1980 AND THE INTERNATIONAL BANKING ACT OF 1978

The Federal Reserve has established a basic deposits-reporting framework for administering Regulation D, Reserve Requirements of Depository Institutions, and for constructing, analyzing, and controlling the monetary and reserves aggregates. The framework consists of four categories of deposit reporting. Every institution is placed into one of these four categories for deposit reporting purposes.[1] In general, the larger the institution, the more detailed or more frequent the institution will have to report.

The first two reporting categories, characterized as "detailed reporting," apply to those institutions that are not exempt from reserve requirements ("non-exempt" institutions). The last two reporting categories, characterized as "reduced reporting," apply to institutions that are exempt from reserve requirements ("exempt" institutions). The reserve-requirement "exemption amount" is the amount of total reservable liabilities at each depository institution that is subject to a zero-percent reserve requirement. The exemption amount is used to make the distinction between detailed deposit reporting and reduced reporting.

- Institutions with net transaction accounts equal to or less than the exemption amount over prescribed periods are exempt from reserve requirements and are subject to reduced reporting (categories 3 and 4).
- Institutions with net transaction accounts greater than the exemption amount over prescribed periods are *not* exempt from reserve requirements and are subject to detailed reporting (categories 1 and 2).

Both measures are indexed annually; see Regulation D for the appropriate exemption and cutoff amounts.

The exemption amount and the deposit cutoff for any one calendar year are used by the Federal Reserve to determine deposit-reporting panels in July, effective for September of that year, which continues to September of the following year. All deposit reports are mandatory.

1. Depository institutions that are required to maintain reserves are defined in section 204.1(c) of Regulation D (12 CFR 204.1(c)).

Reporting Categories

"Non-exempt" institutions subject to detailed reporting file the Report of Transaction Accounts, Other Deposits and Vault Cash (FR 2900). Institutions file the report either weekly or quarterly, generally depending on the level of an institution's deposits. The report is used in the calculation of reserve requirements.

"Exempt" institutions subject to "reduced reporting" file either the Annual Report of Deposits and Reservable Liabilities (FR 2910a) or no report at all, depending on their deposit levels.

Report forms and instructions can be found on the Federal Reserve Board's website.

Category One

Depository institutions (other than banking Edge and agreement corporations and U.S. branches and agencies of foreign banks) with net transaction accounts greater than the exemption amount and with a sum of total transaction accounts, savings deposits, and small time deposits greater than or equal to the nonexempt deposit cutoff, or with a sum of total transaction accounts, savings deposits, and small time deposits greater than or equal to the reduced reporting limit, regardless of the amount of net transaction accounts, will be required to submit the FR 2900 weekly.

Banking Edge and agreement corporations and U.S. branches and agencies of foreign banks, regardless of size, must also submit the FR 2900 weekly. They are not eligible for reporting categories 2 through 4 below.

The weekly reporting period for the FR 2900 covers the seven-day period beginning on Tuesday and ending the following Monday.

Category Two

Depository institutions with net transaction accounts greater than the exemption amount and with a sum of total transaction accounts, savings deposits, and small time deposits less than the nonexempt deposit cutoff are required to submit the FR 2900 once each quarter, in March, June, September, and December.

The quarterly reporting period for the FR 2900 covers the seven-day period beginning on the third Tuesday of the report month and ending the following Monday.

Category Three

Depository institutions with net transaction accounts less than or equal to the exemption amount and with total deposits greater than the exemption amount but with total transaction accounts, savings deposits, and small time deposits below the reduced reporting limit are required to submit the FR 2910a. This report is filed as of June 30 each year.

Category Four

Depository institutions whose net transaction accounts and total deposits are less than or equal to the exemption amount are not required to submit any Federal Reserve deposit report as long as data on the level of an institution's deposits are readily available on a condition report.

Institutions for which deposit data are not readily available on a condition report will be required to submit the FR 2910a report to determine the appropriate reporting category.

See page IV-4 and IV-5 of the Federal Reserve's *Reserve Maintenance Manual* at http://www.frbservices.org/files/regulations/pdf/rmm.pdf.

Annual Panel Determinations

Each year the Federal Reserve reviews the institutions in the four reporting categories, and reassignments of institutions ("panel shifts") are determined each July and become effective in September. The panel shifts reflect movements in each individual depository institution's total deposits or total reservable liabilities across the prevailing boundaries (the exemption amount and the deposit cutoff) that separate the reporting categories. Documentation is available on the Federal Reserve's procedures (including the reports, data items, and reporting periods) for measuring an institution's total reservable liabilities and total deposits against the prevailing cutoffs for the annual panel determinations. Two special types of panel shifts are described below.

- *Voluntary shifts.* In July, the Federal Reserve informs each institution of its particular reporting requirement effective for September of that year to September of the following year. Any depository institution assigned to one particular category may elect instead to report deposits (and, if appropriate, to maintain reserves) in accordance with a higher-level category. (For example, an institution assigned to the FR 2900 quarterly reporting category may elect instead to report the FR 2900 weekly.) However, any such voluntary shifts may take place only once a year during the normal September panel shifts. Voluntary shifts to a lower-level category are not permitted.
- *Fast-growing institutions.* The Federal Reserve may require a depository institution that is experiencing above-normal growth to report on a more detailed or frequent basis before the September panel shifts.

For more detailed information, see the Federal Reserve's "Reserve Maintenance Manual."

REPORTS REQUIRED UNDER REGULATION H AND THE SECURITIES EXCHANGE ACT OF 1934

Section 12(i) of the Securities Exchange Act of 1934 (the 1934 act), as amended by the Sarbanes-Oxley Act of 2002, vests the Board with the authority to administer and enforce certain provisions of the 1934 act and the Sarbanes-Oxley Act with respect to state member banks that have a class of securities registered under section 12(b) or 12(g) of the 1934 act (registered state member banks). In particular, the Board is charged with enforcing sections 12, 13, 14(a), 14(c), 14(d), 14(f), and 16 of the 1934 act and sections 301, 302, 303, 304, 306(a), 401(b), 404, 406, and 407 of the Sarbanes-Oxley Act[2] with respect to registered state member banks. Sec-

2. See 15 USC 78j-1, 78*l*–78n, 78p, 7241–7244(a), 7261(b), 7262, 7264, and 7265.

tion 208.36(a) of Regulation H, which implements these provisions, generally requires registered state member banks to comply with any rules, regulations, and reporting forms adopted by the Securities and Exchange Commission (SEC) under the above-listed sections of the 1934 act and the Sarbanes-Oxley Act. (See 12 CFR 208.36(a), as amended by 68 *Fed. Reg.* 4096 (January 28, 2003).) Registered state member banks, however, generally must file any forms or reports required by these rules with the Board, rather than the SEC.

If a state member bank has a class of securities registered under section 12 of the 1934 act and, thus, is a registered state member bank, the examiner should consult with the bank's management to ensure that the reports required by Regulation H are properly filed with the Board. Listed below are a few of the most common forms and reports that must be filed with the Board by a registered state member bank pursuant to Regulation H. This list, however, is not exclusive and examiners should consult Board staff or Regulation H, the 1934 act, the Sarbanes-Oxley Act, and the SEC's implementing rules if questions arise concerning the filing of reports by a registered state member bank. See the list of reporting forms and the individual reporting forms and instructions on the SEC's website: www.sec.gov.

Section 12 of the 1934 Act

Form 8-A is for the registration of certain classes of securities pursuant to sections 12(b) or 12(g) of the 1934 act for, among other things, listing on national securities exchanges. Form F-10 is the general reporting form for registration of securities pursuant to the 1933 act and sections 12(b) or 12(g) of the 1934 act for classes of securities of issuers for which no other reporting form is prescribed.

Section 13 of the 1934 Act

Form 8-K must be filed within 4 business days after the occurrence of the earliest of one or more specified events that are required to be reported and that affect the bank or its operations, such as changes in control of registrant or an acquisition or disposition of a significant amount of assets. See the ''Information to be Included in the Report'' within the report instructions. Form 10-Q is for quarterly and transition reports and must be filed within 40 days for large accelerated filers; accelerated filers; or for others, 45 days after the end of each of the first three fiscal quarters. Form 10-K is for annual and transition reports that must be filed within 60 to 90 calendar days after the end of the registrant's fiscal year.

Section 16 of the 1934 Act

Section 16 requires the directors, officers, and principal shareholders of public companies to file reports concerning the purchase and sale of the company's equity securities. Form 3 collects the insider's initial beneficial ownership of registered companies, including banks. Form 4 collects changes in the insider's beneficial ownership. Form 5 is an annual statement of changes in beneficial ownership of securities.

Sarbanes-Oxley Act

The Sarbanes-Oxley Act[3] (the act) and the SEC's implementing rules require the principal executive officer and principal financial officer of public companies to file certain certifications with the company's annual 10-K report and quarterly 10-Q reports. The certifications must, among other things, state that the officer has reviewed the report, indicate that the report (to the officer's knowledge) does not contain any material misstatements or omissions, and contain certain representations concerning the company's internal controls.

The act requires the annual 10-K report of public companies to include a statement of management's responsibility for maintaining adequate internal-control structures and procedures for financial reporting and to contain an assessment of the effectiveness of these controls and procedures.[4] The company's external auditor must attest to, and report on, management's assessment. These reports and attestations are similar to the internal-control reports and attestations required by section 36 of the Federal Deposit Insurance Act (12 USC 1831m) for insured depository institutions with total assets of $500 million or more.

3. See 15 USC 7241 (section 302 of the act).
4. See 15 USC 7262 (section 404 of the act).

The act[5] and the SEC's rules also require public companies to disclose in their periodic reports whether the company has adopted a code of ethics for its senior financial officers and whether the company's audit committee includes a "financial expert." If the company has not adopted a code of ethics or does not have a financial expert on its audit committee, the company must explain the reasons why not.

REPORTING AND INQUIRY REQUIREMENTS FOR LOST AND STOLEN SECURITIES

Every national securities exchange member, registered securities association member, broker, dealer, municipal securities dealer, government securities broker or dealer, registered transfer agent, and registered clearing agency and its participants, as well as every member bank of the Federal Reserve System and every bank whose deposits are insured by the Federal Deposit Insurance Corporation (reporting institutions), must register with the SEC's designee, the Securities Information Center, Inc. (SIC). All lost, missing, stolen, or counterfeit securities must be reported to the SIC. Except in certain limited circumstances, each insured bank is responsible for contacting the SIC to determine if the securities coming into its possession, whether by pledge, transfer, or some other manner, have been previously reported as missing, lost, stolen, or counterfeit.

All functions within a bank that handle or process securities are subject to the *reporting* requirements. Only the transfer-agent function is exempt from the *inquiry* requirements. Accordingly, all bank departments likely to be affected, including the trust, investment, transfer-agent, custody, or dealer departments, and the lending operations as relating to collateral loans, should be familiar with the requirements set out in 17 CFR 240.17f-1. Securities exempt from the reporting requirements are—

- registered U.S. Treasury securities of the U.S. government and federal agencies thereof,
- securities that have not been assigned CUSIP numbers, and
- bond coupons

5. See 15 USC 7264–7265 (sections 406 and 407 of the act).

- global securities
- uncertified securities, and
- any securities issue for which there is neither a record nor beneficial owners that can obtain negotiable securities certificates.

Securities exempt from the inquiry requirements are—

- securities received directly from the issuer or its agent at issuance,
- securities received from another reporting institution or from a Federal Reserve Bank or Branch,
- securities received from a customer of the reporting institution in the name of the customer or nominee, and
- securities that are a part of a transaction of $10,000 or less (aggregate face value for bonds or market value for stocks).

Lost, Missing, Stolen, or Counterfeit Securities

Form X-17F-1A must be filed with the SIC within one business day after the discovery of—

- a theft or loss of any security when there is a substantial indication of criminal activity,
- a security that has been lost or missing for two business days when criminal actions are not suspected, and
- a security that is counterfeit.

The reporting form must be filed within two business days of notification of nonreceipt when delivery of securities sent by the bank—

- is made by mail or draft and payment is not received within 10 business days, and confirmation of nondelivery has been made by the receiving institution; and
- is in person and no receipt is maintained by the bank.

If securities sent by the bank, either in person or through a clearing agency, are lost in transit and the certificate numbers of the securities can be determined, the bank (delivering institution) must report the certificate numbers of the securities within two business days after notice of non-receipt or as soon as the certificate numbers of the securities can be ascertained.

When a shipment of retired securities certificates is in transit between any unaffiliated transfer agents, banks, brokers, dealers, or other reporting institutions, and the delivering institution fails to receive notice of receipt or nonreceipt of the certificates, the delivering institution is required to act to determine the facts. When the certificates are not recovered by the delivering institution, the delivering institution must report the certificates as lost, stolen, or missing within a reasonable time period, but in any event within twenty business days from the date of shipment. The delivery of lost or missing securities to the bank must be reported within one business day after discovery and notification of certificate numbers. Securities that are considered lost or missing as a result of count or verifications must be reported no later than 10 business days after discovery or as soon as certificate numbers can be ascertained.

Copies of all reports required to be filed under 17 CFR 240.17f-1 must also be submitted to the registered transfer agent for the issue being reported and, if criminal activities are suspected, to the Federal Bureau of Investigation. Copies of filed or received Forms X-17F-1A must be maintained in an easily accessible place for three years.

TRANSFER-AGENT ACTIVITIES

If a bank acts as a transfer agent for its own stock, the stock of its holding company, or any other equity security, it may have to register with the Board as a transfer agent pursuant to the requirements of Regulation H (section 208.31). State member bank transfer agents must comply with the SEC's rules prescribing operational and reporting requirements, which the SEC adopted pursuant to section 17A(2) of the 1934 act (15 USC 78q-1). For member banks, see 17 CFR 240.17Ac2 (1-2) and 240.17Ad-1-240.17Ad-16). (See section 208.31(b) of Regulation H.) Any entity performing transfer agent functions for a security is required to register if the security is registered on a national securities exchange and if the issuer has total assets of $10 million and a class of equity security held on record by 500 or more persons. The registrations are public filings and are *not* confidential.

The interagency Transfer Agent Registration and Amendment Form, Form TA-1, is used by member banks and other entities to register before becoming, and then to act as, a transfer agent. They also use the reporting form to amend registration information as necessary. The information collected includes the company name, all business addresses, and information about the registrant's proposed activities as a transfer agent.

The Federal Reserve uses the information to act upon registration applications and to aid in performing supervisory duties. The Federal Reserve forwards copies of the completed registration forms to the Securities and Exchange Commission, which maintains registration data to aid in its statutory mandate to develop rules and standards applicable to all registered transfer agents.

Municipal Securities Dealer Activities

A state member bank, subsidiary, department, or division thereof that is a municipal securities dealer must register and file amendments with both the SEC and the Federal Reserve Board Board as a municipal securities dealer by filing the SEC's Form MSD, pursuant to Section 15 B(a) of the Securities Exchange Act of 1934 and the SEC's rule 15Ba2-1. A discussion of the bank's responsibilities as a municipal securities dealer, filing requirements, and other information, including examination procedures, are discussed in section 2030.1. A notice of withdrawal from registration as a municipal securities dealer pursuant to section 15B(c) must be filed with the SEC and the Board on the SEC's Form MSDW when the municipal securities dealer is a bank, or a separately identifiable department or division of a bank.

Government Securities Broker and Dealer Activities

If a state member bank, a foreign bank, a state branch or an agency of a foreign bank, or a commercial lending company owned or controlled by a foreign bank acts as a government securities broker or dealer, it may have to file notice with the Board as a government securities broker or dealer by filing FR G-FIN, pursuant to section 15C(a)(1)(B) of the Securities and Exchange Act of 1934. This notice collects the institution's identifying information and the names and titles of its managers of government securities activities; the notice requires the institution to state whether any person associated with the respondent's government securities activities has been involved in disciplinary proceedings related to securities sales. When such a financial institution intends to cease engaging in broker or dealer activities, it must notify its regulator by using the Notice by Financial Institutions of Termination of Activities as a Government Securities Broker or Government Securities Dealer (FR G-FINW). A discussion of the bank's responsibilities as a government securities broker or dealer, filing requirements, and other information, including examination procedures, are discussed in SR-87-37, as amended. See also SR-94-5, 93-40, 90-1, and 88-26. The Board has also developed a Summary Report of Government Securities Broker/Dealer Activities (GSB-D report).

