

Trading and Capital-Markets Activities Manual

Supplement 13—January 2009

Nature of Changes

The “Investment Securities and End-User-Activities” section (3000.1) has been revised to conform the discussion of the Uniform Agreement on the Classification of Assets and Appraisal of Securities Held by Banks and Thrifts (the uniform agreement) with the guid-

ance contained in the *Commercial Bank Examination Manual*. The Uniform Agreement was jointly issued by the federal banking and thrift agencies on June 15, 2004. The agreement sets forth the definitions of the classification categories and the specific examination procedures and information for classifying securities.

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Supplement 12—April 2007

Nature of Changes

Examination objectives, examination procedures, and an internal control questionnaire (sections 2030.2, 2030.3, and 2030.4, respectively) have been added to the Market Liquidity Risk of Trading Activities section.

An internal control questionnaire (section 3005.4) has been added to the Liquidity Risk

sections. Small corrections were made to other Liquidity Risk sections (3005.1, 3005.3, and 3005.5). In addition, the Interagency Advisory on the Use of the Federal Reserve's Primary Credit Program in Effective Liquidity Management (SR-03-15) has been added as appendix 5 to section 3005.5

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Supplement 11—September 2006

Nature of Changes

Capital-Markets Activities

An expanded discussion of well-established sound practices for managing the funding liquidity and liquidity-risk exposure of financial institutions (section 3005.1, “Liquidity Risk”) has been added. The new section summarizes important concepts surrounding the liquidity of financial institutions, explains the basic objectives of liquidity-risk management, and discusses the key elements and practices associated with sound liquidity-risk management. The section incorporates existing liquidity-risk management guidance, which is discussed in separate sections of this manual and the *Commercial Bank Examination Manual*, as well as in guidance issued by the Office of the Comptroller of

the Currency, the Federal Deposit Insurance Corporation, and the Basel Committee on Banking Supervision. The section also includes a discussion of the analytical process for evaluating and rating an institution’s inherent liquidity-risk exposure and the quality of its liquidity-risk management. Examination objectives and examination procedures have been added (sections 3005.2 and 3005.3, respectively). An appendix section (3005.5) provides additional background on special topics related to liquidity-risk management, including the various measurement tools, techniques, and considerations that institutions generally consider when they evaluate their liquidity-risk management practices.

The new section replaces the general liquidity-risk discussion formerly found in section 2030.1, which has been renamed “Market Liquidity Risk of Trading Activities.”

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Trading and Capital-Markets Activities Manual

Supplement 10—September 2003

Nature of Changes

Capital-Markets Activities

Two SR-letters on accrued interest receivables have been added to section 3020.1, “Securitization and Secondary-Market Credit Activities.” Both letters include interagency guidance. SR-02-12 (May 17, 2002) provides guidance on the regulatory capital treatment of accrued interest

receivables related to credit card securitizations. SR-02-22 (December 4, 2002) clarifies the earlier guidance to state that, when the institution’s (seller’s) right to an accrued interest receivable is subordinated as a result of a securitization, the seller generally should include the accrued interest receivable as a subordinated retained interest in accounting for the sale of credit card receivables and in computing the gain or loss on sale.

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Trading and Capital-Markets Activities Manual

Supplement 9—April 2003

Nature of Changes

Trading Activities

Section 2030.1, “Liquidity Risk,” has been revised to include information on the Federal Reserve’s new discount window programs: primary credit and secondary credit. Effective January 9, 2003, these programs replaced the adjustment credit and extended credit programs. A banking organization’s funding-liquidity plans may include accessing the Federal Reserve’s discount window. The examination procedures, section 2030.3, have also been updated.

In section 2100.1, “Financial Performance,” several revisions were made to the discussion of pricing models. Institutions that use pricing models to value and hedge complex financial securities in illiquid markets should have a sound model-validation process. Such a process evaluates, among other things, a model’s sensitivity to material sources of model risk. An institution’s model-validation function should also work closely with the new-product-approval function to determine what effect a new product has on the institution’s pricing model.

The definitions of tier 1 and tier 2 capital in section 2110.1, “Capital Adequacy,” have been updated. The section was further revised in the market-risk subsection to state that, for purposes of the market-risk capital calculation, an institution must meet an additional restriction: The sum of its tier 2 capital and tier 3 capital allocated for market risk may not exceed 250 percent of tier 1 capital allocated for market risk.

