INTRODUCTION

Off-balance sheet activities encompass a variety of items including certain loan commitments, certain letters of credit, and revolving underwriting facilities. Additionally, swaps, futures, forwards, and option contracts are derivative instruments whose notional values are carried off-balance sheet, but whose fair values are recorded on the balance sheet. Examiners reviewing off-balance sheet derivative contracts will find resources such as the Capital Markets Handbook, the Consolidated Reports of Condition and Income (Call Report) Instructions, Senior Capital Markets Specialists, and capital markets and accounting subject matter experts helpful.

Off-balance sheet fee producing activities can improve earnings ratios, at a faster pace than on-balance sheet fee producing activities. Earnings ratios typically use assets as a component. Since earnings generated from these activities are included in income, while total asset balances are not affected, ratios appear higher than they would if the income was derived from on-balance sheet activities. Because these types of activities remain off the balance sheet, capital to asset ratios (with the exception of risk-based capital ratios) are not adversely affected regardless of the volume of business conducted. But, the volume and risk of the off-balance sheet activities needs to be considered by the examiner in the evaluation of capital adequacy. Regulatory concern with off-balance sheet activities arises since they subject a bank to certain risks, including credit risk. Many of the risks involved in these off-balance sheet activities are indeterminable on an offsite-monitoring basis.

OFF-BALANCE SHEET ITEMS AND DERIVATIVES

Accounting treatment for derivatives activities is largely governed by Statement of Financial Accounting Standard No. (FAS) 133, *Accounting for Derivative Instruments and Hedging* Activities, and FAS 149, *Amendment of Statement 133*. In general terms, FAS 133 provides that derivative contracts must be reported at fair value on the balance sheet. Prior to the issuance of FAS 133, accounting standards generally allowed derivative contracts to be carried off-balance sheet.

General guidance regarding the risks involved with derivatives instruments and the proper recording and accounting are outlined below. Expanded guidance is delineated in the Capital Markets Handbook and the Call Report Glossary and the instructions for RC-L – Derivatives and Off-Balance Sheet Items.

OFF-BALANCE SHEET LENDING ACTIVITIES

An evaluation of off-balance sheet lending activities should apply the same general examination techniques that are used in the evaluation of a direct loan portfolio. For example, banks with a material level of contingent liabilities should have written policies addressing such activities adopted and approved by their board of directors. The policies should cover credit underwriting standards, documentation and file maintenance requirements, collection and review procedures, officer and customer borrowing and lending limits, exposures requiring committee or board approval, and periodic reports to the board of directors. Overall limits on these contingent liabilities and specific sub-limits on the various types of off-balance sheet lending activities, either as a dollar amount or as a relative percentage (such as a percent of total assets or capital), should also be considered.

In reviewing individual credit lines, all of a customer's borrowing arrangements with the bank (e.g., direct loans, letters of credit, and loan commitments) should be considered. Additionally, many of the factors analyzed in evaluating a direct loan (e.g., financial performance, ability and willingness to pay, collateral protection, future prospects) are also applicable to the review of such contingent liabilities as letters of credit and loan commitments. When analyzing these off-balance sheet lending activities, examiners should evaluate the probability of draws under the arrangements and whether an allowance adequately reflects the risks inherent in off-balance sheet lending activities. (Such allowances should not be included in the allowance for loan and lease losses (ALLL) since off-balance sheet items are not included within the scope of FAS 5 and 114.) Allowances for off-balance sheet items should be made to "Other liabilities." Consideration should also be given to legal lending limits, including the provision of Part 337 of the FDIC Rules and Regulations, which generally requires standby letters of credit to be included when determining any legal limitation on loans to one borrower.

Letters of Credit

A letter of credit is a document issued by a bank on behalf of its customer authorizing a third party to draw drafts on the bank up to a stipulated amount and with specified terms and conditions. The letter of credit is a conditional commitment (except when prepaid by the account party) on the bank’s part to provide payment on drafts drawn in accordance with the document terms. There are four basic types of letters of credit: travelers, those sold for cash, commercial, and standby.

Travelers – A travelers letter of credit is addressed by the bank to its correspondents authorizing drafts by the person named in accordance with specified terms. These letters are generally sold for cash.