INTERNATIONAL ACTIVITIES

A bank must file certain reports if it is conducting or intends to conduct international activities through either foreign branches or Edge Act or agreement corporations. Listed below is a brief description of each of these reports.

FFIEC 009—Country Exposure Report

FFIEC 009 is filed quarterly by all U.S. banks and bank holding companies that meet certain ownership criteria and that, on a fully consolidated basis, have total outstanding claims of $30 million or more (or equivalent) on foreign residents of the U.S. Information is collected on the distribution by country of these foreign claims on foreigners held by U.S. banks and bank holding companies.

FFIEC 009a—Country Exposure Information Report

FFIEC 009a is a quarterly supplement to the Country Exposure Report (FFIEC 009) that provides specific information about the reporting institution's exposures in particular countries of U.S. banking institutions. Part A must be filed when exposure to a single country exceeds 1 percent of the banking institution's total assets or 20 percent of that institution's capital, whichever is less. Part B provides a list of countries where exposures were between 0.75 percent and 1 percent of the respondent's assets or between 15 percent and 20 percent of capital.

FFIEC 030/FFIEC 030S—Foreign Branch Report of Condition/Abbreviated Foreign Branch Report of Condition

These reports collect information on the structure and geographic distribution of foreign branch assets, liabilities, derivatives, and off-balance-sheet data of foreign branches of insured U.S.-chartered commercial banks. For purposes of this report, branches in Puerto Rico and other U.S. territories and possessions are considered foreign branches. Participation in the completion and submittal of the reports is mandatory.

The FFIEC 030 is filed quarterly for significant branches, with either $2 billion or commitments to purchase foreign currencies and U.S. dollar exchange of at least $5 billion. It is filed annually for other branches with total assets in excess of $250 million. The Federal Reserve uses the data to plan examinations and to analyze the foreign operations of domestic banks. Growth trends can be measured by bank, by country, and by bank within country. Aggregate data are a useful source of information on bank activities.

The FFIEC 030S collects financial data items for smaller, less-complex branches. It is filed annually, as of December 31, for foreign branches that do not meet the criteria to file the FFIEC 030 but have total assets of $50 million or more (but less than or equal to $250 million).

FR 2064—Recordkeeping Requirements

Effective September 1, 2001, the FR 2064 reporting form was replaced with a recordkeeping requirement and certain structure information was moved to the FR Y-10, Report of Changes in Organizational Structure. Internationally active U.S. banking organizations are still expected to maintain adequate internal records to allow examiners to review compliance with the investment provisions of Regulation K, under the recordkeeping requirements of FR 2064 (no form is associated with this recordkeeping requirement). For each investment made under subpart A of Regulation K, records should be maintained on the type of investment (for example, equity (voting shares, nonvoting shares, partnerships, interests conferring ownership rights, participating loans)), binding commitments, capital contributions, and subordinated debt), the amount of the investment, the percentage ownership, activities conducted by the company and the legal authority for such activities, and whether the investment was made under general-consent, prior-notice, or specific-consent authority. For those investments made under general-consent authority, information also must be maintained that demonstrates compliance with the various limits set out in sections 211.8 and 211.10 of Regulation K.

Information maintained by the banking organization should be made available to examination staff during the course of on-site examinations and pursuant to other supervisory requests. The recordkeeping must be adequate to permit examiners to determine compliance. Examiners are expected to review a sample of these investments to determine the accuracy of the organization's records and to determine compliance with the regulation. (See SR-02-2.)

FR 2314/FR 2314S—Financial Statements of Foreign Subsidiaries of U.S. Banking Organizations

The FR 2314 is reported quarterly or annually, as of the last calendar day of the quarter, based on certain threshold criteria. The FR 2314 collects selected financial information for direct or indirect foreign subsidiaries of U.S. state member banks, Edge and agreement corporations, and bank holding companies. The FR 2314 consists of a balance sheet and income statement; information on changes in equity capital, changes in the allowance for loan and lease losses, off-balance-sheet items, and loans; and a memoranda section. The FR 2314S should be filed annually as of December 31 and collects four financial data items for smaller, less complex subsidiaries.

FR 2502q—Quarterly Report of Assets and Liabilities of Large Foreign Offices of U.S. Banks

The FR 2502q report is to be submitted by U.S. head offices of bank holding companies, commercial banks, and Edge and agreement corporations that file for their major foreign branches and large banking subsidiaries. It provides a geographic breakdown of each office's assets and liabilities. Branches of a U.S. bank with $500 million or more in total assets and foreign banking subsidiaries with $2 billion or more in total assets, or $10 million in deposit liabilities, are required to file this report quarterly.

FR 2886b—Consolidated Report of Condition and Income for Edge Act and Agreement Corporations

FR 2886b covers the operations of the reporting corporation, including any international banking facilities of the reporter. Corporations engaged in banking must submit the data at least quarterly.

FR 2915—Report of Foreign Currency Deposits

FR 2915 collects seven-day averages of the amounts outstanding of foreign currency–denominated deposits held at U.S. offices of the depository institution, converted to U.S. dollars and included in the Report of Transaction Accounts, Other Deposits and Vault Cash (FR 2900). The report is collected with the reporting week that begins the third Tuesday of March, June, September, and December.

FR Y-10—Report of Changes in Organizational Structure

The Y-10 is used to report, among other things, information on worldwide organizational structure of bank holding companies (BHCs), member banks, Edge and agreement corporations, and the U.S. operations of foreign banking organizations (FBOs)[6]. The reporting form

6. An FBO with U.S. operations that is not or ceases to be a "qualifying foreign banking organization" (QFBO) within the meaning of Regulation K, and is not otherwise treated as

includes detailed information on the structure of top-tier BHCs organized under U.S. or foreign law that are not FBOs, regardless of financial holding company (FHC) status; FBOs (both qualifying and nonqualifying) whether or not a BHC; state member banks not controlled by a BHC or FBO; Edge and agreement corporations not controlled by a BHC, FBO, or member bank; and nationally chartered banks not controlled by a BHC or FBO, but only with respect to their foreign investments. Within 30 calendar days of the event, banking organizations are required to report changes in investments as well as new activities (both foreign and domestic) on the FR Y-10 report. The reporting form includes the structure information on changes in FBOs (formerly the FR Y-10F) and the change in status of foreign branch of U.S. banking organizations (formerly the FR 2058).

The Board has placed greater importance on monitoring the level of international investments to ensure compliance with relevant banking laws and regulations, and to ensure that banking organizations do not expose themselves to undue risk. Examiners and other Federal Reserve System staff have a continuing need to monitor compliance with the Federal Reserve Act and sections 211.8–211.10 of the revised Regulation K.

Investments of less than 25 percent of the voting shares of a foreign nonbanking company are reported on the FR Y-10.[7] However, using the FR Y-6 (Annual Report of Bank Holding Companies) and the FR Y-7 report (Annual Report of Foreign Banking Organizations), banking organizations are required to report annually all investments, including those between 5 percent and 25 percent of voting shares.[8] The FR Y-6, FR Y-7, and the FR Y-10 collect information on structure and geographical information relating to foreign investments for ongoing monitoring.

a QFBO under Regulation K, should consult with Federal Reserve staff regarding the scope of its reporting obligations. In general, an FBO that is not or is not treated as a QFBO is subject to the nonbanking restrictions of the BHC Act with respect to its worldwide operations and, thus, would have to report on the FR Y-10 changes to its worldwide organizational structure.

7. Regulation K authorizes portfolio investments in less than 20 percent of the shares of a foreign company regardless of the activities engaged in by that company. Portfolio investments within the general-consent limits are required to be reported annually on the FR Y-6.

8. Investments representing less than 5 percent ownership are not required to be reported.

Examiners are expected to review investment amounts and activities during the examination process. The portion of an examination dealing with Regulation K compliance should focus on confirming investments made pursuant to the general-consent provisions to meet the restrictions on investment amount and activities in sections 211.8–211.10 of Regulation K. Investments made under the general-consent provisions of Regulation K can be sizable, and thus can pose significant risk to the banking organization. Examiners should keep in mind that the Board has the authority to rescind an organization's general-consent investment privileges for various reasons, including safety-and-soundness concerns and noncompliance with the existing requirements of Regulation K. (See SR-02-2.)

Treasury International Capital Forms

The following reports are collected to gather information on international capital movements by U.S. banks and their Edge Act and agreement corporations, other depository institutions, international banking facilities, and bank holding companies.

- BC: Report of U.S. Dollar Claims of Depository Institutions, Bank Holding Companies/Financial Holding Companies, Brokers, and Dealers on Foreigners
- BL-1: Report of U.S. Dollar Liabilities of Depository Institutions, Bank Holding Companies/Financial Holding Companies, Brokers, and Dealers to Foreign-Residents
- BL-2: Report of Customers' U.S. Dollar Liabilities to Foreigners
- BQ-1: Report of Customers' U.S. Dollar Claims on Foreigners
- BQ-2: Part 1. Report of Foreign Currency Liabilities and Claims of Depository Institutions, Bank Holding Companies/Financial Holding Companies, Brokers and Dealers, and of Their Domestic Customers vis-à-vis Foreigners
- BQ-2: Part 2. Report of Customers' Foreign Currency Liabilities to Foreigners
- BQ-3: Report of Maturities of Selected Liabilities of Depository Institutions, Bank Holding Companies/Financial Holding Companies, Brokers, and Dealers to Foreigners

D: Report of Holdings of, and Transactions in, Financial Derivatives Contracts
S: Purchases and Sales of Long-Term Securities by Foreign-Residents
SHC/SHCA: Report of U.S. Ownership of Foreign Securities, Including Selected Money Market Instruments
SHL/SHLA: Foreign-Residents' Holdings of U.S. Securities, Including Selected Money Market Instruments

Consolidated Foreign Currency Reports of Major Market Participants

The Treasury Foreign Currency (TFC) Report of major market participants collects data on the foreign exchange contracts and actively manages positions of major nonbank market participants. This report is collected and processed by the Federal Reserve System, acting as fiscal agent for the Department of the Treasury. These data are designed to assess and monitor the foreign exchange developments in the spot, forward, futures, and options markets on an individual and aggregate basis. The TFC series is comprised of three reports: (1) the Weekly Consolidated Foreign Currency Report of Major Market Participants (TFC-1), (2) the Monthly Consolidated Foreign Currency Report of Major Market Participants (TFC-2), and (3) the Quarterly Consolidated Foreign Currency Report (TFC-3).

1. To determine that required reports are being filed on time.
2. To determine that the contents of reports are accurate.
3. To effect corrective action when official reporting, practices, policies, or procedures are deficient.

1. Complete or update the Internal Control Questionnaire, if selected for implementation.
2. Determine the bank's historical record of submitting timely and accurate reports by reviewing workpapers and the Regulatory Reports Monitoring Program.
3. Instruct those examiners assigned specific departments that generate regulatory reports to:
   a. Determine from department records what regulatory reports should have been filed because of the passage of time or the occurrence of an event.
   b. Obtain copies of all regulatory reports filed by the department since the previous examination.
   c. Check the reports obtained in the preceding step and the date of filing against statutory and regulatory requirements.
   d. Instruct the bank to prepare and submit any delinquent reports.
   e. For the most recent filing of those reports submitted on a periodic basis and all other reports submitted since the last examination, perform the following:
      - Reconcile the line items shown on the reports to the bank's general ledger, subsidiary ledgers, or daily statements.
      - Obtain the bank's workpapers applicable to each line item and reconcile individual items to the reports.
      - Determine whether other examining personnel uncovered any misstatement of assets, liabilities, income, or expense during their examination of the various departments.
      - Determine that the reports are prepared in accordance with Federal Reserve and/or other applicable instructions.
   f. On the basis of the work performed in the preceding step, perform either of the following, as appropriate:
      - If the reports are found to be substantially correct, limit the review of the remaining periodic reports filed since the last examination to the reconciliation of financial statement account categories to general ledger control accounts.
      - If the reports are found to be substantially incorrect, extend the procedures outlined in step 3.e to the remaining periodic reports filed since the last examination for those areas where items were found to be substantially incorrect.
   g. Scan all periodic reports for unusual fluctuations. Investigate fluctuations, if any.
4. Review compliance with the missing, lost, counterfeit, or stolen securities requirements of 17 CFR 240.17f-1 by:
   a. Discussing with appropriate officers and personnel the procedures in effect regarding the filing of Form X-17F-1A (Missing, Lost, Stolen, or Counterfeit Securities Report).
   b. Discussing with the appropriate persons the procedures in effect regarding compliance with the inquiry requirements.
   c. Substantiating Internal Control questions 6 through 15, as appropriate.
5. Prepare comments in appropriate report form and discuss with management:
   a. Violations of law or regulations.
   b. Inaccurate reports, and, if applicable, the need for amended reports. If amended reports are considered appropriate, consult with Reserve Bank supervisory personnel before requesting the bank to refile the report(s).
   c. Material differences in the annual report of the state member bank whose securities are subject to registration pursuant to the Securities Exchange Act of 1934. (State law governs the furnishing of annual reports to stockholders for banks with less than 500 shareholders.)
   d. Recommended corrective action when policies, practices, or procedures are deficient or when reports have been filed incorrectly, late, or not at all.

      The comments must include, if applicable, the name(s) and the "as of" date(s) of amended report(s); and the date of filing, amount of, and explanation of any material difference existing in either the numerical items or narrative statements in the annual report.
6. Update the workpapers with any information that will facilitate future examinations.

Review the bank's internal controls, policies, practices, and procedures for regulatory reports. The bank's system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used, and other pertinent information.

1. Do requests for all regulatory reports come to one individual or department?
2. Does that individual or department have the authority to request that required information be prepared by the applicable banking department?
3. To ensure that all regulatory reports are submitted on a timely basis and are accurate, determine the following:
   a. If completion of the report requires information from several departments:
      - Is a written memorandum sent to the various departments requesting the information?
      - Is the memorandum addressed to a department head?
      - Does the memorandum have a due date?
      - Are procedures in effect to send second requests if the memorandum is not returned by its original due date?
      - Does completion of the memorandum require two signatures, that of the person gathering the information and that of the person's superior who is held responsible for its accuracy?
   b. If completion of the report requires information from one department, is there separation of duties to ensure that the raw data to complete the report is compiled by one person and verified by another person, prior to submission?
4. After the report is prepared, but prior to its submission, is it checked by:
   a. The supervisor of the department preparing the report, who takes personal responsibility for its accuracy and submission on a timely basis?
   b. Bank personnel who have no part in the report's preparation?
5. Do report workpapers leave a clear audit trail from the raw data to the finished report and are they readily available for inspection?

Review the bank's system for compliance with the reporting and inquiry requirements of the lost and stolen securities provisions of 17 CFR 240.17f-1.

6. Has the bank registered as a direct or indirect inquirer with the Securities Information Center, Inc.?
7. Are reports submitted within one business day of discovery when:
   a. Theft or loss of a security is believed to have occurred through criminal activity?
   b. A security has been missing or lost for two business days, except in certain cases?
   c. A security is counterfeit?
8. Are reports submitted by the bank, as a delivering institution, within two business days of notification of nonreceipt when:
   a. Delivery is in person and no receipt is maintained by the bank?
   b. Delivery of securities is made by mail or via draft, and payment is not received within 10 business days and confirmation of nondelivery has been made by the receiving institution?
   c. Securities are lost in transit and the certificate number(s) can be determined?
9. Are reports submitted by the bank, as a receiving institution, within one business day of discovery and notification of the certificate number(s) when:
   a. Securities are delivered through a clearing agency and the delivering institution has supplied the certificate numbers within the required two business days after request?
   b. Securities are delivered over the window and the delivering institution has a receipt and supplies the certificate number(s) within the required two business days after request?
10. Are securities that are considered to be lost or missing as a result of counts or verifications reported no later than ten business days after discovery or as soon after as the certificate number(s) can be ascertained?
11. Are copies of those reports submitted to the registered transfer agent for the issue and, in

the case of suspected criminal activity, the Federal Bureau of Investigation?