In section 2120.1, “Accounting,” references to Statement of Financial Accounting Standards No. 133 (FAS 133), “Accounting for Derivative Instruments and Hedging Activities,” were updated to state that FAS 133 was amended by Statement of Financial Accounting Standards Nos. 137 and 138 (FAS 137 and FAS 138). The examination objectives, examination procedures, internal control questionnaire, and appendix on related financial-statement disclosures, sections 2120.2, 2120.3, 2120.4, and 2120.5 respectively, were also updated for this change.

Section 2130.5, the appendix to “Regulatory Reporting,” was updated to include a description of Form FR Y-12, Consolidated BHC Report of Equity Investments in Nonfinancial Companies.

Section 2140.1, “Regulatory Compliance,” was updated to reflect that, under the Gramm-Leach-Bliley Act enacted in 1999, financial holding companies are permitted to establish broker-dealer subsidiaries engaged in securities underwriting, dealing, and market making, without the restrictions that were applicable to section 20 subsidiaries.

Section 2150.1, “Ethics,” was revised to reinforce that an institution’s policies and procedures should provide for at least an annual review, revision, and approval of its ethical standards and code of conduct. The standards and code should be communicated throughout the organization and reinforced by periodic training. The discussion of legal and reputational risks notes that, although banking organizations are not directly accountable for the actions of their customers, organizations should recognize that, to the extent their name or product is associated with a customer’s misconduct, additional legal and reputational risks may arise. An organization’s policies and procedures should ensure that legal- and reputational-risk issues are vetted and resolved at an appropriate level of seniority. The examination objectives, examination procedures, and internal control questionnaire, sections 2150.2, 2150.3, and 2150.4 respectively, were also revised.

Capital-Markets Activities

Section 3020.1, “Securitization and Secondary-Market Activities,” has been updated to include information on banking organizations’ providing implicit recourse to a 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. (See SR-02-15.) In addition, the section was revised to include a discussion on the inclusion of supervisory-linked covenants in securitization documents. This practice has significant implications for an institution’s liquidity and is considered an unsafe and unsound banking practice. (See SR-02-14.)

In section 3040.1, “Equity Investment and Merchant Banking Activities,” a reference to FAS 133 was updated to reflect its amendment by FAS 137 and FAS 138. The examination

objectives and procedures, sections 3040.2 and 3040.3 respectively, have also been updated for this change.

Instrument Profiles

The following international instrument profiles have been updated:

- section 4215.1, “French Government Bonds and Notes”
- section 4220.1, “German Government Bonds and Notes”
- section 4225.1, “Irish Government Bonds”
- section 4230.1, “Italian Government Bonds and Notes”

- section 4235.1, “Japanese Government Bonds and Notes”
- section 4240.1, “Spanish Government Bonds”
- section 4250.1, “United Kingdom Government Bonds”

In section 4350.1, “Credit Derivatives,” the discussion of credit-default swaps was amended to include a list of common market conventions. The information on market participants was also revised and references to the 2003 Credit Derivatives Definitions of the International Swaps and Derivatives Association were added.

References to FAS 133 in the instrument profiles (sections 4010.1 through 4355.1) have been updated to reflect that the statement was amended by FAS 137 and FAS 138.

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Trading and Capital-Markets Activities Manual

Supplement 8—September 2002

Nature of Changes

Trading Activities

In section 2020.1, “Counterparty Credit Risk and Presettlement Risk,” a new subsection on off-market or prefunded derivatives transactions has been added to provide examples of derivatives transactions that are the functional equivalent of extensions of credit to counterparties and to describe the risks associated with them. The discussion of assessment of counterparty credit risk has been revised to specify that banking organizations should understand and confirm with their counterparties the business purpose of derivatives transactions.

A more detailed discussion of contingency funding plans has been added to section 2030.1, “Liquidity Risk.” The characteristics of effective contingency funding plans, such as forming a crisis-management team and establishing action plans for different levels of liquidity stress, are described. Specific information on contingency liquidity for bank holding companies is also provided.

Section 2070.1, “Legal Risk,” has been reorganized and updated. A new subsection describes

how a banking organization can mitigate the risk that may arise if a counterparty claims that a bank-recommended or -structured derivatives transaction was unsuitable for it. Other changes discuss the new-product approval process in banking organizations, including the role of in-house or outside legal counsel in defining and approving new products. The examination objectives and examination procedures, sections 2070.2 and 2070.3, respectively, have also been updated.