Sold for Cash – When a letter of credit is sold for cash, the bank receives funds from the account party at the time of issuance. This letter is not reported as a contingent liability, but rather as a demand deposit.

Commercial – A commercial letter of credit is issued specifically to facilitate trade or commerce. Generally, drafts will be drawn when the underlying transaction is consummated as intended. Commercial letters of credit not sold for cash do, however, represent contingent liabilities and should be accorded examination treatment as such. Refer to the International Banking section of this Manual for further details on commercial letters of credit.

Standby – A standby letter of credit (SBLC) is an irrevocable commitment on the part of the issuing bank to make payment to a designated beneficiary. It obligates the bank to guarantee or stand as surety for the benefit of a third party. SBLCs can be either financial-oriented, where the account party is to make payment to the beneficiary, or performance-oriented, where a service is to be performed by the account party. SBLCs are issued for a variety of purposes, such as to improve the credit ratings for issuers of industrial development revenue bonds and commercial paper; to provide back-up facilities for loans granted by third parties; to assure performance under construction and employment contracts; and to ensure the account party satisfies financial obligations payable to major suppliers or under tax shelter programs.

FASB Interpretation No. (FIN) 45, *Guarantor's Accounting and Disclosure Requirements of Guarantees, Including Indirect Guarantees of Indebtedness of Others*, clarifies that a guarantor is required to recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee. FIN 45 applies to standby letters of credit, both financial and performance. Commercial letters of credit are not considered guarantees, and therefore, are not subject to FIN 45.

An SBLC differs from a commercial letter of credit in that the latter facilitates the sale of goods and is expected to be drawn upon by the beneficiary in the normal course of business, whereas the SBLC is not, generally, expected to be used unless the account party defaults in meeting an obligation to the beneficiary.

While no particular form is required for a SBLC, it should contain certain descriptive information. First, there should be a separate binding agreement wherein the account party agrees to reimburse the bank for any payments made under the SBLC. The actual letter should be labeled as a "standby letter of credit," be limited in amount, cover a specific time period, and indicate the relevant information that must be presented to the bank before any draws will be honored due to the account party's failure to perform. Since the bank is not a party to the contract between the account party and the beneficiary, the SBLC should not be worded so as to involve the bank in making determinations of fact or law at issue between the parties.

The two primary areas of risk relative to SBLCs are credit risk (the possibility of default on the part of the account party), and funding risk (the potential inability of the bank to fund a large draw from normal sources). An SBLC is a potential extension of credit and should be evaluated in a manner similar to evaluating a direct loan. The risk could be significant under an SBLC given its irrevocable nature, especially if the SBLC is written for an extended time period. Deterioration in the financial position of a customer could allow for a direct loan commitment to be rescinded if the commitment contained a "material adverse change" clause; however, such would not be applicable with an SBLC since it is an irrevocable agreement between the bank and the beneficiary. Some SBLCs may have an automatic renewal provision and will roll over until notice of cancellation is given by either the bank or beneficiary prior to a maturity date. However, notice given by the bank usually allows the beneficiary to draw under the letter irrespective of whether the account party is performing.

SBLCs, like loans, can be participated and syndicated. Unlike loans, however, the sale of SBLC participations does not diminish the total contingent liability of the originating bank. The name of the originating bank is on the actual letter of credit, and it must therefore honor all drafts whether or not the participants are willing or able to disburse their pro rata share. Syndications, on the other hand, represent legal apportionments of liability. If one of the banks fails to fulfill its obligation under the SBLC, the remaining banks are not liable for that bank's share.

Section 337.2(d) of the FDIC Rules and Regulations requires banks to maintain adequate controls and subsidiary records of SBLCs comparable to records maintained on direct loans so that a bank's total liability may be determined at all times. Banks are also required to adequately reflect all SBLCs on published financial statements. Credit files should be kept current as to the status of SBLCs, and reports should be provided on a regular basis to the directors on the volume of standby letters, with a breakdown by type, as well as by industry.

This report will enable any concentrations to be monitored so that steps can be taken to reduce any undue exposure should economic or financial trends so dictate.

It may be appropriate to adversely classify or Special Mention an SBLC if draws under the SBLC are probable and credit weaknesses exist. For example, deterioration in the account party's financial standing could jeopardize performance under the letter of credit and result in a draw by the beneficiary. If a draw under an SBLC were to occur, the offsetting loan to the account party could then become a collection problem, especially if it was unsecured.