12. Are all recoveries of securities reported within one business day of recovery or finding? (Note: Only the institution that initially reported the security as missing can make a recovery report.)
13. Are inquiries made when the bank takes in any security that is not:
    a. Received directly from the issuer or issuing agent at issuance?
    b. Received from another reporting institution or Federal Reserve bank in its capacity as fiscal agent?
    c. Received from a bank customer and is registered in the name of the customer or its nominee?
14. Are all reports made on Form X-17F-1A or facsimile?
15. Are copies of Form X-17F-1A and subsequent confirmations and other information received maintained for three years in an easily accessible location?

CONCLUSION

16. Does the foregoing information provide an adequate basis for evaluating internal controls in that deficiencies in areas not covered by this questionnaire do not significantly impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
17. Are internal controls adequate based on a composite evaluation, as evidenced by answers to the foregoing questions?

Sale of Uninsured Nondeposit Debt Obligations on Bank Premises

Effective date May 1996

Section 4160.1

INTRODUCTION

State member banks have, at times, engaged in issuing nondeposit debt securities on their own behalf or assisted in the sale of these instruments (for example, commercial paper or other short-term or long-term debt securities, such as thrift notes and subordinated debentures) on behalf of their parent bank holding companies or other affiliates. It is important to ensure that these securities are not issued, marketed, or sold in a manner that could give the purchaser the impression that the obligations are federally insured deposits. Consequently, state member banks and their subsidiaries that have issued or plan to issue nondeposit debt securities should not market or sell these instruments in any public area of the bank where retail deposits are accepted, including any lobby area of the bank.

PROCEDURES

This policy is not intended to prevent banks from selling their uninsured debt instruments in a manner that is consistent with sound and prudent banking practices. These instruments generally may be sold to investors in various ways away from the retail deposit-taking and general lobby areas of the bank. In this regard, personnel not regularly involved in deposit-taking activities or in opening new deposit accounts may make prospective investors in the community aware of uninsured debt obligations outside of the retail deposit-taking and general lobby areas. Also, these instruments may generally be sold by an employee or officer segregated from the retail deposit-taking and general lobby areas of the bank, even if the employee or officer occasionally accepts deposits or opens an account (but not as a part of his or her regular duties), so long as the arrangement is not structured in a way that misleads the purchaser or is otherwise contrary to supervisory guidelines.

Further, state member banks involved in this activity should establish procedures to ensure that potential purchasers understand that the debt security is not federally insured or guaranteed. Specifically, the debt security should boldly state on its face that it is not insured by the Federal Deposit Insurance Corporation. In addition, this information should be verbally stated to the purchaser, and, in cases where purchasers do not take physical possession of the obligation, the purchaser should be provided with printed advice that conveys this information.

SUPERVISORY GUIDANCE

As noted, a state member bank may also become involved in the sale of uninsured debt obligations of its parent bank holding company or a nonbank affiliate. It is a longstanding policy of the Federal Reserve that debt obligations of a bank holding company or a nonbank affiliate not be issued, marketed, or sold in a way that conveys the misimpression or misunderstanding that these instruments are either (1) federally insured deposits or (2) obligations of or guaranteed by the subsidiary bank. The purchase of these holding company obligations by retail depositors of the subsidiary bank can, in the event of default, result in losses to individuals who believed that they had acquired federally insured or guaranteed instruments. In addition to the problems created for these individuals, this situation could impair public confidence in the bank and lead to unexpected withdrawals or liquidity pressures.

If a state member bank intends to market or sell or to allow its parent holding company or a nonbank affiliate to market or sell uninsured nondeposit debt obligations on bank premises, the bank should establish internal controls to ensure that the promotion, sale, and subsequent customer relationship resulting from the sale of these debt obligations is separated from the retail deposit-taking functions of the bank. For further information on commercial paper, see section 2030, ‘‘Bank Dealer Activities.’’

Sale of Uninsured Nondeposit Debt Obligations on Bank Premises

Examination Objectives

Effective date May 1996

Section 4160.2

1. To determine if uninsured nondeposit debt obligations of the state member bank or an affiliate are sold on bank premises.
2. To determine if the policies, practices, procedures, and internal controls for the sale of uninsured nondeposit debt instruments are adequate.
3. To ensure that the marketing and sale of uninsured nondeposit debt instruments are not conducted in a manner that conveys the impression or suggestion that they are federally insured deposits. Additionally, holding company or affiliate instruments should not convey the impression or suggestion that they are obligations of or guaranteed by the state member bank.
4. To ensure that the marketing and sale of uninsured nondeposit debt obligations are sufficiently separated and distinguished from retail banking operations, particularly the deposit-taking function.
5. To initiate corrective action if policies, practices, or procedures related to the sale of uninsured nondeposit debt instruments are deficient.

Sale of Uninsured Nondeposit Debt Obligations on Bank Premises

Examination Procedures

Effective date September 1992

Section 4160.3

1. Verify that the bank does not sell uninsured nondeposit debt instruments at teller windows or other areas where retail deposits are routinely accepted, including general lobby areas surrounding teller windows and personal banking desks.
2. Assess the adequacy of disclosures and the separation of the marketing and sale of uninsured nondeposit debt obligations from the retail deposit-taking function by assuring that:
   a. the debt instrument, advertising, and all related documents disclose prominently in bold print that the debt instrument is not insured by the Federal Deposit Insurance Corporation (bank holding company debt instruments should also state that the instrument is not an obligation of, or guaranteed by, the bank);
   b. advertisements that promote uninsured debt obligations of the bank (or an affiliate) do not also promote insured deposits of the bank in a way that could lead to confusion;
   c. the obligor of the uninsured debt instrument is prominently disclosed and names or logos of the bank are not used on holding company or nonbank affiliate instruments in a way that might suggest the insured bank is the obligor;
   d. adequate verbal disclosures are made during telemarketing contacts and at the time of sale (a review of employee instructions or a telemarketing script, or appropriate questions directed to an employee handling this function, could assist an examiner in assessing the adequacy of verbal disclosure);
   e. retail deposit-taking employees of the insured depository institution are not engaged in the promotion or sale of uninsured nondeposit debt instruments;
   f. information on uninsured nondeposit debt instruments is not contained in the retail deposit statements of customers or in the immediate retail deposit-taking area; and
   g. account information on holdings of uninsured nondeposit debt instruments is not included on insured deposit statements.
3. Encourage the bank to obtain a signed statement from the customer indicating that the customer understands that the uninsured debt instrument is not a deposit and is not FDIC insured.

Depository institutions have become increasingly involved in selling uninsured nondeposit investment products, such as mutual funds or annuities, on their premises to retail customers. In response to this development, an interagency statement on retail sales of nondeposit investment products (interagency statement) was issued on February 15, 1994, to enhance customer protection and lessen possible customer confusion that these products are insured deposits.[1] The interagency statement applies to all insured banks and thrifts, including state member banks and the U.S. branches and agencies of foreign banks.

The guidelines contained in the interagency statement apply to retail recommendations or sales of nondeposit investment products made by—

- employees of a depository institution,
- employees of an affiliated or unaffiliated third party occurring on the premises of the banking organization (including telephone sales, investment recommendations by employees, and sales or recommendations initiated by mail from its premises), and
- sales resulting from a referral of retail customers by the institution to a third party when the depository institution receives a benefit for the referral.

Retail sales include (but are not limited to) sales to individuals by depository-institution personnel or third-party personnel conducted in or adjacent to a depository institution's lobby area. The sales of government and municipal securities made in a depository institution's dealer department located away from the lobby area are not subject to the interagency statement. In addition, the interagency statement generally does not apply to fiduciary accounts administered by a depository institution. However, for fiduciary accounts where the customer directs investments, such as self-directed individual retirement accounts, the disclosures prescribed by the interagency statement (see the "Disclosures and Advertising" subsection below) should be provided. Furthermore, the interagency statement applies to affiliated broker-dealers when the sales occur on the premises of the depository institution. The interagency statement also applies to sales activities of an affiliated broker-dealer resulting from a referral of retail customers by the depository institution.

The Rules of Fair Practice of the Financial Industry Regulatory Authority govern sales of securities by its member broker-dealers. In addition, the federal securities laws prohibit materially misleading or inaccurate representations in connection with the offer or sale of securities and require that sales of registered securities be accompanied by a prospectus that complies with SEC disclosure requirements.

Examiners should determine whether the institution has adequate policies and procedures to govern the conduct of the sales activities on bank premises and, in particular, whether sales of nondeposit investment products are distinguished from the deposit-taking activities of the bank through disclosure and physical means that are designed to prevent customer confusion.

Although the interagency statement does not apply to sales of nondeposit investment products to nonretail customers, such as fiduciary customers, examiners should also apply the examination procedures prescribed in SR-94-34 ("Examination Procedures for Retail Sales of Nondeposit Investment Products," May 26, 1994) when retail customers are directed to the institution's trust department, where they may purchase nondeposit investment products by simply completing a customer agreement.

PROGRAM MANAGEMENT

Banks must adopt policies and procedures governing nondeposit investment product retail sales programs. These policies and procedures should be in place before the commencement of the retail sale of nondeposit investment products on bank premises.

The bank's board of directors is responsible for ensuring that retail sales of nondeposit investment products comply with the interagency statement and with all applicable state and federal laws and regulations. Therefore, the

1. The interagency statement was issued to Federal Reserve Banks under cover of a supervisory letter, SR-94-11 ("Interagency Statement on Retail Sales of Nondeposit Investment Products," February 17, 1994). Additional guidance is provided in SR-95-46 ("Interpretation of Interagency Statement on Retail Sales of Nondeposit Investment Products," September 14, 1995).

board, or a designated committee of the board, should adopt written policies that address the risks and management of these sales programs. Policies and procedures should reflect the size, complexity, and volume of the institution's activities or, when applicable, the institution's arrangements with any third parties selling these products on bank premises. The bank's policies and procedures should be reviewed periodically by the board of directors, or its designated committee, to ensure that they are consistent with the institution's current practices, applicable laws, regulations, and guidelines.

A bank's policies and procedures for nondeposit investment products should, at a minimum, address (1) disclosure and advertising, (2) the physical separation of investment sales from deposit-taking activities, (3) compliance and audit requirements, (4) suitability concerns, and (5) other sales practices and related risks. In addition, policies and procedures should address the following areas.

Types of Products Sold

When evaluating nondeposit investment products, management should consider what products best meet the needs of the bank's customers. Policies should outline the criteria and procedures that will be used to select and periodically review nondeposit investment products that are recommended or sold on the bank's premises. Institutions should periodically review the products offered to ensure that they meet their customers' needs.

Use of Identical or Similar Names

Because of the possibility of customer confusion, a nondeposit investment product must not have a name that is identical to the name of the bank or its affiliates. However, a bank may sell a nondeposit investment product with a similar name as long as the sales program addresses the even greater risk that customers may regard the product as an insured deposit or other obligation of the bank. Moreover, the bank should review the issuer's disclosure documents for compliance with SEC requirements, which call for a thorough explanation of the relationship between the bank and the mutual fund.

The Federal Reserve applies a stricter rule to investment adviser activities under Regulation Y (12 CFR 225.125) when a bank holding company (as opposed to a bank) or nonbank subsidiary acts as an investment advisor to a mutual fund. In this case, the fund may not have a name that is identical to, similar to, or a variation of the name of the bank holding company.

Permissible Use of Customer Information

Banks should adopt policies and procedures on the use of confidential customer information for any purpose in connection with the sale of nondeposit investment products. The industry guidelines permit institutions to share with third parties only limited customer information, such as the name, address, telephone number, and types of products owned. The guidelines do not permit the sharing of more confidential information, such as specific or aggregate dollar amounts of investments or net worth, without the customer's prior acknowledgment and written consent.

Arrangements with Third Parties

A majority of all nondeposit investment products sold on bank premises are sold by representatives of third parties. Under these arrangements, the third party has access to the institution's customers, and the bank is able to make nondeposit investment products available to interested customers without having to commit the resources and personnel necessary to sell the products directly. Third parties include wholly owned subsidiaries of a bank, bank-affiliated broker-dealers (section 20 companies[2] or discount brokerage firms), unaffiliated broker-dealers, insurance companies, or other companies in the business of distributing nondeposit investment products on a retail basis.

Bank management should conduct a comprehensive review of an unaffiliated third party before entering into any arrangement. The review should include an assessment of the third party's

2. A nonbank subsidiary of a bank holding company that has been authorized to underwrite and deal in certain debt and equity securities that cannot be underwritten or dealt in by member banks directly.

financial status, management experience, reputation, and ability to fulfill its contractual obligations to the bank, including its compliance with the interagency statement.

Banks should enter into written agreements with any affiliated and unaffiliated third parties that sell nondeposit investment products on bank premises. These agreements should be approved by the bank's board of directors or its designated committee. Agreements should outline the duties and responsibilities of each party; describe third-party activities permitted on the institution's premises; address the sharing or use of confidential customer information for investment sales activities; and define the terms for use of the bank's office space, equipment, and personnel. If an arrangement includes dual employees (bank employees also utilized by a third party), the agreement must provide for written employment contracts that specify the duties of these employees and their compensation arrangements.

In addition, a third-party agreement should specify that the third party will comply with all applicable laws and regulations and will conduct its activities in a manner consistent with the interagency statement. The agreement should authorize the institution to monitor the third party's compliance with its agreement, as well as authorize the bank and Federal Reserve examination staff to have access to third-party records considered necessary to evaluate this compliance. These records should include examination results, sales practice reviews, and related correspondence provided to the third party by securities regulatory authorities. Finally, the agreement should provide for indemnification of the institution by an unaffiliated third party for the conduct of its employees in connection with its sales activities. Notwithstanding the provisions of a third-party agreement, bank management should monitor the conduct of nondeposit investment product sales programs to ensure that sales of the products are distinct from other bank activities and are not conducted in a manner that could confuse customers about the lack of insurance coverage for these investments.

Contingency Planning

Nondeposit investment products are subject to price fluctuations caused by changes in interest rates and stock market valuations. In the event of a sudden, sharp drop in the market value of nondeposit investment products, institutions may experience a heavy volume of customer inquiries, complaints, and redemptions. Therefore, management should develop contingency plans to address these situations. A major element of any contingency plan should be to provide customers with access to information about their investments. Other factors to consider in contingency planning include public relations and the ability of operations staff to handle increased volumes of transactions.

DISCLOSURES AND ADVERTISING

Content, Form, and Timing of Disclosures

Nondeposit investment product sales programs should ensure that customers are clearly and fully informed of the nature and risks associated with these products. In addition, nondeposit investment products must be clearly differentiated from insured deposits. The interagency statement identifies the following minimum disclosures that must be made to customers when providing investment advice, making investment recommendations, or effecting nondeposit investment product transactions:

- They are not insured by the FDIC.
- They are not deposits or other obligations of the institution and are not guaranteed by the institution.
- They are subject to investment risks, including the possible loss of the principal invested.

There are limited situations in which the disclosure guidelines need not apply or where a shorter logo format may be used in lieu of the longer written disclosures.

The interagency statement disclosures do not need to be provided in the following situations:

- radio broadcasts of 30 seconds or less;
- electronic signs,[3] and
- signs, such as banners and posters, when they are used only as location indicators.

3. "Electronic signs" may include billboard-type signs that are electronic, time-and-temperature signs, and ticker-tape signs. Electronic signs would not include such media as television, on-line services, or ATMs.