Capital-Markets Activities

Section 3040.1, “Equity Investment and Merchant Banking Activities,” has been completely revised. The accounting, valuation, and risk management of equity investments in banking organizations are summarized. In addition, the section explains the legal and regulatory compliance requirements for these transactions—including the January 2002 rule establishing minimum regulatory capital requirements for equity investments in nonfinancial companies. Examination objectives and examination procedures, sections 3040.2 and 3040.3, respectively, have been added.

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Trading and Capital-Markets Activities Manual

Supplement 7—April 2002

Nature of Changes

Section 3000.1, “Investment Securities and End-User Activities,” has been revised to explain recent interpretations of sections 23A and 23B of the Federal Reserve Act. The internal control questionnaire, section 3000.4, has also been updated.

- A final rule, effective June 11, 2001, provides three exemptions from the quantitative limits and collateral requirements of section 23A. The exemptions apply to certain loans an insured depository institution makes to third parties that use the proceeds to purchase securities or assets through an affiliate of the depository institution.
- A final rule, effective June 11, 2001, exempts from section 23A an insured depository institution’s purchase of a security from an affiliated broker-dealer registered with the Securities and Exchange Commission (SEC), provided several conditions are met. Among other conditions, the purchased security must have a ready market, as defined by the SEC, and a publicly available market quotation.
- An interim rule, effective January 1, 2002, confirms that (1) derivative transactions between an insured depository institution and its affiliates and (2) intraday extensions of credit by an insured depository institution to

its affiliates are subject to the market-terms requirement of section 23B.

In Section 3020.1, “Securitization and Secondary-Market Credit Activities,” the discussion of risk-based provisions affecting asset securitizations has been updated to include a final rule on the capital treatment of recourse obligations, residual interests, and direct-credit substitutes resulting from asset securitizations. The new rule treats recourse obligations and direct-credit substitutes more consistently than the current risk-based capital standards, adds new standards for the treatment of residual interests, and introduces a ratings-based approach to assigning risk weights within a securitization. There is a one-year transition period for applying the new rules to existing transactions. All transactions settled on or after January 1, 2002, are subject to the revised rules.

Revisions to section 3040.1, “Equity Investment and Merchant Banking Activities,” incorporate a final rule establishing special minimum regulatory capital requirements for equity investments in nonfinancial companies. The new requirements, effective April 1, 2002, impose a series of marginal capital charges on covered equity investments. The charges increase with the level of a banking organization’s overall exposure to equity investments relative to tier 1 capital.

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Trading and Capital-Markets Activities Manual

Supplement 6—September 2001

Nature of Changes

Sections 2120.1, “Accounting,” and 3020.1, “Securitization and Secondary-Market Credit Activities,” have been corrected to remove references to Statement of Financial Accounting Standards No. 125 (FAS 125), which has been replaced by Statement of Financial Accounting

Standards No. 140 (FAS 140). Section 2120.1 was further corrected to replace a reference to Accounting Principles Board (APB) Opinion No.16 with Statement of Financial Accounting Standards No. 141 (FAS 141), “Business Combinations.” References to FAS 125 have also been removed from the instrument profiles (sections 4010.1 through 4255.1 and section 4353.1).

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Trading and Capital-Markets Activities Manual

Supplement 5—April 2001

Nature of Changes

Trading Activities

Section 2120.1, "Accounting," has been revised to incorporate the following recent guidance from the Financial Accounting Standards Board: Statement of Financial Accounting Standards (SFAS) No. 133, "Accounting for Derivative Instruments and Hedging Activities," and SFAS No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities." (SFAS 140 supersedes SFAS 125, which had the same title). The accounting treatment for securitizations, repurchase agreements, derivative instruments, and foreign-currency instruments has been updated. The discussion on accounting for derivatives includes information on fair-value, cash-flow, and foreign-currency hedges. The examination objectives, examination procedures, internal control questionnaire, and appendix on financial statement disclosures, sections 2120.2, 2120.3, 2120.4, and 2120.5, respectively, have also been updated.

In section 2130.1, "Regulatory Reporting," references to the obsolete Monthly Consolidated Foreign Currency Report (FFIEC form 035) have been removed, and the guidance on institutions that are required to file the FR Y-20 report has been revised. The examination objectives, examination procedures, internal control questionnaire, and appendix on reports for trading instruments, sections 2130.2, 2130.3, 2130.4, and 2130.5, respectively, have also been updated.