Loan Commitments

A formal loan commitment is a written agreement, signed by the borrower and lender, detailing terms and conditions under which a loan of up to a specified amount will be made. The commitment will have an expiration date and, for agreeing to make the accommodation, the bank may require a fee to be paid and/or require the maintenance of a stipulated compensating balance by the customer. A commitment can be irrevocable, like an SBLC facility, operating as an unconditional guarantee by the bank to lend when called upon to do so by the customer. In many instances, however, commitments are conditioned on the maintenance of a satisfactory financial standing by the customer and the absence of default in other covenants. A bank may also enter into an agreement to purchase loans from another institution, which should be reflected as off-balance sheet items, until the sale is consummated. Loan commitments intended for sale are covered under Mortgage Banking later in this Section.

Some commitments are expected to be used, such as a revolving working capital line for operating purposes or a term loan facility wherein the proceeds will be used for such purposes as equipment purchases, construction and development of property, or acquisitions of other companies. Other commitments serve as backup facilities, such as for a commercial paper issue, whereby usage would not be anticipated unless the customer was unable to retire or roll over the issue at maturity.

Less detailed than a formal loan commitment, is a line of credit, which expresses to the customer, usually by letter, a willingness to lend up to a certain amount over a specified time frame, frequently one-year in duration. These lines of credit are disclosed to the customer and are referred to as "advised" or "confirmed" lines, in contrast to "guidance" lines, which are not made known to the customer, but are merely used by the bank as lending guidelines for internal control and operational purposes. Many lines of credit are cancelable if the customer's financial condition deteriorates, while others are simply subject to cancellation at the bank's option.

Disagreements can arise as to what constitutes a legally binding commitment on the part of the bank. Descriptive terminology alone, as used by the bank, might 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 may be a legally binding commitment to lend, especially if consideration has been given by the customer and if the terms of the agreement between the parties result in a contract. It is important to identify the extent of the bank's legally binding and revocable commitments to ensure that obligations are properly documented and legally defensible should the bank contemplate canceling a loan commitment.

Credit documentation frequently contains a "material adverse change" (MAC) clause, which is intended to allow the bank to terminate the commitment or line of credit arrangement if the customer's financial condition deteriorates. The extent to which MAC clauses are enforceable depends on whether a legally binding relationship continues to exist when specific financial covenants are violated. 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 or personal endorsements.

Whether funding of a commitment or line of credit will be required cannot always be determined in a routine manner and careful analysis will frequently be necessary. A MAC clause could allow the bank to refuse funding to a financially troubled borrower, or a covenant default might also be a means of canceling the commitment or line of credit. Some banks might refuse funding if any covenant is broken, whereas others might take a more accommodating approach and make advances short of a bankruptcy situation. The procedure followed by the bank in acceding to or denying take down requests where adverse conditions have arisen is an important consideration in the examiner's overall evaluation of credit risk.

In assessing the adequacy of a bank's asset/liability management program, it is important to evaluate the anticipated funding of loan commitments and lines of credit relative to anticipated funding sources. At each examination, the amount of funding that is anticipated for unused commitments and disclosed lines of credit should be estimated. If the amount is large relative to the bank's liquidity position, completion of the Cash Flow Projection workpaper may be useful to give an indication of cash availability and whether borrowings will be needed to meet anticipated draws. For further information, refer to the Liquidity and Funds Management section of this Manual.

OFF-BALANCE SHEET ASSET TRANSFERS

Mortgage Banking

Under FAS 149, *Amendment of Statement 133*, loan commitments that relate to the origination or purchase of mortgage loans that will be *held for sale*, commonly referred to as interest rate lock commitments, must be accounted for as derivatives by the issuers of the commitment. Interest rate lock commitments include floating and fixed rate commitments to fund loans intended for sale. Since they are derivatives, interest rate lock commitments must be fair valued and accounted for on the general ledger. Mortgage loan commitments (both floating and fixed rate) that must be accounted for as derivative instruments are considered over-the-counter written interest rate options. The total notional amount of loan commitments *held for sale* is typically reported in RC-L Derivatives and Off-Balance Sheet Items within the category for Gross Amounts of Derivatives.