Additionally, third-party vendors not affiliated with the depository institution need not make the interagency statement disclosures on nondeposit investment product confirmations and in account statements that may incidentally, with a valid business purpose, contain the name of the depository institution.

Shorter, logo-format disclosures may be used in visual media, such as television broadcasts, ATM screens, billboards, signs, posters, and written advertisements and promotional materials, such as brochures. The text of an acceptable logo-format disclosure would include the following statements:

- Not FDIC-Insured.
- No Bank Guarantee.
- May Lose Value.

Disclosure is the most important way of ensuring that the differences between nondeposit investment products and insured deposits are understood by retail customers. Accordingly, it is critical that the minimum disclosures be presented clearly and concisely in both oral and written communications. In this regard, the minimum disclosures should be provided—

- orally during any sales presentations (including telemarketing contacts) or when investment advice is given,
- orally and in writing before or at the time an investment account to purchase these products is opened, and
- in all advertisements and other promotional materials (discussed further below).

The minimum disclosures may be made on a customer account agreement or on a separate disclosure form. The disclosures must be conspicuous (highlighted through bolding, boxes, and/or a larger typeface). Disclosures contained directly on a customer account agreement should be located on the front of the agreement or adjacent to the customer signature block.

Banks are to obtain a written acknowledgment—on the customer account agreement or on a separate form—from a customer confirming that he or she has received and understands the minimum disclosures. For nondeposit investment product accounts established before the issuance of the interagency statement, banks should obtain a disclosure acknowledgment from the customer at the time of the customer's next purchase transaction. If an institution solicits customers by telephone or mail, it should ensure that the customers receive the written disclosures and an acknowledgment to be signed and returned to the institution.

Customer account statements, including combined statements for linked accounts and trade confirmations that are provided by the bank or an affiliate, should contain the minimum disclosures if they display the name or logo of the bank or its affiliate. Statements that provide account information about insured deposits and nondeposit investment products should clearly segregate the information about nondeposit investment products from the information about deposits to avoid customer confusion.

Advertising

The interagency statement provides that advertisements in all media forms that identify specific investment products must conspicuously include the minimum disclosures and must not suggest or convey any inaccurate or misleading impressions about the nature of a nondeposit investment product. Promotional material that contains information about both FDIC-insured products and nondeposit investment products should clearly segregate the information about the two product types. When promotional sales materials related to nondeposit investment products are displayed in the bank's retail areas, they should be grouped separately from material related to insured bank products.

Telemarketing scripts should be reviewed to determine whether bank personnel are inquiring about customer investment objectives, offering investment advice, or identifying particular investment products or types of products. In these cases, the scripts must contain the minimum disclosures, and bank personnel relying on the scripts must be formally authorized to sell nondeposit investment products by their employers. Further, these personnel must have training that is the substantive equivalent of that required for personnel qualified to sell securities as registered representatives (see the "Training" subsection below).

Additional Disclosures

A bank should apprise customers of certain material relationships. For example, a customer should be informed by sales personnel orally and in writing before the sale about any advisory relationship existing between the bank (or an affiliate) and a mutual fund whose shares are being sold by the institution. Similarly, fees, penalties, or surrender charges associated with a nondeposit investment product should be disclosed by sales personnel orally and in writing before or at the time the customer purchases the product. The SEC requires written disclosure of this information in the investment product's prospectus.

If sales activities include any written or oral representations concerning insurance coverage by any entity other than the FDIC (for example, SIPC insurance of broker-dealer accounts, a state insurance fund, or a private insurance company), then clear and accurate explanations of the coverage must also be provided to customers at that time to minimize possible confusion with FDIC insurance. These disclosures should not suggest that other forms of insurance are the substantive equivalent to FDIC deposit insurance.

SETTING AND CIRCUMSTANCES

Physical Separation from Deposit Activities

Selling or recommending nondeposit investment products on bank premises may give the impression that the products are FDIC-insured or are obligations of the bank. To minimize customer confusion with deposit products, nondeposit investment product sales activities should be conducted in a location that is physically distinct from the areas where retail deposits are taken. Bank employees located at teller windows may not provide investment advice, recommend investment products, or accept orders (even unsolicited orders) for nondeposit investment products.

To decide whether nondeposit investment product sales activities are sufficiently separate from deposit activities, the particular circumstances of each bank need to be evaluated. FDIC insurance signs and insured deposit-related promotional material should be removed from the investment product sales area and replaced with appropriate signs indicating that the area is used for the sale of investment products. Signs referring to specific investments should prominently contain the minimum disclosures. In the limited situation where physical constraints prevent nondeposit investment product sales activities from being conducted in a distinct and separate area, the institution has a heightened responsibility to ensure that appropriate measures are taken to minimize customer confusion.

In the case of banks that are affiliated with section 20 companies that sell retail investment products directly to bank customers, the requirement for separation of deposit-taking facilities from the securities operations of the section 20 company is absolute under the relevant firewall conditions imposed on these companies by the Board. Accordingly, retail sales activities conducted by a section 20 company must be in a separate office which, at a minimum, is set off from deposit-taking activities by partitions and identified by signs with the name of the section 20 company. Further, section 20 company employees may not be dual employees of the bank. Business cards for designated sales personnel should clearly indicate that they sell nondeposit investment products or, if applicable, are employed by a broker-dealer.

The interagency statement was intended generally to cover sales made to retail customers in the bank lobby. However, some institutions may have an arrangement whereby retail customers purchase nondeposit investment products at a location of the institution that is generally confined to institutional services (for example, corporate money desk). In these cases, the bank should still ensure that retail customers receive the minimum disclosures to minimize any possible customer confusion with nondeposit investment products and insured deposits.

Hybrid Instruments and Accounts

When an institution offers accounts that link traditional bank deposits with nondeposit investment products, such as a cash-management account,[4] the accounts should be opened in the investment sales area by trained personnel. In light of the hybrid characteristics of these products, the opportunity for customer confusion is amplified, and the institution should take special care during the account-opening process to ensure that a customer is accurately informed that

4. A hybrid account may incorporate deposit and brokerage services, credit/debit card features, and automated sweep arrangements.

- funds deposited into a sweep account will only be FDIC-insured until they are swept into a nondeposit investment product account and
- customer account statements may disclose balances for both insured and nondeposit product accounts.

DESIGNATION, TRAINING, AND SUPERVISION OF PERSONNEL

Hiring and Training of Sales Personnel

Banks hiring sales personnel for nondeposit investment product programs should investigate the backgrounds of prospective employees. When a candidate for employment has previous investment industry experience, the bank should check whether the individual has been the subject of any disciplinary actions by securities, state, or other regulators.

Unregistered bank sales personnel should receive training that is the substantive equivalent of that provided to personnel qualified to sell securities as registered representatives. Training should cover the areas of product knowledge, trading practices, regulatory requirements and restrictions, and customer-protection issues. In addition, training programs should cover the bank's policies and procedures for sales of nondeposit investment products and should be conducted continually to ensure that staff are familiar with new products and compliance issues.

For those bank employees whose sales activities are limited to mutual funds or variable annuities, the equivalent training is that ordinarily needed to pass NASD's series 6 limited representative examination, which typically involves approximately 30 to 60 hours of preparation, including about 20 hours of classroom training. Bank employees who are authorized to sell additional investment products and securities should receive training that is appropriate to pass the NYSE's series 7 general securities representative examination, which typically involves 160 to 250 hours of study, including at least 40 hours of classroom training.

The training of third-party or dual employees is the responsibility of the third party. When entering into an agreement with a third party, bank management should be satisfied that the third party is able to train third-party and dual employees with respect to compliance with the minimum disclosures and other requirements of the interagency statement. Copies of third-party training and compliance materials should be obtained and reviewed by the bank to monitor the third party's performance regarding its training obligations.

Training of Bank Personnel Who Make Referrals

Bank employees, such as tellers and platform personnel, who are not authorized to provide investment advice, make investment recommendations, or sell nondeposit investment products, but who may refer customers to authorized nondeposit investment products sales personnel, should receive training about the strict limitations on their activities. In general, bank personnel who are not authorized to sell nondeposit investment products are not permitted to discuss general or specific investment products, prequalify prospective customers as to financial status and investment history and objectives, open new accounts, or take orders on a solicited or unsolicited basis. These personnel may contact customers for the purposes of—

- determining whether the customer wishes to receive investment information
- inquiring whether the customer wishes to discuss investments with an authorized sales representative, and
- arranging appointments to meet with authorized bank sales personnel or third-party broker-dealer registered sales personnel.

The minimum disclosure guidelines do not apply to referrals made by personnel not authorized to sell nondeposit investment products if the referral does not provide investment advice, identify specific investment products, or make investment recommendations.

Supervision of Personnel

Bank policies and procedures should designate, by title or name, the individuals responsible for supervising nondeposit investment product sales activities, as well as the referral activities of bank employees not authorized to sell these products. Personnel responsible for managing the sales programs for these products should have supervisory experience and training equivalent to that required of a general securities principal, as required by the NASD for broker-dealers. Supervisory personnel should be responsible for the bank's compliance with policies and procedures on nondeposit investment products, applicable laws and regulations, and the interagency statement. When sales of these products are conducted by a third party, supervisory personnel should be responsible for monitoring compliance with the agreement between the bank and the third party, as well as compliance with the interagency statement, particularly the guideline calling for nondeposit investment product sales to be separate and distinct from the deposit activities of the bank.

SUITABILITY AND SALES PRACTICES

Suitability of Recommendations

Suitability refers to the matching of customer financial means and investment objectives with a suitable product. If customers are placed into unsuitable investments, the resulting loss of consumer confidence could have detrimental effects on the bank's reputation. Many first-time investors may not fully understand the risks associated with nondeposit investment products and may assume that the bank is responsible for the preservation of the principal of their investment.

Banks that sell nondeposit investment products directly to customers should develop detailed policies and procedures addressing the suitability of investment recommendations and related recordkeeping requirements. Sales personnel that recommend nondeposit investment products to customers should have reasonable grounds for believing that the recommended products are suitable for the particular customer on the basis of information he or she has provided. A reasonable effort must be made to obtain, record, and update information concerning the customer's financial profile (for example, tax status, other investments, income), investment objectives, and other information necessary to make recommendations.

In determining whether sales personnel are meeting their suitability responsibilities, examiners should review the practices for conformance with the bank's policies and procedures. The examiner's review should include a sample of customer files to determine the extent of customer information collected, recorded, and updated (for subsequent purchases) and should determine whether investment recommendations appear unsuitable in light of this information.

Nondeposit investment product sales programs conducted by third-party broker-dealers are subject to the NASD's suitability and other sales practice rules. To avoid duplicating NASD examination efforts, examiners should rely on the NASD's most recent sales practice review of the third party, when available. If an NASD review has not been completed within the last two years, Reserve Banks should consult with Board staff to determine an appropriate examination scope for suitability compliance before proceeding further.

Sales Practices and Customer Complaints

Banks should have policies and procedures that address undesirable practices by sales personnel, such as practices to generate additional commission income for the employee by churning or switching accounts from one product to another. Banks should have policies and procedures for handling customer complaints related to nondeposit investment products. The process should provide for the recording and tracking of all complaints and require periodic reviews of complaints by compliance personnel. The merits and circumstances of each complaint (including all documentation relating to the transaction) should be considered when determining the proper form of resolution. Reasonable time-frames should be established for addressing complaints.

COMPENSATION

Incentive compensation programs specifically related to the sale of nondeposit investment products may include sales commissions, limited fees for referring prospective customers to an authorized sales representative, and nonmonetary compensation (prizes, awards, and gifts). Compensation that is paid by unaffiliated third parties (for example, mutual fund distributors) to bank staff must be approved in writing by bank management, be consistent with the bank's written internal code of conduct for the acceptance of remuneration from third parties, and be consistent with the proscriptions of the Bank Bribery Act (18 USC 215) and the banking agencies' implementing guidelines to that act. (See SR-87-36, "Bank Bribery Act Guidelines," October 30, 1987.) Compensation policies should establish appropriate limits on the extent of compensation that may be paid to banking organization staff by unaffiliated third parties.

Incentive compensation programs must not be structured in such a way that they result in unsuitable investment recommendations or sales to customers. In addition, if sales personnel sell both deposit and nondeposit products, similar financial incentives should be in place for sales of both types of products. A compensation program that offers significantly higher remuneration for selling a specific product (such as a proprietary mutual fund) may be inappropriate if it results in unsuitable recommendations to customers. A compensation program that is intended to provide remuneration for a group of bank employees (such as a branch or department) is permissible as long as the program is based on the group's overall performance in meeting bank objectives for a broad variety of bank services and products and not on the volume of sales of nondeposit investment products.

Individual bank employees, such as tellers, may receive a one-time nominal fee of a fixed-dollar amount for referring customers to authorized sales personnel to discuss nondeposit investment products. However, the payment of the fee should not depend on whether the referral results in a transaction. Nonmonetary compensation to bank employees for referrals should be similarly structured. Auditors and compliance personnel should not participate in incentive compensation programs that are directly related to the results of nondeposit investment product sales programs.

COMPLIANCE

Banks must develop and maintain written policies and procedures that effectively monitor and assess compliance with the interagency statement and other applicable laws and regulations and that ensure appropriate follow-up to correct identified deficiencies. Compliance programs should be independent of sales activities with respect to scheduling, compensation, and performance evaluations. Compliance findings should periodically be reported to the bank's board of directors or a designated committee of the board as part of the institution's ongoing oversight of nondeposit investment product activities. Compliance personnel should have appropriate training and experience with nondeposit investment product sales programs, applicable laws and regulations, and the interagency statement.

Banks should institute compliance programs for nondeposit investment products that are similar to those of securities broker-dealers. This includes a review of new accounts and a periodic review of transactions in existing accounts to identify any potentially abusive practices, such as unsuitable recommendations, churning, or switching. Compliance personnel should also oversee the prompt resolution of customer complaints and review complaint logs for questionable sales practices. Management-information-system reports on early redemptions and sales patterns for specific sales representatives and products should also be used by compliance personnel to identify any potentially abusive practices. In addition, the referral activities of bank personnel should be reviewed to ensure that they conform to the guidelines in the interagency statement.

When nondeposit investment products are sold by third parties on bank premises, the bank's compliance program should provide for oversight of the third party's compliance with its agreement with the bank, including its conformance to the disclosure and separate-facilities guidelines of the interagency statement. The results of this oversight should be reported to the board of directors or a designated committee of the board. Management should obtain the third party's commitment to promptly correct identified problems. Proper follow-up by the bank's compliance personnel should verify the third party's corrective actions.

AUDITS

Audit personnel should be responsible for assessing the effectiveness of the institution's compliance function and overall management of the nondeposit investment product sales program. The scope and frequency of audit reviews of nondeposit investment product activities will depend on the complexity and sales volume of a sales program and on whether there are any indications of potential or actual problems. Audits should cover all of the issues discussed in the interagency statement. Internal audit staff should be familiar with nondeposit investment products and receive ongoing training. Findings should be reported to the board of directors or to a designated committee of the board, and proper follow-up should be performed. Audit activities with respect to third parties should include a review of their compliance function and the effectiveness of the bank's oversight of the third party's activities.

1. To determine that the banking organization has taken appropriate measures to ensure that retail customers clearly understand the differences between insured deposits and nondeposit investment products and that they receive the minimum disclosures both orally during sales presentations (including telemarketing) and in writing.
2. To assess the adequacy of the institution's policies and procedures, sales practices, and oversight by management and the board of directors to ensure an operating environment that fosters customer protection in all facets of the sales program.
3. To ensure that the sales program is conducted in a safe and sound manner that is in compliance with the interagency statement, Federal Reserve guidelines, regulations, and applicable laws.
4. To assess the effectiveness of the institution's compliance and audit programs for nondeposit investment product operations.
5. To obtain commitments for corrective action when policies, procedures, practices, or management oversight is deficient or when the institution has failed to comply with the interagency statement or applicable laws and regulations.