The Gramm-Leach-Bliley Act (GLB Act), enacted in 1999, removed some restrictions that were formerly applicable to section 20 subsidiaries engaged in underwriting, dealing, and other related activities. Under the GLB Act, banking regulators are also required to rely to the greatest extent possible on the functional

regulator of securities firms. Section 2140.1, "Regulatory Compliance," has been revised to incorporate these provisions of the GLB Act.

Capital-Markets Activities

New information on the valuation of retained interests, including SR-99-37 and its related interagency guidance, has been added to section 3020.1, "Securitization and Secondary-Market Credit Activities." The subsection on internal controls has also been expanded to include the minimum requirements for management information systems reports on securitization activities.

A new section 3040.1, "Equity Investment and Merchant Banking Activities," has been added. The new section incorporates the supervisory letter on these activities (SR-00-9) that was formerly in section 4360.1. The section also provides new guidance on merchant banking activities of financial holding companies, including investment limitations, cross-marketing limitations, and special rules for private equity funds.

Instrument Profiles

The "Accounting Treatment" subsections in the instrument profiles have been revised to delete references to obsolete accounting standards and add references to SFAS 133 and SFAS 140. Section 4350.1, "Credit Derivatives," was further revised to expand the risk-based capital weighting guidance. In section 4353.1, "Collateralized Loan Obligations," more detailed information was provided on the risk-based capital weighting of three types of transactions for synthetic collateralized loan obligations.

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Supplement 4—September 2000

Equity Investments and Merchant Banking

The Federal Reserve's supervisory letter SR-00-9, issued June 22, 2000, has been added as a new instrument profile, section 4360.1. The section provides guidance for managing the risks of equity investments and merchant banking activities, which have become important sources of earnings at some financial institutions. Furthermore, the recently enacted Gramm-Leach-Bliley Act provides additional

merchant banking authority to financial holding companies.

The new section outlines sound practices for equity investments and merchant banking, appropriate disclosure practices for institutions engaging in these activities, and additional risk-management issues for institutions engaging in transactions with portfolio companies. A final rule on the conduct of equity investment and merchant banking activities is forthcoming and will be included in a future update to this manual.

Filing Instructions

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Trading and Capital-Markets Activities Manual

Supplement 3—April 2000

Capital Adequacy

A subsection on the capital treatment of synthetic collateralized loan obligations (CLOs) has been added to section 2110.1, “Capital Adequacy.” The use of credit derivatives to synthetically replicate CLOs has raised questions about how to calculate their leverage and risk-based capital ratios. The new material discusses supervisory and examination considerations for three types of synthetic CLO transactions in banking organizations: (1) the entire notional amount of the reference portfolio is hedged, (2) a high-quality senior risk position in the reference portfolio is retained, and (3) a first-loss position is retained.

Accounting

“Accounting,” section 2120.1, was revised in the “Netting or Offsetting Assets and Liabilities” subsection to clarify the conditions necessary for a master netting arrangement to exist and to add information from the Financial Accounting Standards Board’s Interpretation 41. A new subsection also provides guidance on accounting for derivative instruments under FASB Statement of Financial Accounting Standard No. 133 (SFAS 133), which is effective for fiscal years beginning after June 15, 2000. SFAS 133 requires banking organizations to recognize all derivatives on their balance sheets as assets or liabilities, and to report them at their fair value.

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Trading and Capital-Markets Activities Manual

Supplement 2—September 1999

Nature of Changes

This supplement reflects new or revised statutory and regulatory provisions and new or revised supervisory instructions or guidance issued by the Division of Banking Supervision and Regulation since the publication of the March 1999 supplement.

Counterparty Credit Risk

Section 2020.1, “Counterparty Credit Risk and Presettlement Risk,” has been revised to add a list of conditions examiners should use when evaluating credit-risk management in banking institutions, as provided in SR-99-3 (February 1, 1999). The guidance on collateral arrangements has been expanded to incorporate recent recommendations from the central banks of the Group of Ten countries on over-the-counter derivatives settlement procedures, as well as market-practice recommendations from the 1999 collateral review by the International Swaps and Derivatives Association. The examination objectives, examination procedures, and internal control questionnaire (sections 2020.2, 2020.3, and 2020.4, respectively) have also been updated.