Many times the bank will originate a forward contract to sell loans (which could be mandatory delivery, best efforts, or private-label securitization) with investors. In addition to the held for sale loan commitment that is accounted for as a derivative, the bank must account for the forward contract to sell loans. Institutions cannot offset derivatives with negative fair values against those with positive fair values, unless the criteria for "netting" under generally accepted accounting procedures (GAAP) have been satisfied.

Commitments to originate mortgage loans that will be *held for investment* purposes and commitments to originate other types of loans are **not** considered derivatives. Unused portions of loan commitments that are not considered derivatives should continue to be reported as off-balance sheet items.

Assets Sold Without Recourse

Assets (including loans) sold without recourse are generally not a contingent liability. In the case of participations, the bank should reflect on the general ledger only that portion of participated loans it retained. However, some banks may follow the practice of repurchasing loan participations and absorbing any loss on such loans even when no legal responsibility exists. It is necessary to determine management's attitude toward repurchasing these assets in order to evaluate the degree of risk involved. Contingent liabilities may result if the bank, as seller of a loan participation without recourse, does not comply with participation and/or loan agreement provisions. 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 on the part of the borrower. The purchaser of the participation may also assert claims against the bank on the basis that the financial information relied upon when acquiring the loan was inaccurate, misleading, or fraudulent and that the bank as a seller was aware of this fact. Therefore, a certain degree of risk may in fact be evident in participation loans sold without recourse. Examiners need to be mindful of this possibility and the financial consequences it may have on the bank. Further discussion of loan participations is contained in the Loans section of this Manual.

Assets Sold With Recourse

Assets transferred in transactions that **do not** qualify as sales under GAAP remain as balance sheet assets. For example, loan transfers that do not qualify for sale treatment would remain on the balance sheet and the proceeds raised from transfer are reflected as a secured borrowing with pledge of collateral.

Assets (including loans) sold with recourse **may qualify** for sale treatment under FAS 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, if certain criteria are met. Under FAS 140, a transfer of financial assets is accounted for as a sale if the transferor surrenders control over those assets and receives consideration other than an interest in the transferred assets. Control is evaluated using three criteria: legal isolation of the financial assets from the transferor (purported seller); the ability of the transferee (investor) to pledge or sell the assets; and the absence of a right or obligation of the transferor to repurchase the financial assets.

If the asset transfer (e.g., a loan sale) qualifies as a sale under FAS 140, the asset may be removed from the general ledger. However, if an asset transfer, which qualifies for sale treatment under GAAP, contains certain recourse provisions, the transaction would be treated as an asset sale with recourse for purposes of reporting risk-based capital information in Schedules RC-R and RC-S within the Call Report. In those circumstances, examiners need to consider the recourse attributes when calculating risk-based capital. When reviewing assets sold with recourse, examiners should refer to the Call Report Glossary under

Sales of Assets for Risk-Based Capital Purposes, FAS 140, and Part 325 of the FDIC Rules and Regulations.

Recourse and Direct Credit Substitutes

A recourse obligation or direct credit substitute typically arises when an institution transfers assets in a sale and retains an obligation to repurchase the assets or absorb losses due to a default of principal or interest or any other deficiency in the performance of the underlying obligor or some other party. Recourse may also exist implicitly where a bank provides credit enhancement beyond any contractual obligation to support assets it sold.

When an examiner encounters recourse arrangements or direct credit substitutes (commonly found in securitization and mortgage banking operations), they should refer to the outstanding Financial Institution Letters, Call Report guidance, Part 325 of the FDIC Rules and Regulations, and FAS 133 and 140.

OFF-BALANCE SHEET CONTINGENT LIABILITIES

Asset-Backed Commercial Paper Programs

Asset-backed commercial paper programs are usually carried out through a bankruptcy-remote, special-purpose entity, which generally is sponsored and administered by a bank to provide funding to its corporate customers. Some programs will qualify for consolidation onto a bank's general ledger. For programs that are not consolidated, a bank should report the credit enhancements and liquidity facilities it provides to the programs as off-balance sheet liabilities.