1. Verify through the minutes of the board of directors that the directors have approved the sale of uninsured annuities, reviewed, and approved the choice of an underwriter in the past year.
2. Determine if the bank adequately evaluates the underwriter's financial condition at least annually and regularly reviews the credit ratings assigned to the underwriter by at least two independent agencies evaluating annuity underwriters. (Banks engaged in the sale of annuities are expected to sell only products of financially secure underwriters and to make current ratings of the underwriter available to an investor when purchasing an uninsured annuity.)
3. Verify that the bank does not sell uninsured annuities at teller windows or other areas where retail deposits are routinely accepted.
4. Assess the adequacy of disclosures and the separation of the marketing and sale of uninsured annuities from the retail deposit-taking function by ensuring that—
   a. the contract, advertising, and all related documents disclose prominently in bold print that the annuities are not deposits or obligations of an insured depository institution and are not insured by the Federal Deposit Insurance Corporation;
   b. advertisements do not contain words, such as ''deposit,'' ''CD,'' etc., that could lead an investor to believe an annuity is an insured deposit instrument;
   c. the obligor of the annuity contract is prominently disclosed and names or logos of the insured bank are not used in a way that might suggest the insured bank is the obligor;
   d. adequate verbal disclosures are made during telemarketing contacts and at the time of sale;
   e. retail deposit-taking employees of the insured depository institution are not engaged in the promotion or sale of uninsured annuities;
   f. information on uninsured annuities is not contained in retail deposit statements of customers (either as advertising on deposit statements or as ''junk mail'' stuffers included with deposit statements) or in the immediate retail deposit-taking area;
   g. account information on annuities owned by customers is not included on insured deposit statements; and
   h. officer or employee remuneration associated with selling annuities is limited to reasonable levels in relation to the individual's salary. (As a guideline in reviewing remuneration, see the Board's policy statement on disposition of credit life insurance, as discussed in the Consumer Credit, Examination Procedures, section of this manual.)
5. If the bank allows a third-party entity to market annuities on depository-institution premises, assess the adequacy of disclosures and the separation of the marketing and sale of uninsured annuities from the retail deposit-taking function by determining that—
   a. the bank has ensured that the third-party company is properly registered or licensed to conduct this activity,
   b. bank personnel are not involved in sales activities conducted by the third party,
   c. desks or offices used to market or sell annuities are separate and distinctly identified as being used by an outside party, and
   d. bank personnel do not normally use desks or offices used by a third party for annuities sales.
6. Encourage the bank to obtain a signed statement from the customer indicating that the customer understands that the annuity is not a deposit or any other obligation of the bank, that the bank is only acting as an agent for the insurance company (underwriter), and that the annuity is not FDIC-insured.

INTERAGENCY POLICY ON BANKS AND THRIFTS PROVIDING FINANCIAL SUPPORT TO FUNDS ADVISED BY THE BANKING ORGANIZATION OR ITS AFFILIATES

On January 5, 2004, the federal banking agencies[1] (the agencies) issued an interagency policy statement to alert banking organizations, including their boards of directors and senior management, of the safety-and-soundness implications of, and the legal impediments to, a bank providing financial support to investment funds[2] advised by the bank, its subsidiaries, or affiliates (affiliated investment funds). A banking organization's investment advisory services can pose material risks to the bank's liquidity, earnings, capital, and reputation and can harm investors, if the associated risks are not effectively controlled. (See SR-04-1.)

Banks are under no statutory requirement to provide financial support to the funds they advise; however, circumstances may motivate banks to do so for reasons of reputation risk and liability mitigation. This type of support by banking organizations to funds they advise has included credit extensions, cash infusions, asset purchases, and the acquisition of fund shares. In very limited circumstances, certain arrangements between banks and the funds they advise have been expressly determined to be legally permissible and safe and sound when properly conducted and managed. However, the agencies are concerned about other occasions when emergency liquidity needs may prompt banks to support their advised funds in ways that raise prudential and legal concerns. Federal laws and regulations place significant restrictions on transactions between banks and their advised funds. In particular, sections 23A and 23B of the Federal Reserve Act and the Board's Regulation W (12 CFR 223) place quantitative limits and collateral and market-terms requirements on many transactions between a bank and certain of its advised funds.

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

2. Bank-advised investment funds include mutual funds, alternative strategy funds, collective investment funds, and other funds where the bank, its subsidiaries, or affiliates is the investment adviser and receives a fee for its investment advice.

Interagency Policy

To avoid engaging in unsafe and unsound banking practices, banks should adopt appropriate policies and procedures governing routine or emergency transactions with bank-advised investment funds. Such policies and procedures should be designed to ensure that the bank will *not* (1) inappropriately place its resources and reputation at risk for the benefit of the funds' investors and creditors; (2) violate the limits and requirements contained in sections 23A and 23B of the Federal Reserve Act and Regulation W, other applicable legal requirements, or any special supervisory condition imposed by the agencies; or (3) create an expectation that the bank will prop up the advised fund. Further, the agencies expect banking organizations to maintain appropriate controls over investment advisory activities that include:

- Establishing alternative sources of emergency support from the parent holding company, nonbank affiliates, or external third parties prior to seeking support from the bank.
- Instituting effective policies and procedures for identifying potential circumstances triggering the need for financial support and the process for obtaining such support. In the limited instances that the bank provides financial support, the bank's procedures should include an oversight process that requires formal approval from the bank's board of directors, or an appropriate board-designated committee, independent of the investment advisory function. The bank's audit committee also should review the transaction to ensure that appropriate policies and procedures were followed.
- Implementing an effective risk-management system for controlling and monitoring risks posed to the bank by the organization's investment advisory activities. Risk controls should include establishing appropriate risk limits, liquidity planning, performance measurement systems, stress testing, compliance reviews, and management reporting to mitigate the need for significant bank support.

- Implementing policies and procedures that ensure that the bank is in compliance with existing disclosure and advertising requirements to clearly differentiate the investments in advised funds from obligations of the bank or insured deposits.
- Ensuring proper regulatory reporting of contingent liabilities arising out of its investment advisory activities in the banking organization's published financial statements in accordance with FAS 5, and fiduciary settlements, surcharges, and other losses arising out of its investment advisory activities in accordance with the instructions for completing call report Schedule RC-T (Fiduciary and Related Services).

Notification of a Banking Organization's Primary Federal Regulator

Because of the potential risks posed by the provision of financial support to advised funds, bank management should notify and consult with its appropriate federal banking agency prior to (or immediately after, in the event of an emergency) the bank providing material financial support to its advised funds. The appropriate federal banking agency will closely scrutinize the circumstances surrounding the transaction and will address situations that raise supervisory concerns.

Investment-Funds Support
Examination Objectives
Effective date May 2004

Section 4180.2

1. To determine if the bank provides support to an advised fund and, if so, the type of support that is being provided.
2. If the bank is providing support to an advised fund, to ascertain whether the type of support raises prudential (safety-and-soundness) or legal concerns, such as noncompliance with sections 23A and 23B of the Federal Reserve Act, and with Regulation W.
3. To determine whether the bank has adopted appropriate policies and procedures governing routine or emergency transactions with funds that it advises.
4. To find out if the bank has established appropriate controls over investment advisory activities.
5. If a bank has provided material financial support to an advised fund, to determine if the bank notified its primary federal regulator before engaging in the activity.

1. Determine if the bank has inappropriately placed its resources at risk for the benefit of an affiliated investment fund's investors and creditors.
2. Ascertain whether the bank's advisory services to investment funds pose material risks to the bank's liquidity, earnings, and capital.
3. Determine if the bank provides support to an investment fund and if that support violates the limits and requirements of sections 23A and 23B of the Federal Reserve Act, and Regulation W; other applicable legal requirements; or any special supervisory condition imposed by the bank's primary federal supervisory agency.
4. Find out if the bank has given any form of assurances or expectations that it will provide financial or other support to an advised fund.
5. Ascertain whether the bank has established appropriate controls over investment advisory activities, such as:
   a. Establishing alternative sources of emergency support that can be made available to an advised fund from the parent holding company, nonbank affiliates, or external third parties before the fund seeks financial support from the bank.
   b. Instituting effective policies and procedures to—
      - identify potential circumstances that would trigger the need for financial support by an affiliated fund, and establish the process for obtaining that support;
      - ensure that the bank is in compliance with existing disclosure and advertising requirements that clearly differentiate the investments in advised funds from the bank's other obligations or federally insured deposits; and
      - avoid unsafe and unsound banking practices by initiating procedures that govern routine or emergency transactions with bank-advised investment funds.
   c. Implementing an effective risk-management system for controlling and monitoring risks posed to the bank by its investment advisory activities.
   d. Ensuring the bank's proper reporting, in its financial statements, of contingent liabilities that arise out of its investment advisory activities (in accordance with FAS 5 and the bank call report instructions for completing Schedule RC-T for fiduciary activities).
6. Determine if the bank notified and consulted with the appropriate supervising Federal Reserve Bank before (or, in an emergency, immediately after) providing financial support to an affiliated investment fund.

Review the bank's internal controls, policies, practices, and procedures concerning investment funds that it advises. When performing that task, conduct examination reviews and procedures to answer the following questions:

1. Has the bank—
   a. inappropriately placed its financial resources or reputation at risk for the benefit of affiliated investment funds' investors and creditors?
   b. violated the limits and requirements in sections 23A and 23B of the Federal Reserve Act and in Regulation W, with regard to its transactions with advised investment funds?
   c. created any expectation that the bank will prop up an advised fund?
2. Do the bank's advisory services pose material risks to its liquidity, earnings, and capital?
3. Does the bank encourage its advised investment funds to establish alternative sources of financial support so that the funds can avoid seeking support from the bank itself?
4. Has the bank provided support to the funds it advises, such as with extensions of credit, cash infusions, asset purchases, acquisition of fund shares, or any other type of financial support?
5. Has the bank implemented and maintained an effective risk-management system for controlling and monitoring the risks posed to the bank by its investment advisory activities?
6. Did the bank's board of directors adopt appropriate policies and procedures to avoid engaging in unsafe and unsound banking practices with respect to routine or emergency transactions with bank-advised investment funds?
7. Has the bank's management properly reported contingencies arising out of its investment advisory activities, in accordance with FAS 5, and also any fiduciary settlements, surcharges, and other losses arising out of its investment advisory activities, in accordance with the instructions of the bank call report schedule RC-T (Fiduciary and Related Services)?
8. Has the bank's management notified and consulted with its appropriate supervising Federal Reserve Bank before (or, in an emergency, immediately after) providing material financial support to advised funds?

Fiduciary activities and other related services generally include traditional trust services, such as personal trust, corporate trust, and transfer-agent services and employee benefit account products and services, as well as custody and securities-lending services, clearing and settlement, private banking, asset management, and investment advisory activities. (See SR-01-5.)

Pursuant to 12 USC 24 (seventh), 92a, and 93a, the Office of the Comptroller of the Currency (OCC) has established standards (the OCC rules for fiduciary activities of national banks). These rules are typically considered the industry standard for fiduciary activities of all financial institutions operating in the United States. (See 12 CFR 9.) When considering whether a state member bank has adhered to industry standards for fiduciary activities, Federal Reserve System (FRS) examiners can refer to the guidance set forth in the OCC rules and FRS and OCC examination manuals, as well as the examination materials issued by other U.S. financial institution regulatory agencies. With respect to a state member bank subsidiary, the appropriate bank, thrift, or functional regulator has the primary supervisory responsibility for evaluating risks, hedging, and risk management at the legal-entity level for the entity that the regulator supervises. (See SR-00-13.) Examiners should seek to use the examination findings of the functional regulator.

A risk-focused fiduciary examination concentrates on understanding and evaluating risk and assessing the internal controls the state member bank has employed to manage risk. The program encompasses continuous monitoring; targeted reviews of fiduciary activities; preparation of supervisory risk profiles and assessments; and the development of supervisory plans, which are integrated into the preplanning of an examination. Conclusions are used to develop an overall safety-and-soundness evaluation of the state member bank's fiduciary activities. (See SR-96-10.)

The Federal Reserve System's fiduciary-examination program reviews and assesses the risk-management practices and related aspects of a state member bank's fiduciary activities. This approach results in (1) the use of a more diversified examiner population, including those with capital-markets, information systems, and safety-and-soundness experience; (2) an emphasis on assessing the individual organization's unique risk profile; and (3) reviews of risk identification, measurement, monitoring, and control. Examiners should use the state member bank's control disciplines (internal audit, risk management, and compliance program) whenever possible.

Examiners have access to a broad variety of FRS supervisory information and analytical support tools to evaluate the fiduciary activities of financial institutions. The Uniform Bank Performance Report (UBPR) can assist examiners in evaluating a state member bank's fiduciary business lines or activities relative to its peers. (See the UBPR, pages Trust 1 and Trust 1A.) Beginning with the December 2002 release, "Section II: Technical Information" of the *UBPR User's Guide* (available online at www.ffiec.gov/ubprguide.htm) discusses the availability of the Total Fiduciary Assets within a fiduciary group number (peer group). (See page II-3.) "Total Fiduciary Assets" are the totals of managed and nonmanaged fiduciary assets for FDIC-insured commercial and savings banks, as reported on Schedule RC-T of the call report.

COMPLEX FIDUCIARY ORGANIZATIONS

SR-01-5 explains that complex fiduciary organizations are those banking organizations that conduct significant or complex fiduciary activities. This includes large complex banking organizations (LCBOs), other large or regional institutions for which fiduciary activities represent a significant portion of their business, and clearing agencies registered with the Securities and Exchange Commission (SEC) for which the Federal Reserve is the primary supervisor. The fiduciary-examination frequency should be determined on the basis of the impact that fiduciary activities have on the organization's risk profile. At a minimum, all material fiduciary business lines should be subject to examination over a two-year period or examination cycle as part of the continuous supervision process, with higher-risk areas generally reviewed annually.

Composite Uniform Interagency Trust Rating System (UITRS) ratings and transfer-agent ratings reflecting the overall condition of the fiduciary function at each institution, and any component ratings considered relevant, should be assigned or updated in a timely manner on the basis of the results of examinations, targeted reviews, or other assessments of fiduciary activities. UITRS ratings do not need to be assigned for each targeted business-line review. However, at a minimum, composite UITRS and transfer-agent ratings should be updated annually, and any material findings related to these areas should be included in the annual summary supervisory report. Any significant concerns should be reflected in the safety-and-soundness examination ratings. Fiduciary risks and fiduciary-risk management assessments should also be reflected in the relevant risk-assessment and risk-management ratings for the banking organization, as necessary.

OTHER INSTITUTIONS OFFERING FIDUCIARY AND TRANSFER-AGENT SERVICES

The frequency of fiduciary and transfer-agent examinations for other institutions, generally smaller state-chartered Federal Reserve member banks and trust companies with noncomplex operations, should be determined on the basis of the significance of their fiduciary and transfer-agent activities and an assessment of the level of risk the activities present to the institution. This scheduling guidance also applies to initial examinations of new institutions and to those institutions subject to Federal Reserve supervision as a result of a charter conversion.

At a minimum, fiduciary activities should be reviewed no less frequently than during every other routine safety-and-soundness examination. Examinations governed by alternating examination programs with state banking authorities may continue to be performed in accordance with those arrangements or as necessary to incorporate the provisions of SR-01-5. Examinations of fiduciary activities at noncomplex limited-purpose trust companies and other fiduciary institutions subject to supervision by the Federal Reserve that do not receive routine safety-and-soundness examinations should be conducted no less frequently than every two years.

Composite UITRS and transfer-agent examination ratings reflecting the overall condition of the function, and any component ratings considered relevant, should be assigned or updated at the completion of the examination or assessment. Material examination findings should be integrated into the overall examination report for the institution, which should clearly indicate the significance of any findings to the safety and soundness of the institution and the impact of the findings on any relevant risk assessments and risk-management ratings.