Capital Adequacy

A new subsection on assessing capital adequacy at large, complex banking organizations has been added to section 2110.1, “Capital Adequacy.” The new guidance outlines the fundamental elements of a sound internal analysis of capital adequacy, describes the risks that should be addressed in this analysis, and discusses the examiner’s review of an institution’s capital adequacy analysis. Other revisions were made to expand the guidance on market-risk measure, including the use of internal models and qualitative and quantitative requirements for market-risk management.

Accounting

In section 2120.1, “Accounting,” the description of the Statement of Financial Accounting Standard No. 133, “Accounting for Derivative Instruments and Hedging Activities,” has been updated. The Financial Accounting Standards Board has delayed the statement’s effective date to fiscal years beginning after June 15, 1999.

A reference to an outdated Federal Reserve policy statement on securities activities has been removed. The appendix on financial-statement disclosures, section 2120.5, has also been updated.

Filing Instructions

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Trading and Capital-Markets Activities Manual

Supplement 1—March 1999

This supplement reflects new or revised statutory and regulatory provisions and new or revised supervisory instructions or guidance issued by

the Division of Banking Supervision and Regulation since the publication of the manual in February 1998.

LIST OF CHANGES

Counterparty Credit Risk

Section 2020.1, Counterparty Credit Risk and Presettlement Risk, has been revised to incorporate the supervisory guidance on counterparty credit risk management provided in SR-99-3 (February 1, 1999). Specific guidance on the calculation of potential future exposure, exposure-monitoring and limit systems, the importance of stress testing and scenario analysis, and the interrelationship between credit and market risk, is included. Additional guidance on credit enhancements, including collateral, close-out provisions, and margining requirements, is provided. The section discusses in detail the need for robust counterparty credit risk management policies and internal controls to ensure that existing practice conforms to stated policies. The unique risks posed by institutional investors and hedge funds are detailed in a separate subsection, which includes a discussion of the January 1999 report of the Basle Committee on Banking Supervision on the risks posed by hedge funds to creditors and the accompanying sound practices standards for interactions with hedge funds. The examination objectives, examination procedures, and internal control questionnaire (sections 2020.2, 2020.3, and 2020.4, respectively) have also been updated.

In section 2021.1, Counterparty Credit Risk and Settlement Risk, a discussion of the Board's June 1998 Policy Statement on Privately Operated Multilateral Settlement Systems provides guidance on the additional settlement risks posed by these systems.

Legal Risk

Section 2070.1, Legal Risk, has been updated to include a discussion on the importance of properly and accurately defining the trigger events that provide for payments between counterparties, in light of experiences during the market

disruptions of 1998. A subsection on nondeliverable forwards and the need for explicit documentation of these contracts is also added. The examination objectives and examination procedures (sections 2070.2 and 2070.3, respectively) have been updated.

Capital Adequacy

Section 2110.1, Capital Adequacy, has been updated to reflect regulatory changes to the definition of tier 1 and tier 2 capital and to include a revised discussion of the regulatory treatment of credit derivatives.

Accounting

In section 2120.1, Accounting, a brief description of the Statement of Financial Accounting Standards No. 133 (SFAS 133) for derivatives has been added. SFAS 133 is effective for fiscal years beginning after June 15, 1999, with an effective date of January 1, 2000, for most banks. The description of SFAS 133 will be expanded in subsequent revisions to the manual.

Securities

Section 3000.1, Investment Securities and End-User Activities, has been revised to reflect the Policy Statement on Investment Securities and End-User Derivatives Activities, published by the Federal Financial Institutions Examination Council, and the rescission of the high-risk test for mortgage-derivative products.

Interest-Rate Risk

In section 3010.1, Interest-Rate Risk Management, a discussion of an examination scope for noncomplex institutions has been revised to

delete specific criteria previously used to identify institutions in which only baseline examination procedures were necessary. The revised focus is on the overall risk profile of the individual institution in lieu of dependence on strict quantitative criteria.

obligations (CLOs) has been added as section 4353.1. CLOs are securitizations of portfolios of commercial and industrial loans through a bankruptcy-remote special-purpose vehicle that issues asset-backed securities in one or more classes (or tranches). Alternatively, CLOs may be synthetically created through the use of credit derivatives.

Collateralized Loan Obligations

A new product profile on collateralized loan

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