Bankers Acceptances

The following discussion refers to the roles of accepting and endorsing banks in bankers acceptances. It does not apply to banks purchasing other banks' acceptances for investment purposes, which is described in the Other Assets and Liabilities section of this Manual. Bankers acceptances may represent either a direct or contingent liability of the bank. If the bank creates the acceptance, it constitutes a direct liability that must be paid on a specified future date. If a bank participates in the funding risk of an acceptance created by another bank, the liability resulting from such endorsement is only contingent in nature. In analyzing the degree of risk associated with these contingent liabilities, the financial strength and repayment ability of the accepting bank should be taken into consideration. Further discussion of bankers acceptances is contained in the International Banking section of this Manual under the heading Forms of International Lending.

Revolving Underwriting Facilities

A revolving underwriting facility (RUF) (also referred to as a note issuance facility) is a commitment by a group of banks to purchase at a fixed spread over some interest rate index, the short-term notes that the issuer/borrower is unable to sell in the Euromarket at or below this predetermined rate. In effect, the borrower anticipates selling the notes as funds are needed at money market rates, but if unable to do so, has the assurance that credit will be available under the RUF at a maximum spread over the stipulated index. A lead bank generally arranges the facility and receives a one-time fee, and the RUF banks receive an annual commitment or underwriting fee. When the borrower elects to draw down funds, placement agents arrange for a sale of the notes and normally receive compensation based on the amount of notes placed. The notes usually have a maturity range of 90 days to one-year and the purchasers bear the risk of any default on the part of the borrower. There are also standby RUFs, which are commitments under which Euronotes are not expected to be sold in the normal course of the borrower's business.

Inability to sell notes in the Euromarket could be the result of a financial deterioration on the part of the borrower, but it could also be due to volatile short-term market conditions, which precipitate a call by the borrower on the participating banks for funding under the RUF arrangement. The evaluation of RUFs by the examiner will follow the same procedures used for the review of loan commitments. An adverse classification should be accorded if it is determined that a loan of inferior quality will have to be funded under a RUF.

ADVERSELY CLASSIFIED CONTINGENT LIABILITIES

For examination purposes, Category I contingent liabilities are defined as those which will give rise to a concomitant increase in bank assets if the contingencies convert into actual liabilities. Such contingencies should be evaluated for credit risk and if appropriate, listed for Special Mention or subjected to adverse classification. This examination treatment does not apply to Category II contingent liabilities where there will be no equivalent increase in assets if a contingency becomes a direct liability. Examination treatment of Category II contingencies is covered under Contingent Liabilities in the Capital section of this Manual.

Classification of Category I contingencies is dependent upon two factors: the likelihood of the liability becoming direct and the credit risk of the potential acquired asset. Examiners should refer to the Report of Examination Instructions and the Bank of Anytown contained in this Manual for Report of Examination treatment when adversely classifying or special mentioning contingent liabilities.

Adverse classification and Special Mention definitions for direct loans are set forth in the Loans section of this Manual. The following adverse classification and Special Mention criteria should be viewed as a supplement to those definitions and considered when evaluating contingent liability credit risk.

Special Mention – The chance of the contingency becoming an actual liability is at least reasonably possible, and the potentially acquired assets are considered worthy of Special Mention. An example would be the undrawn portion of a poorly supervised accounts receivable line where the drawn portion is listed for Special Mention.

Substandard – The chance of the contingency becoming an actual liability is at least reasonably possible, and the potentially acquired assets are considered no better than Substandard quality. Undisbursed loan funds in a speculative real estate venture in which the disbursed portion is classified Substandard and the probability of the bank acquiring the underlying property is high, would be an example of a Substandard contingency.

Doubtful – The chance of the contingency becoming an actual liability is probable, and the potentially acquired assets are considered of Doubtful quality. Undisbursed loan funds on an incomplete construction project wherein cost overruns or diversion of funds will likely result in the bank sustaining significant loss from disposing the underlying property could be an example of a Doubtful contingency.

Loss – The chance of the contingency becoming an actual liability is probable, and the potentially acquired assets are not considered of bankable quality. A letter of credit on which the bank will probably be forced to honor draws that are considered uncollectible is an example of a Loss contingency. A Loss classification normally indicates that a balance sheet liability (specific reserve) should be established to cover the estimated loss. For further information as to when a contingency should be reflected as a direct liability on the balance sheet, refer to FAS 5, *Accounting for Contingencies*.