ORGANIZATIONS WITH SUPERVISORY CONCERNS

Organizations whose fiduciary activities have raised supervisory concerns should be subject to an additional level of supervisory attention on the basis of the severity of those supervisory concerns. Generally, this would include those organizations with a composite UITRS rating of 3, 4, or 5; a transfer-agent rating of B or C; or significant deficiencies in one or more component-rating categories. In the case of an institution assigned a UITRS rating of 4 or 5 or a transfer-agent rating of C, supervisory action should be initiated promptly and continued until the problems or deficiencies have been appropriately addressed.

Under the Securities and Exchange Act of 1934, the Federal Reserve continues to be responsible for examining transfer agents and clearing agencies for which it is the primary supervisor, including reviewing compliance with SEC rules. Any material violations of transfer-agent or clearing-agency rules must be reported promptly to Board staff to facilitate coordination with the SEC.

RISK PROFILE OF FIDUCIARY ACTIVITIES

Regular supervisory assessments of the risk of fiduciary activities, as outlined in SR-01-5, support the supervisory process. Risk profiles for LCBOs are updated quarterly in accordance with the provisions of SR-99-15. These risk profiles should include explicit consideration of the risks of fiduciary activities. For other complex fiduciary organizations, risk profiles reflecting fiduciary activities should be prepared and updated as needed, but no less frequently than annually. For these organizations, supervisory plans should detail the fiduciary specialist's recommended examination coverage of fiduciary activities. For banking organizations supervised by the Federal Reserve that have smaller, noncomplex fiduciary operations, formal risk profiles may not be necessary. However, fiduciary-risk information should normally be updated at each examination or inspection and incorporated into supervisory plans.

Risk profiles should include an assessment of the inherent risk in the organization's fiduciary activities, as well as a consideration of the effectiveness of its risk management. Risk assessments would normally include the following factors:

- the size and number of fiduciary accounts and assets administered
- the nature and complexity of fiduciary products and services offered
- significant changes to management or staffing for fiduciary services
- significant changes to data processing systems supporting fiduciary services
- new affiliations, partnerships, or outsourcing arrangements
- changes in strategic direction affecting fiduciary services or exposure to emerging risks
- significant litigation, settlements, or charge-offs
- the length of time since the last on-site examination in which fiduciary activities were reviewed, and the scope of that examination
- the significance of prior examination findings
- the effectiveness of the organization's control environment, including its audit function, and the adequacy of its risk-management practices relative to the nature and scope of its business

RISK FOCUS

As explained in SR-96-10, for a complex institution, fiduciary examiners will direct their attention to assessing the organization's functions and its ability to identify, measure, monitor, and control fiduciary, market, credit, and operational risks. Examiners should assess risks that result from the fiduciary's investment-management, investment advisory, mutual funds, global custody, and securities-lending and processing activities. Any other activities that are subject to adverse movements in market rates or prices, or to operating problems associated with processing a large volume of securities, should also be assessed. These fiduciary activities could result in material losses to trust customers and, in turn, expose the institution to financial losses and litigation if not conducted in a manner consistent with the fiduciary's duty of loyalty and the investor's stated objectives.

A review of internal controls and policies and procedures is an integral part of the examination program. Facets of a fiduciary examination include management competence and accountability, management's review of risks associated with the introduction of new products and services, and management's overall risk awareness.

The emphasis on risk assessment and control parallels the guidelines and procedures pertaining to state member bank examinations and bank holding company inspections, as described in SR-95-51, and recognizes the efforts of many progressive institutions in establishing fiduciary-risk assessment and control initiatives of their own. When rating the quality of risk management of fiduciary activities, examiners should place primary consideration on findings relating to the following elements of a sound risk-management system: (1) active board and senior management oversight; (2) adequate policies, procedures, and limits; (3) adequate risk-measurement, -monitoring, and management information systems; and (4) comprehensive internal controls. Each of these elements is described further below, along with a list of considerations relevant to assessing the adequacy of each element.

Active Board and Management Oversight

Given that a board of directors has ultimate responsibility for all of the activities of its institution, the board should approve overall fiduciary business strategies and policies, including those related to identifying, measuring, monitoring, and controlling fiduciary risks. A board of directors must understand the nature of the risks that are significant to the organization, and it should ensure that management is taking the steps necessary to manage these risks.

Senior management has the responsibility for implementing approved strategies in a way that will limit fiduciary risks and ensure compliance with laws and regulations. Senior management should, therefore, be fully involved in the fiduciary activities of their institution and have sufficient knowledge of all fiduciary business lines to ensure that necessary policies, controls, and risk-monitoring systems are in place and that accountability and lines of authority are clearly defined. In assessing the quality of fiduciary oversight by boards of directors and senior management, examiners should consider whether these conditions exist:

- The board and senior management have a clear understanding and working knowledge of the types of fiduciary activities the institution performs and of the risks inherent in them. They have approved appropriate policies, procedures, recordkeeping systems, and reporting systems to support the fiduciary activities and to help measure and monitor risks. They have established procedures to stay informed about changes in fiduciary activities and the associated risks.
- Management at all levels adequately supervises the daily activities of officers and employees to ensure that the lines of fiduciary business are managed and staffed by persons whose knowledge, experience, and expertise are consistent with the nature and scope of the organization's fiduciary activities.
- Before offering new services or introducing new products, management identifies the fiduciary risks associated with them and ensures that internal controls are in place to manage the service or product and its accompanying risk.

Adequate Policies, Procedures, and Limits

An institution's directors and senior management should establish fiduciary and fiduciary-risk management policies and procedures commensurate with the types of activities the institution conducts. The policies and procedures should provide enough detailed guidance to ensure that all material areas of fiduciary activity and risk are addressed. They should also be modified when necessary to respond to changes in the organization's activities. A smaller, less complex institution that has effective management and that is heavily involved in daily operations generally would be expected to have more basic policies addressing the significant areas of its activities and setting forth a limited but appropriate set of requirements and procedures. In a larger institution, where senior management must rely on a widely dispersed staff to implement strategies in a wide range of complex situations, far more detailed policies and related procedures would be expected. In assessing the adequacy of an institution's fiduciary and fiduciary-risk management policies and procedures, examiners should consider whether these conditions exist:

- The institution's policies and procedures adequately address the fiduciary activities performed and are consistent with management's experience level and with the institution's stated goals and objectives.
- The institution's policies and procedures provide for adequate identification, measurement, monitoring, and control of the risks posed by its fiduciary activities.
- Policies clearly establish accountability and set forth lines of authority.
- Policies provide for review of new fiduciary services and activities to ensure that they are suitable and consistent with fiduciary-customer objectives, and to ensure that the systems necessary to identify, measure, monitor, and control risks associated with new services and activities are in place before the activity is initiated.

Adequate Risk-Monitoring and Management Information Systems

Risk monitoring requires institutions to identify and measure all areas of material fiduciary risk continuously. Risk-monitoring activities must be supported by management information systems that provide senior management with timely reports on financial condition, operating performance, marketing efforts, new products and services, pending or threatened litigation, and risk exposure arising from fiduciary activities. The information system also must provide regular and more detailed reports for managers engaged in the daily management of the institution's activities.

The sophistication of risk-monitoring and control information systems should be commensurate with the complexity of the institution's fiduciary operations. Less complex institutions may require only a limited number of management reports to support risk-monitoring activities. Larger, more complex institutions, however, would be expected to have much more comprehensive reporting and monitoring systems. These systems would allow for more frequent reporting and closer monitoring of complex activities. In assessing the adequacy of an institution's measurement and monitoring of fiduciary risk, examiners should consider whether these conditions exist:

- The institution's fiduciary-risk monitoring practices and reports encompass all of its business lines and activities, and they are structured to monitor exposures consistent with established goals, limits, and objectives.
- Key assumptions, data sources, and procedures used in identifying, measuring, and monitoring fiduciary risk are appropriate for the activities the institution performs and are adequately documented and continuously tested for reliability.
- Reports to management are accurate and timely and contain sufficient information for policy and decision makers to identify any adverse trends and any potential or real problems. The reports must be adequate for management to evaluate the level of fiduciary risk faced by the institution.

Adequate Internal Controls

A comprehensive internal-control structure is critical to the safe and sound functioning of an institution and its fiduciary-risk management system. Establishing and maintaining a system of internal controls that sets forth official lines of authority and an appropriate segregation of duties is one of management's most important responsibilities.

A well-structured system of internal controls promotes effective fiduciary operations and reliable reporting; safeguards assets; and helps to ensure compliance with laws, regulations, and institutional policies. Controls should be periodically tested by an independent party (preferably the auditor or at least an individual not involved in the process being reviewed) who reports directly to either the institution's board of directors or one of its designated committees. Given the importance of appropriate internal controls to organizations of all sizes and risk profiles, the results of these reviews should be adequately documented, as should management's responses to them. In evaluating the adequacy of an institution's internal controls as they relate to fiduciary activities, examiners should consider whether these conditions exist:

- The system of internal controls is appropriate to the type and level of fiduciary activities.
- The institution's organizational structure establishes clear lines of authority and responsibility.
- Reporting lines are sufficiently independent of the control areas and from the business lines, and there is adequate separation of duties throughout the institution.
- Financial, operational, and regulatory reports are reliable, accurate, and timely.
- Adequate procedures exist for ensuring compliance with laws and regulations.
- Internal-audit or other control-review practices provide for independence and objectivity.
- Internal controls and information systems are adequately tested and reviewed, with findings documented and weaknesses given appropriate and timely attention.
- The board of directors or the audit committee reviews the effectiveness of internal audits and other control-review activities regularly.

The fiduciary-risk assessment and control categories and tools listed above are not all-inclusive. They are guidelines for the fiduciary examiner and fiduciary-activities management to use in their risk-assessment and -control efforts. The examination of fiduciary activities may require some modification, depending on how the activities are organized and the complexity of the products and services offered.

INVESTMENT OF FIDUCIARY ASSETS IN MUTUAL FUNDS AND POTENTIAL CONFLICTS OF INTEREST

Banks and trust institutions encounter various direct or indirect financial incentives to place trust assets with particular mutual funds. These incentives include fees for using nonaffiliated fund families as well as incentives for using an institution's proprietary mutual funds. The primary supervisory concern is that an institution may fail to act in the best interest of its beneficiaries if it stands to benefit independently from a particular investment. As a result, an institution may be exposed to an increased risk of legal action by account beneficiaries, and it could potentially violate laws or regulations. The Federal Reserve Board issued SR-99-7 to help institutions minimize these risks and ensure that their activities meet fiduciary standards.

Institutions should ensure that they perform and document an appropriate level of due diligence before entering into any compensation arrangements with mutual fund providers or before placing fiduciary assets in their own proprietary mutual funds. SR-99-7 discusses the type of measures that should be included in this process, including a reasoned legal opinion addressing the activity, appropriate policies and procedures, and documented analysis and ongoing review of investment decisions. For issues pertaining to retail sales of nondeposit investment products and matters relating to compensation, see section 4170.1.

Types of Financial Incentives

Financial incentives for placing trust assets with particular mutual funds range from payments structured as reimbursements for services or for transferring business to an unaffiliated fund family, to financial benefits that arise from using mutual funds that are managed by the institution or an affiliate. In some cases, such as service fees for administrative and recordkeeping functions performed by the trust institution, the permissibility of such payments may be specifically addressed under state law. However, guidance under applicable law may be less clear for other financial incentives. In all cases, decisions to place fiduciary assets in particular investments must be consistent with the underlying trust documents and must be undertaken in the best interest of the trust beneficiary.

Certain mutual fund providers offer compensation in the form of ''service'' fees to institutions that invest fiduciary assets in particular mutual funds. These fees, referred to variously as shareholder, subaccounting, or administrative-service fees, are structured as payments to reimburse the institution for performing standard recordkeeping and accounting functions for the institution's fiduciary accounts, such as maintaining shareholder subaccounts and records, transmitting mutual fund communications as necessary, and arranging mutual fund transactions. These fees are typically based on a percentage or basis-point amount of the dollar value of assets invested or on transaction volume.

Nearly every state legislature modified its laws in the 1990s to allow explicitly the acceptance of such service fees by fiduciaries under certain conditions. These conditions often include compliance with standards of prudence, quality, and appropriateness for the account, and a determination of the ''reasonableness'' of the fees received by the institution. The Office of the Comptroller of the Currency (OCC) also adopted these general standards for national banks.[1] However, the Employee Retirement Income Security Act of 1974 (ERISA) generally prohibits fee arrangements between fiduciaries and third parties, such as mutual fund providers, with limited exceptions.[2] ERISA requirements supersede state laws and guidelines put forth by the bank regulatory agencies.

Although there has been no comprehensive review of the extent to which mutual fund providers are offering the types of incentive payments cited above, the practice is not uncommon. In addition to these service fees, another form of compensation reportedly offered by some mutual fund providers is a lump-sum payment based on assets transferred into a mutual fund.

Similar conflict-of-interest concerns are raised by the investment of fiduciary-account assets in mutual funds for which the institution or an affiliate acts as investment adviser (referred to as ''proprietary'' funds). In this case, the institution receives a financial benefit from management fees generated by the mutual fund investments.[3]

Due-Diligence Measures

Although many state laws explicitly authorize certain fee arrangements in conjunction with the investment of trust assets in mutual funds, institutions nonetheless face heightened legal and compliance risks from activities in which a conflict of interest exists, particularly if proper fiduciary standards are not observed and documented. Section 23B of the Federal Reserve Act (FRA) requires, before a member bank purchases shares issued by an affiliate, including investment-fund shares, that the board of directors approve the purchase based on a determination that the purchase is a sound investment for the bank, irrespective that an affiliate is the principal underwriter.[4] Even for investments in which the institution does not exercise investment discretion, disclosure or other requirements may apply. Therefore, institutions should ensure that they perform and document an appropriate level of due diligence before entering into any fee arrangements similar to those described above or before placing fiduciary assets in proprietary mutual funds. According to SR-99-7, the following measures should be included in this process:

- *A reasoned legal opinion.* The institution should obtain a reasoned opinion of counsel that addresses the conflict of interest inherent in the receipt of fees or other forms of compensation from mutual fund providers in connection with the investment of fiduciary assets. The opinion should address the permissibility of the investment and compensation under applicable state or federal laws, the trust instrument, or court order, as well as any applicable disclosure requirements or ''reasonableness'' standard for fees set forth in the law.
- *Establishment of policies and procedures.* The institution should establish written policies and procedures governing the acceptance of fees or other compensation from mutual fund providers, as well as the use of proprietary mutual funds. The policies must be reviewed and approved by the institution's board of directors or its designated committee. Policies

1. In general, national banks may make these investments and receive such fees if the practice is authorized by applicable law and if the investment is prudent and appropriate for fiduciary accounts and consistent with fiduciary requirements established by state law. These requirements include a ''reasonableness'' test for any fees received by the institution. (OCC Interpretive Letter No. 704, February 1996.)

2. ERISA section 406(b)(3), Department of Labor, Pension Welfare and Benefits Administration Advisory Opinion 97-15A and Advisory Opinion 97-16A.

3. A Board interpretation of Federal Reserve Regulation Y addresses the investment of fiduciary-account assets in mutual funds for which the trustee bank's holding company acts as investment adviser. In general, such investments are prohibited unless specifically authorized by the trust instrument, court order, or state law. See *Federal Reserve Regulatory Service* 4–177.

4. 12 USC 371c-1(b)(2).

and procedures should, at a minimum, address the following issues: (1) designation of decision-making authority; (2) analysis and documentation of investment decisions; (3) compliance with applicable laws, regulations, and sound fiduciary principles, including any disclosure requirements or reasonableness standards for fees; and (4) staff training and methods for monitoring compliance with policies and procedures by internal or external audit staff.

- *Analysis and documentation of investment decisions.* Where an institution receives fees or other compensation in connection with fiduciary-account investments over which it has investment discretion or where such investments are made in the institution's proprietary mutual funds, the institution should fully document its analysis supporting the investment decision. This analysis should be performed on a regular, ongoing basis and would typically include factors such as historical performance comparisons to similar mutual funds, management fees and expense ratios, and ratings by recognized mutual-fund rating services. The institution should also document its assessment that the investment is, and continues to be, appropriate for the individual account, in the best interest of account beneficiaries, and in compliance with section 23B of the FRA and with provisions of the "prudent-investor" or "prudent-man rules," as appropriate.

UNIFORM INTERAGENCY TRUST RATING SYSTEM

In December 1998, the Federal Reserve Board issued implementing guidelines for the Uniform Interagency Trust Rating System (UITRS).[5] The revised UITRS was made effective for examinations commencing on or after January 1, 1999.[6] Federal Reserve examiners should assign UITRS ratings in conformance with the definitions adopted by the Federal Financial Institutions Examination Council (FFIEC), as augmented by the guidance below.

A full composite UITRS rating is *required* to be assigned as a result of all trust examinations, except for targeted examinations, where component ratings need only be assigned for those areas included within the examination's scope. In those cases, component ratings should be assigned as the targeted examinations are completed. When an institution's trust activities are examined as a series of limited reviews over a period of time, the full UITRS rating should be assigned when the examination is considered complete, or at least as often as required under SR-01-05.

Additional Considerations for Specific UITRS Components

Management

The revised UITRS puts greater emphasis on assessing the quality of an institution's risk management, consistent with guidance previously provided to Federal Reserve examiners in SR-96-10. Examiners should continue to include in risk profiles and risk-management assessments the key risks outlined in SR-95-51, including reputation risk, operational risk, legal risk, credit risk, market risk, and liquidity risk. Whether all of these risks or a subset of them is relevant to the assessment of risk management, and thus to the management rating, depends on the scope of the particular institution's fiduciary activities. The other four UITRS rating components may also include consideration of the institution's ability to manage some or all of these risks.

Earnings

Examiners must *evaluate* earnings for all institutions that exercise fiduciary powers. In addition, an earnings *rating* must be assigned for institutions that, at the time of the examination, have total fiduciary assets of more than $100 million and for all nondeposit trust companies. For all other institutions, examiners are not required to assign a rating and should only do so in cases where fiduciary activities are significant and the earnings rating would be meaningful to the overall rating. In these cases, examiners should use the standard earnings-rating definition, rather than the alternate-rating definitions provided in the UITRS. For examinations where no earnings

5. The UITRS was developed by the Federal Financial Institutions Examination Council. SR-98-37 mandated the use of UITRS for Federal Reserve examinations of fiduciary activities.

6. See 63 *Fed. Reg.* 54704 (October 13, 1998).

rating is assigned, a rating of 0 should be given for the earnings component, and this component should be excluded from consideration in the composite rating.

Earnings ratings of 3 or worse should be reserved for institutions whose earnings performance indicates a supervisory problem requiring corrective action, which, if left unaddressed, may pose a risk to the institution. Federal Reserve examiners may, therefore, assign an earnings rating of 2 for an institution that has experienced losses in its fiduciary activities, provided that (1) management has determined that there are benefits to the overall institution or its community from offering fiduciary services, (2) losses from fiduciary activities are stable and consistent with management expectations, and (3) such losses do not have a significant adverse effect on the profitability of the institution as a whole.

Asset Management

As noted in the UITRS, the asset-management component may not be applicable for some institutions because their activities do not involve the management of discretionary assets. A rating for asset management may, therefore, be omitted for examinations of institutions whose operations are limited to activities such as directed-agency relationships, securities clearing, nonfiduciary custody relationships, or transfer-agent or registrar activities. However, this component rating should be assigned for an institution that provides investment advice, even though it does not have discretion over the account assets. Where an asset-management rating is not assigned for a particular examination, a rating of 0 should be given, and this component should be excluded from consideration in the composite rating.

Examination Reports

SR-96-26 requires that the UITRS rating be disclosed to the institution in the summary section of each examination report. In addition, the individual numerical component ratings, which should also be disclosed in the open section of the report, may be included in the summary section. If the component ratings are included in the summary section, the ratings should also be included in the open-section pages of the report in which trust findings are presented. If the Reserve Bank prefers not to disclose the examiner's evaluation of the component ratings to the institution, this information may be included in the confidential section of the report. Regardless of where in the report it appears, the evaluation must include sufficient detail to justify the rating assigned.

UITRS Description

Under the UITRS, the fiduciary activities of financial institutions are assigned a composite rating based on an evaluation and rating of five essential components of an institution's fiduciary activities. Composite and component ratings are assigned based on a 1-to-5 numerical scale. A 1 is the highest rating and indicates the strongest performance and risk-management practices and the least degree of supervisory concern. A 5 is the lowest rating and indicates the weakest performance and risk-management practices and, therefore, the highest degree of supervisory concern. The evaluation of the composite and components considers the size and sophistication, the nature and complexity, and the risk profile of the institution's fiduciary activities.

The composite rating generally bears a close relationship to the component ratings assigned. However, the composite rating is not derived by computing an arithmetic average of the component ratings. Each component rating is based on a qualitative analysis of the factors that make up a particular component and on its interrelationship with the other components. When assigning a composite rating, some components may be given more weight than others depending on the situation at the institution. In general, the assignment of a composite rating may incorporate any factor that bears significantly on the overall administration of the financial institution's fiduciary activities. Assigned composite and component ratings are disclosed to the institution's board of directors and senior management.

Management's ability to respond to changing circumstances and address the risks that may arise from changing business conditions, or from the initiation of new fiduciary activities or products, is an important factor in evaluating an institution's overall fiduciary-risk profile and the level of supervisory attention warranted. For this reason, the management component is given special consideration when assigning a composite rating.

The ability of management to identify, measure, monitor, and control the risks of its fiduciary operations is also taken into account when assigning each component rating. It is recognized, however, that appropriate management practices may vary considerably among financial institutions, depending on the size, complexity, and risk profiles of their fiduciary activities. For less complex institutions engaged solely in traditional fiduciary activities and whose directors and senior managers are actively involved in the oversight and management of day-to-day operations, relatively basic management systems and controls may be adequate. On the other hand, at more complex institutions, detailed and formal management systems and controls are needed to address a broader range of activities and to provide senior managers and directors with the information they need to supervise day-to-day activities.

All institutions are expected to properly manage their risks. For less complex institutions engaging in less risky activities, detailed or highly formalized management systems and controls are not required to receive strong or satisfactory component or composite ratings.

Composite Ratings

Composite ratings are based on a careful evaluation of how an institution conducts its fiduciary activities. The review encompasses the capability of management, the soundness of policies and practices, the quality of service rendered to the public, and the effect of fiduciary activities on the soundness of the institution. The composite ratings are defined as follows.

Composite 1

Administration of fiduciary activities is sound in every respect. Generally, all components are rated 1 or 2. Any weaknesses are minor and can be handled in a routine manner by management. The institution is in substantial compliance with fiduciary laws and regulations. Risk-management practices are strong relative to the size, complexity, and risk profile of the institution's fiduciary activities. Fiduciary activities are conducted in accordance with sound fiduciary principles and give no cause for supervisory concern.

Composite 2

Administration of fiduciary activities is fundamentally sound. Generally, no component rating should be more severe than 3. Only moderate weaknesses are present and are well within management's capabilities and willingness to correct. Fiduciary activities are conducted in substantial compliance with laws and regulations. Overall risk-management practices are satisfactory relative to the institution's size, complexity, and risk profile. There are no material supervisory concerns and, as a result, the supervisory response is informal and limited.

Composite 3

Administration of fiduciary activities exhibits some degree of supervisory concern in one or more of the component areas. A combination of weaknesses exists that may range from moderate to severe; however, the magnitude of the deficiencies generally does not cause a component to be rated more severely than 4. Management may lack the ability or willingness to effectively address weaknesses within appropriate time frames. Additionally, fiduciary activities may reveal some significant noncompliance with laws and regulations. Risk-management practices may be less than satisfactory relative to the institution's size, complexity, and risk profile. Although problems of relative significance may exist, they are not of such importance as to pose a threat to the trust beneficiaries generally or to the soundness of the institution. The institution's fiduciary activities require more-than-normal supervision and may include formal or informal enforcement actions.

Composite 4

Fiduciary activities generally exhibit unsafe and unsound practices or conditions, resulting in unsatisfactory performance. The problems range from severe to critically deficient and may be centered around inexperienced or inattentive management, weak or dangerous operating practices, or an accumulation of unsatisfactory features of lesser importance. The weaknesses and problems are not being satisfactorily addressed or resolved by the board of directors and management. There may be significant noncompliance with laws and regulations. Risk-management practices are generally unacceptable relative to the size, complexity, and risk profile of fiduciary activities. These problems pose a threat to the account beneficiaries generally and, if left unchecked, could evolve into conditions that could cause significant losses to the institution and ultimately undermine public confidence in the institution. Close supervisory attention is required, which means, in most cases, formal enforcement action is necessary to address the problems.

Composite 5

Fiduciary activities are conducted in an extremely unsafe and unsound manner. Administration of fiduciary activities is critically deficient in numerous major respects, with problems resulting from incompetent or neglectful administration, flagrant or repeated disregard for laws and regulations, or a willful departure from sound fiduciary principles and practices. The volume and severity of problems are beyond management's ability or willingness to control or correct. Such conditions evidence a flagrant disregard for the interests of the beneficiaries and may pose a serious threat to the soundness of the institution. Continuous close supervisory attention is warranted and may include termination of the institution's fiduciary activities.

Component Ratings

The five key components used to assess an institution's fiduciary activities are (1) the capability of management; (2) the adequacy of operations, controls, and audits; (3) the quality and level of earnings; (4) compliance with governing instruments, applicable law (including self-dealing and conflicts-of-interest laws and regulations), and sound fiduciary principles; and (5) the management of fiduciary assets. Each of the component-rating descriptions is divided into three sections: a narrative description of the component, a list of the principal factors used to evaluate that component, and a description of each numerical rating for that component. Some of the evaluation factors are repeated under one or more of the other components to reinforce the interrelationship among components.

Management

The management rating reflects the capability of the board of directors and management, in their respective roles, to identify, measure, monitor, and control the risks of an institution's fiduciary activities. The rating also reflects the ability of the board of directors and management to ensure that the institution's fiduciary activities are conducted in a safe and sound manner and in compliance with applicable laws and regulations. Directors should provide clear guidance regarding acceptable risk-exposure levels and ensure that appropriate policies, procedures, and practices are established and followed. Senior fiduciary management is responsible for developing and implementing policies, procedures, and practices that translate the board's objectives and risk limits into prudent operating standards.

Depending on the nature and scope of an institution's fiduciary activities, management practices may need to address some or all of the following risks: reputation, operating or transaction, strategic, compliance, legal, credit, market, liquidity, and other risks. Sound management practices are demonstrated by active oversight by the board of directors and management; competent personnel; adequate policies, processes, and controls that consider the size and complexity of the institution's fiduciary activities; and effective risk-monitoring and management information systems. This rating should reflect the board's and management's ability as it applies to all aspects of fiduciary activities in which the institution is involved.

The management rating is based on an assessment of the capability and performance of management and the board of directors, including, but not limited to, the following evaluation factors:

- the level and quality of oversight and support of fiduciary activities by the board of directors and management, including committee structure and adequate documentation of committee actions
- the ability of the board of directors and management, in their respective roles, to plan for and respond to risks that may arise from

changing business conditions or the introduction of new activities or products
- the adequacy of and conformance with appropriate internal policies, practices, and controls addressing the operations and risks of significant fiduciary activities
- the accuracy, timeliness, and effectiveness of management information and risk-monitoring systems appropriate for the institution's size, complexity, and fiduciary-risk profile
- the overall level of compliance with laws, regulations, and sound fiduciary principles
- responsiveness to recommendations from auditors and regulatory authorities
- strategic planning for fiduciary products and services
- the level of experience and competence of fiduciary management and staff, including issues relating to turnover and succession planning
- the adequacy of insurance coverage
- the availability of competent legal counsel
- the extent and nature of pending litigation associated with fiduciary activities, and its potential impact on earnings, capital, and the institution's reputation
- the process for identifying and responding to fiduciary-customer complaints.

Ratings of management. A rating of 1 indicates strong performance by management and the board of directors and strong risk-management practices relative to the size, complexity, and risk profile of the institution's fiduciary activities. All significant risks are consistently and effectively identified, measured, monitored, and controlled. Management and the board are proactive and have demonstrated the ability to promptly and successfully address existing and potential problems and risks.

A rating of 2 indicates satisfactory management and board performance and risk-management practices relative to the size, complexity, and risk profile of the institution's fiduciary activities. Moderate weaknesses may exist, but are not material to the sound administration of fiduciary activities and are being addressed. In general, significant risks and problems are effectively identified, measured, monitored, and controlled.

A rating of 3 indicates management and board performance that needs improvement or risk-management practices that are less than satisfactory given the nature of the institution's fiduciary activities. The capabilities of management or the board of directors may be insufficient for the size, complexity, and risk profile of the institution's fiduciary activities. Problems and significant risks may be inadequately identified, measured, monitored, or controlled.

A rating of 4 indicates deficient management and board performance or risk-management practices that are inadequate considering the size, complexity, and risk profile of the institution's fiduciary activities. The level of problems and risk exposure is excessive. Problems and significant risks are inadequately identified, measured, monitored, or controlled and require immediate action by the board and management to protect the assets of account beneficiaries and to prevent erosion of public confidence in the institution. Replacing or strengthening management or the board may be necessary.

A rating of 5 indicates critically deficient management and board performance or risk-management practices. Management and the board of directors have not demonstrated the ability to correct problems and implement appropriate risk-management practices. Problems and significant risks are inadequately identified, measured, monitored, or controlled and now threaten the continued viability of the institution or its administration of fiduciary activities, and they pose a threat to the safety of the assets of account beneficiaries. Replacing or strengthening management or the board of directors is necessary.

Operations, Internal Controls, and Auditing

The operations, internal controls, and auditing rating reflects the adequacy of the institution's fiduciary operating systems and internal controls in relation to the volume and character of business conducted. Audit coverage must ensure the integrity of the financial records, the sufficiency of internal controls, and the adequacy of the compliance process.

Fiduciary operating systems, internal controls, and the audit function subject an institution primarily to transaction and compliance risk. Other risks, including reputation, strategic, and financial risk, also may be present. The ability of management to identify, measure, monitor, and control these risks is reflected in this rating.

The operations, internal controls, and auditing rating is based on, but not limited to, an assessment of the following evaluation factors:

- operations and internal controls, including the adequacy of—
  - — staff, facilities, and operating systems;
  - — records, accounting, and data processing systems (including controls over systems access and such accounting procedures as aging, investigation, and disposition of items in suspense accounts);
  - — trading functions and securities-lending activities;
  - — vault controls and securities movement;
  - — segregation of duties;
  - — controls over disbursements (checks or electronic) and unissued securities;
  - — controls over income-processing activities; and
  - — reconciliation processes (depository, cash, vault, subcustodians, suspense accounts, etc.)
- disaster or business-recovery programs—
  - — hold-mail procedures and controls over returned mail, and
  - — investigation and proper escheatment of funds in dormant accounts
- auditing, including—
  - — the independence, frequency, quality, and scope of the internal and external fiduciary-audit function relative to the volume, character, and risk profile of the institution's fiduciary activities;
  - — the volume or severity of internal-control and audit exceptions and the extent to which these issues are tracked and resolved; and
  - — the experience and competence of the audit staff.

Ratings of operations, internal controls, and auditing. A rating of 1 indicates that operations, internal controls, and auditing are strong in relation to the volume and character of the institution's fiduciary activities. All significant risks are consistently and effectively identified, measured, monitored, and controlled.

A rating of 2 indicates that operations, internal controls, and auditing are satisfactory in relation to the volume and character of the institution's fiduciary activities. Moderate weaknesses may exist, but are not material. Significant risks, in general, are effectively identified, measured, monitored, and controlled.

A rating of 3 indicates that operations, internal controls, or auditing need improvement in relation to the volume and character of the institution's fiduciary activities. One or more of these areas are less than satisfactory. Problems and significant risks may be inadequately identified, measured, monitored, or controlled.

A rating of 4 indicates deficient operations, internal controls, or audits. One or more of these areas are inadequate or the level of problems and risk exposure is excessive in relation to the volume and character of the institution's fiduciary activities. Problems and significant risks are inadequately identified, measured, monitored, or controlled and require immediate action. Institutions with this level of deficiencies may make little provision for audits, or they may evidence weak or potentially dangerous operating practices in combination with infrequent or inadequate audits.

A rating of 5 indicates critically deficient operations, internal controls, or audits. Operating practices, with or without audits, pose a serious threat to the safety of assets of fiduciary accounts. Problems and significant risks are inadequately identified, measured, monitored, or controlled and now threaten the ability of the institution to continue engaging in fiduciary activities.

Earnings

The earnings rating reflects the profitability of an institution's fiduciary activities and their effect on the financial condition of the institution. The use and adequacy of budgets and earnings projections by functions, product lines, and clients are reviewed and evaluated. Risk exposure that may lead to negative earnings is also evaluated.

An evaluation of earnings is required for all institutions with fiduciary activities. An assignment of an earnings rating, however, is required only for institutions that, at the time of the examination, have total trust assets of more than $100 million or that are a nondeposit trust company.

The evaluation of earnings is based on, but not limited to, an assessment of the following factors:

- the profitability of fiduciary activities in relation to the size and scope of those activities and to the overall business of the institution
- the overall importance to the institution of offering fiduciary services to its customers and local community

- the effectiveness of the institution's procedures for monitoring fiduciary-activity income and expense relative to the size and scope of these activities and their relative importance to the institution, including the frequency and scope of profitability reviews and planning by the institution's board of directors or a committee thereof

For those institutions for which a rating of earnings is mandatory, additional factors should include the following:

- the level and consistency of profitability, or the lack thereof, generated by the institution's fiduciary activities in relation to the volume and character of the institution's business
- dependence on nonrecurring fees and commissions, such as fees for court accounts
- the effects of charge-offs or compromise actions
- unusual features regarding the composition of business and fee schedules
- accounting practices that contain practices such as (1) unusual methods of allocating direct and indirect expenses and overhead, or (2) unusual methods of allocating fiduciary income and expense where two or more fiduciary institutions within the same holding company family share fiduciary services or processing functions
- the extent of management's use of budgets, projections, and other cost-analysis procedures
- methods used for directors' approval of financial budgets or projections
- management's attitude toward growth and new-business development
- new-business development efforts, including types of business solicited, market potential, advertising, competition, relationships with local organizations, and an evaluation by management of the risk potential inherent in new business areas

Ratings of earnings. A rating of 1 indicates strong earnings. The institution consistently earns a rate of return on its fiduciary activities that is commensurate with the risk of those activities. This rating would normally be supported by a history of consistent profitability over time and a judgment that future earnings prospects are favorable. In addition, management techniques for evaluating and monitoring earnings performance are fully adequate, and there is appropriate oversight by the institution's board of directors or a committee thereof. Management makes effective use of budgets and cost-analysis procedures. Methods used for reporting earnings information to the board of directors, or a committee thereof, are comprehensive.

A rating of 2 indicates satisfactory earnings. Although the earnings record may exhibit some weaknesses, earnings performance does not pose a risk to the overall institution nor to its ability to meet its fiduciary obligations. Generally, fiduciary earnings meet management targets and appear to be at least sustainable. Management processes for evaluating and monitoring earnings are generally sufficient in relationship to the size and risk of fiduciary activities that exist, and any deficiencies can be addressed in the normal course of business. A rating of 2 may also be assigned to institutions with a history of profitable operations if there are indications that management is engaging in activities with which it is not familiar or where there may be inordinately high levels of risk present that have not been adequately evaluated. Alternatively, an institution with otherwise strong earnings performance may also be assigned a 2 rating if there are significant deficiencies in its methods used to monitor and evaluate earnings.

A rating of 3 indicates less-than-satisfactory earnings. Earnings are not commensurate with the risk associated with the fiduciary activities undertaken. Earnings may be erratic or exhibit downward trends, and future prospects are unfavorable. This rating may also be assigned if management processes for evaluating and monitoring earnings exhibit serious deficiencies, provided the deficiencies identified do not pose an immediate danger to either the overall financial condition of the institution or its ability to meet its fiduciary obligations.

A rating of 4 indicates earnings that are seriously deficient. Fiduciary activities have a significant adverse effect on the overall income of the institution and its ability to generate adequate capital to support the continued operation of its fiduciary activities. The institution is characterized by fiduciary earnings performance that is poor historically or that faces the prospect of significant losses in the future. Management processes for monitoring and evaluating earnings may be poor. The board of directors has not adopted appropriate measures to address significant deficiencies.

A rating of 5 indicates critically deficient earnings. In general, an institution with this rating is experiencing losses from fiduciary activities that have a significant negative impact on the overall institution, representing a distinct threat to its viability through the erosion of its capital. The board of directors has not implemented effective actions to address the situation.

Alternate rating of earnings. The UITRS alternate rating of earnings is *not* for use by Federal Reserve System examiners, per the December 1998 Federal Reserve UITRS implementing guidelines. For institutions where the assignment of an earnings rating is not required by the UITRS, an FFIEC federal supervisory agency has the option to assign an earnings rating using an alternate set of ratings. The alternate ratings are provided here so examiners will be able to interpret earnings ratings assigned by other banking supervisors that have adopted the alternate-rating system for earnings. Under the alternate-ratings scheme, alternate ratings are assigned based on the level of implementation of four minimum standards by the board of directors and management:

- *Standard No. 1.* The institution has reasonable methods for measuring income and expense commensurate with the volume and nature of the fiduciary services offered.
- *Standard No. 2.* The level of profitability is reported to the board of directors, or a committee thereof, at least annually.
- *Standard No. 3.* The board of directors periodically determines that the continued offering of fiduciary services provides an essential service to the institution's customers or to the local community.
- *Standard No. 4.* The board of directors, or a committee thereof, reviews the justification for the institution to continue to offer fiduciary services, even if the institution does not earn sufficient income to cover the expenses of providing those services.

Ratings to be applied for the alternate rating of earnings. A rating of 1 may be assigned where an institution has implemented all four minimum standards. If fiduciary earnings are lacking, management views this as a cost of doing business as a full-service institution and believes that the negative effects of not offering fiduciary services are more significant than the expense of administrating those services.

A rating of 2 may be assigned where an institution has implemented, at a minimum, three of the four standards. This rating may be assigned if the institution is not generating positive earnings or where formal earnings information may not be available.

A rating of 3 may be assigned if the institution has implemented at least two of the four standards. Although management may have attempted to identify and quantify other revenue to be earned by offering fiduciary services, it has decided that these services should be offered as a service to customers, even if they cannot be operated profitably.

A rating of 4 may be assigned if the institution has implemented only one of the four standards. Management has undertaken little or no effort to identify or quantify the collateral advantages, if any, to the institution from offering fiduciary services.

A rating of 5 may be assigned if the institution has implemented none of the standards.

Compliance

The compliance rating reflects an institution's overall compliance with applicable laws, regulations, accepted standards of fiduciary conduct, governing account instruments, duties associated with account administration, and internally established policies and procedures. This component specifically incorporates an assessment of a fiduciary's duty of undivided loyalty and compliance with applicable laws, regulations, and accepted standards of fiduciary conduct related to self-dealing and other conflicts of interest.

The compliance component includes reviewing and evaluating the adequacy and soundness of adopted policies, procedures, and practices generally and as they relate to specific transactions and accounts. It also includes reviewing policies, procedures, and practices to evaluate the sensitivity of management and the board of directors to refrain from self-dealing, minimize potential conflicts of interest, and resolve actual conflict situations in favor of the fiduciary-account beneficiaries.

Risks associated with account administration are potentially unlimited because each account is a separate contractual relationship that contains specific obligations. Risks associated with account administration include failure to comply with applicable laws, regulations, or terms of the governing instrument; inadequate account-administration practices; and inexperienced management or inadequately trained staff. Risks associated with a fiduciary's duty of undivided loyalty generally stem from engaging in self-dealing or other conflict-of-interest transactions. An institution may be exposed to compliance, strategic, financial, and reputation risk related to account-administration and conflicts-of-interest activities. The ability of management to identify, measure, monitor, and control these risks is reflected in this rating. Policies, procedures, and practices pertaining to account administration and conflicts of interest are evaluated in light of the size and character of an institution's fiduciary business.

The compliance rating is based on, but not limited to, an assessment of the following evaluation factors:

- compliance with applicable federal and state statutes and regulations, including, but not limited to, federal and state fiduciary laws, the Employee Retirement Income Security Act of 1974, federal and state securities laws, state investment standards, state principal and income acts, and state probate codes
- compliance with the terms of governing instruments
- the adequacy of overall policies, practices, and procedures governing compliance, considering the size, complexity, and risk profile of the institution's fiduciary activities
- the adequacy of policies and procedures addressing account administration
- the adequacy of policies and procedures addressing conflicts of interest, including those designed to prevent the improper use of "material inside information"
- the effectiveness of systems and controls in place to identify actual and potential conflicts of interest
- the adequacy of securities-trading policies and practices relating to the allocation of brokerage business; the payment of services with "soft dollars"; and the combining, crossing, and timing of trades
- the extent and permissibility of transactions with related parties, including, but not limited to, the volume of related commercial and fiduciary relationships and holdings of corporations in which directors, officers, or employees of the institution may be interested
- the decision-making process used to accept, review, and terminate accounts
- the decision-making process related to account-administration duties, including cash balances, overdrafts, and discretionary distributions

Ratings of compliance. A rating of 1 indicates strong compliance policies, procedures, and practices. Policies and procedures covering conflicts of interest and account administration are appropriate in relation to the size and complexity of the institution's fiduciary activities. Accounts are administered in accordance with governing instruments, applicable laws and regulations, sound fiduciary principles, and internal policies and procedures. Any violations are isolated, technical in nature, and easily correctable. All significant risks are consistently and effectively identified, measured, monitored, and controlled.

A rating of 2 indicates fundamentally sound compliance policies, procedures, and practices in relation to the size and complexity of the institution's fiduciary activities. Account administration may be flawed by moderate weaknesses in policies, procedures or practices. Management's practices indicate a determination to minimize the instances of conflicts of interest. Fiduciary activities are conducted in substantial compliance with laws and regulations, and any violations are generally technical in nature. Management corrects violations in a timely manner and without loss to fiduciary accounts. Significant risks are effectively identified, measured, monitored, and controlled.

A rating of 3 indicates compliance practices that are less than satisfactory in relation to the size and complexity of the institution's fiduciary activities. Policies, procedures, and controls have not proven effective and require strengthening. Fiduciary activities may be in substantial noncompliance with laws, regulations, or governing instruments, but losses are no worse than minimal. Although management may have the ability to achieve compliance, the number of violations that exist, or the failure to correct prior violations, is an indication that management has not devoted sufficient time and attention to its compliance responsibilities. Risk-management practices generally need improvement.

A rating of 4 indicates an institution with deficient compliance practices in relation to the size and complexity of its fiduciary activities. Account administration is notably deficient. The institution makes little or no effort to minimize potential conflicts or refrain from self-dealing, and it is confronted with a considerable number of potential or actual conflicts. Numerous substantive and technical violations of laws and regulations exist, and many may remain uncorrected from previous examinations. Management has not exerted sufficient effort to effect compliance and may lack the ability to effectively administer fiduciary activities. The level of compliance problems is significant and, if left unchecked, may subject the institution to monetary losses or reputation risk. Risks are inadequately identified, measured, monitored, and controlled.

A rating of 5 indicates critically deficient compliance practices. Account administration is critically deficient or incompetent, and there is a flagrant disregard for the terms of the governing instruments and interests of account beneficiaries. The institution frequently engages in transactions that compromise its fundamental duty of undivided loyalty to account beneficiaries. There are flagrant or repeated violations of laws and regulations and significant departures from sound fiduciary principles. Management is unwilling or unable to operate within the scope of laws and regulations or within the terms of governing instruments, and efforts to obtain voluntary compliance have been unsuccessful. The severity of noncompliance presents an imminent monetary threat to account beneficiaries and creates significant legal and financial exposure to the institution. Problems and significant risks are inadequately identified, measured, monitored, or controlled and now threaten the ability of management to continue engaging in fiduciary activities.

Asset Management

The asset-management rating reflects the risks associated with managing the assets (including cash) of others. Prudent portfolio management is based on an assessment of the needs and objectives of each account or portfolio. An evaluation of asset management should consider the adequacy of processes related to the investment of all discretionary accounts and portfolios, including collective investment funds, proprietary mutual funds, and investment advisory arrangements.

The institution's asset-management activities subject it to reputation, compliance, and strategic risks. In addition, each individual account or portfolio managed by the institution is subject to financial risks such as market, credit, liquidity, and interest-rate risk, as well as transaction and compliance risk. The ability of management to identify, measure, monitor, and control these risks is reflected in this rating.

The asset-management rating is based on, but not limited to, an assessment of the following evaluation factors:

- the adequacy of overall policies, practices, and procedures governing asset management, considering the size, complexity, and risk profile of the institution's fiduciary activities
- the decision-making processes used for selection, retention, and preservation of discretionary assets, including adequacy of documentation, committee review and approval, and a system to review and approve exceptions
- the use of quantitative tools to measure the various financial risks in investment accounts and portfolios
- the existence of policies and procedures addressing the use of derivatives or other complex investment products
- the adequacy of procedures related to the purchase or retention of miscellaneous assets, including real estate, notes, closely held companies, limited partnerships, mineral interests, insurance, and other unique assets
- the extent and adequacy of periodic reviews of investment performance, taking into consideration the needs and objectives of each account or portfolio
- the monitoring of changes in the composition of fiduciary assets for trends and related risk exposure
- the quality of investment research used in the decision-making process and documentation of the research
- the due-diligence process for evaluating investment advice received from vendors or brokers (including approved or focus lists of securities)
- the due-diligence process for reviewing and approving brokers or counterparties used by the institution

This rating may not be applicable for some institutions because their operations do not include activities involving the management of any discretionary assets. Functions of this type would include, but not necessarily be limited to, directed-agency relationships, securities clearing, nonfiduciary custody relationships, and transfer-agent and registrar activities. In institutions of this type, the rating for asset management may be omitted by the examiner in accordance with the examining agency's implementing guidelines. However, this component should be assigned when the institution provides investment advice, even though it does not have discretion over the account assets. An example of this type of activity would be where the institution selects or recommends the menu of mutual funds offered to participant-directed 401(k) plans.

Ratings of asset management. A rating of 1 indicates strong asset-management practices. Identified weaknesses are minor in nature. Risk exposure is modest in relation to management's abilities and the size and complexity of the assets managed.

A rating of 2 indicates satisfactory asset-management practices. Moderate weaknesses are present and are well within management's ability and willingness to correct. Risk exposure is commensurate with management's abilities and the size and complexity of the assets managed. Supervisory response is limited.

A rating of 3 indicates that asset-management practices are less than satisfactory in relation to the size and complexity of the assets managed. Weaknesses may range from moderate to severe; however, they are not of such significance as to generally pose a threat to the interests of account beneficiaries. Asset-management and risk-management practices generally need to be improved. An elevated level of supervision is normally required.

A rating of 4 indicates deficient asset-management practices in relation to the size and complexity of the assets managed. The levels of risk are significant and inadequately controlled. The problems pose a threat to account beneficiaries generally and, if left unchecked, may subject the institution to losses and could undermine the reputation of the institution.

A rating of 5 represents critically deficient asset-management practices and a flagrant disregard of fiduciary duties. These practices jeopardize the interests of account beneficiaries, subject the institution to losses, and may pose a threat to the soundness of the institution.